5. Case 53-44 - Section XV, 15-204.2(aa) - Training and Educational Costs. A report from the Editing Subcommittee, dated 15 August 1956, presenting an edited version of the subject material was approved by the Committee with the following minor modifications:

15-204.2(aa) (2) (v) was revised to delete (A) and (B). The semicolon appearing after (A) was changed to a comma and the word "and" was added at the end of the paragraph. With these modifications the paragraph was redesignated as (iv) and the existing paragraph (iv) as paragraph (v), deleting the word "and" at the end thereof.

The members were advised that immediately following ASPR approval coordination of the paragraph would be undertaken by the Staff by memorandum with the ASD (M&P).

The subject of industry coordination was discussed, with the Committee recommending that industry be afforded an opportunity to comment, inasmuch as the paragraph covering Training and Educational Costs was marked "Reserved" in the draft of Section XV which was forwarded to industry. Notwithstanding this recommendation, the Committee concurred that formal solicitation of industry comments on this paragraph was a matter for decision by the Staff. AUG 29 1956

11. Case 53-44 - Revision of Part 2, Section XV. The OSD member reported that the Materiel Secretaries have recommended the allowance of costs for help-wanted advertising and advertising in technical publications and that this, plus any remaining problems, is being resolved by higher echelons. A further report will be made by 6 Mar 57.

6 Feb 57

3. Case 53-44 - Revision of Section XV, Part 2. It was noted that this problem is being considered at higher echelons and that a further report will be made on 5 Jun 57. APR 29 1957

Case 53-44 - Revision of Section XV, Part 2. The members concurred in the request of the Staff for an extension of the reporting date to 3 Jul 57.

(5 Jun 57)

Case 53-44 - Revision of Section XV, Part 2. A report on the status of the revision of Section XV, Part 2, was deferred to the 17 Jul 57 meeting.

(10 Jul 57)

Case 53-44 - Revision of Section XV, Part 2. The Chairman reported that action on this case had been suspended pending the outcome of the effort on the single set of cost principles. Copies of the letter of transmittal accompanying the single set, from the Secretary of Defense to the three Departments, were distributed to the members only. A further report will be given at the 14 Aug 57 meeting.

(17 Jul 57)

Case 53-44 - Revision of Section XV, Part 2. The Chairman reported that further action on Part 2, Section XV, is not contemplated, as a result of current efforts to publish the comprehensive set of cost principles. The Army Legal member suggested that in view of this information the case be closed. The members concurred in this suggestion and, accordingly, the case is closed.

(14 Aug 57)

3. Case 53-44 ...ion XV - 15-204.2(bb) - Training and Educational Expenses. The Committee considered a report from the Special Subcommittee, dated 21 August 1956, covering the subject paragraph on training and educational expenses. After considerable discussion the Subcommittee report was modified as quoted below:

"15-204.2(bb) - Training and Educational Expenses

a. The costs of preparation and maintenance of a program of instruction at non-college level designed to increase the vocational effectiveness of employees include the salaries of the director of training and staff, training materials and textbooks when the training program is conducted by the contractor; and tuition, fees, training materials, and textbocks, when the training is of a non-college level in institutions conducted by other than the contractor. Such costs are allowable. In both instances, costs of salaries or wages of trainees during regular working hours are allowable.

b. The costs of part-time technical, engineering and scientific education, at an under-graduate or post-graduate college level, related to the job requirements of bona fide employees, are allowable as follows:

1. Tuition, fees, training materials and textbooks; or, in lieu of tuition, instructors' salaries and the related share of indirect expense, provided that the sum thereof is not in excess of the tuition which would have been paid to the participating educational institution.

2. Straight-time compensation of employees for time spent attending classes during working hours not in excess of a total of 156 hours per year where circumstances do not permit the operation of classes or attendance at classes after regular working hours.

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

d. Maintenance expense and normal depreciation or fair rental on facilities owned or leased by the contractor are allowable to the extent set forth in (k) above, (e) above and (t) above, respectively.

e. The costs of training and education of other than bona fide employees are not allowable.

f. Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships, are considered as contributions and will be treated as provided under ASPR 15-204.3(c)."

The report was referred to the Editing Subcommittee with the request that an edited version be presented for consideration by 21 August 1956. In the interim the ASPR members will clear the proposed paragraph within their respective Departments and the Staff will undertake coordination with the Assistant Secretary of Defense (Manpower and Personnel). The Committee further determined that if the paragraph was cleared in time, it would be inserted in Section XV for issuance concurrently with the printing of that section. The Chairman further advised the members that the proposed paragra probably would be presented to the Procurement and Production Industry Advisory Committee to secure an industrial reaction.

In conjunction with the above paragraph, the subject of the allowability of management and executive training costs was discussed and deferred without action to modify the above paragraph.

In approving the above paragraph the Committee considered and rejecte the concept of allowing full-time salaries for bona fide employees on a full-time basis at post-graduate college levels.

9. Case 53-44 - Revision of Section XV - Part 2 - Paragraph 15-204.2(n) - Overtime. The Navy legal member called the Committee's attention to a discrepancy existing in the present revision of Section XV in paragraph 15-204.2(n) with respect to overtime, extra-pay shift and multi-shift premiums. To correct this situation the Committee approved the substitution of the words "otherwise approved" for the words "otherwise authorzied" appearing in the fourth line of the paragraph. The Committee further approved the deletion of the words "without prior approval" in next to the last line of the paragraph. AUG 7 1956

3. Case 53-44 - Revision of ASPR 12-202 to Conform to Proposed ASPR 15-204.2(n) - (Overtime, Extra-Pay Shift and Multi-Shift Work). The Navy legal member called the Committee's attention to a further change required in the subject paragraph in view of the changes approved at the 8/7/56 meeting in paragraph 15-204.2(n) to remove an inconsistency between the two paragraphs. To correct this situation the Committee approved the substitution of the word "approval" for the word "authorization" as it appeared in the second and third sentences of subparagraph (b) of the ASPR minutes of 17 July 1956. AUG 14 1956

12. Case 53-44 - Revision of Part 2, Section XV - Contract Cost Principles. The Committee considered a report from the Section XV Subcommittee, dated 30 July 1956, presented in response to a report from the Tax Subcommittee dated 21 June 1956. In considering the Section XV Subcommittee's report with respect to the three questions raised by the ASPR Committee and the Subcommittee's suggested treatment thereof, the Committee disagreed with the Subcommittee's clarification of the first question and reinstated the previous language under subparagraph (1) to read:

> ". . .and which are paid or accrued in accordance with generally accepted accounting principles are allowable, . . ."

The Committee further revised the two sentences following (2) (ii) to read:

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

The Committee concurred in the Subcommittee report concerning the other questions. These include retaining the present language of subparagraph (2) (ii) without change and the addition of a proviso provision to subparagraph (3) as follows:

> ". . . , provided any interest actually paid or credited to a contractor incident to a refund of tax, interest and penalty shall be paid or credited to the Government only to the extent that such interest accrued over the period during which the contractor had been reimbursed by the Government for the taxes, interest, and penalties."

As revised above the Committee approved the changes for inclusion in Section XV. AUG 14 1956

3. Case 53-44 Section XV - 15-204.2(bb) - Training and Educational Expens
A report dated 12 July 1956 from the Special Subcommittee established to conside the subject problem was discussed at length. The discussion touched upon many facets of the problem, such as whether the proposed allowance of training and educational expenses was in keeping with the National policy or merely a question of the "cost of doing business" in the present economy. It was pointed out that many commercial concerns have established programs for the advancement of their engineering and scientific employees by supporting their education in after-hour classes and, to some extent, even on a full-time basis at graduate schools. It was further pointed out that it is the President's policy to promote training, particularly higher training, starting at the high school level. In addition, the members were advised that the Hoover Committee had recommended Governmental support and training to encourage Governmental career employees. To some extent, the Army and Navy are now using this practice for certain selected employees.

The Committee then undertook consideration of the proposed paragraph contained in Inclosure 4 of the Subcommittee report, in conjunction with the other inclosures. The paragraph was approved, as modified by the Committee, subject to editing as follows:

"15-204.2(bb) - Training and Educational Expenses

a. Preparation and maintenance of a program of instruction designed to increase the vocational effectiveness of employees include the salaries of the director of training and staff, training materials and textbooks, when the training program is conducted by the contractor; and tuition, fees, training materials, and textbooks, when the training is of a non-college level in institutions conducted by other than the contractor. In both instances, costs may include salaries or wages of trainees during regular working hours.

b. Part-time technical, engineering and scientific education at an under-graduate or post-graduate college level related to the job requirements of the employee as follows:

1. Tuition, fees, training materials and textbooks.

2. Where circumstances do not permit education after paid working hours, regular employee compensation is also allowable for instruction not in excess of a total of 156 hours per year.

c. Tuition, fees, training materials and textbooks (but not subsistence, salary, or any other emoluments) in connection with scientific and engineering education of bona fide employees on a full-time basis at a post-graduate college level, related to the job requirements of the employee, for a total period not to exceed one school year. In unusual cases where required by military technology, the period may be extended.

d. The costs of training and education of other than bona fide employees, including scholarships and fellowships, are not allowable."

The Committee also noted that it may be necessary to include an appropriate cross-reference to subparagraph (d) of 15-204.2(bb) in the listing of items of unallowable costs.

A further question was raised with respect to the treatment of costs occasioned where contractors established schools at their own locations on the premise that such costs ought to be covered by the above paragraph. As these costs would involve both facilities and faculty expenses, the question of how such costs would be treated was returned to the Subcommittee to draft appropriate coverage for inclusion in the above paragraph 15-204.2(bb). The Subcommittee was requested to provide a report for consideration by 7 August 1956. JUL 31 1956

11. Case 53-44 - Revision of ASPR 12-202 to Conform to Proposed ASPR 15-204.2(n) - (Overtime, Extra-Pay Shift and Multi-Shift Work). The Committee considered a report from the Editing Subcommittee, dated 21 June 1956, presenting an edited version of the subject material. The Committee modified the second and third sentences of subparagraph (b) to read as follows:

> . . . . "On cost-type contracts, and to the extent required by the contracting officer on redeterminable and incentive fixed-price contracts, however, an authorization from the Government for the use of overtime, extra-pay shifts and multi-shifts must be obtained to sustain the charge of any premium labor costs to the contract. Such authorization should generally be obtained prior to the use of overtime, extra-pay shifts and multi-shifts." . . . .
>
> In the last sentence of subparagraph (b) the word "required" was substituted for the word "desired."
>
> In the title of paragraph 12-102 the word "Shifts" was changed to read "Shift" in the phrase "Extra-Pay Shifts."

As modified, the revised paragraph 12-102 was approved for printing concurrently with the printing of Section XV. JUL 17 1956

4. Case 53-44 - Revision of Section XV - Contract Cost Principles - Part 1. The Committee considered a report, dated 6 July 1956, from the Editing Subcommittee presenting an edited version of the revision of Part 1, Section XV. After considerable discussion, in which several suggestions were presented for revision of paragraphs 15-101, 15-102.1 and 15-102.2, the report was returned to the Editing Subcommittee for redrafting, with the request that a revised report be presented for consideration by 31 July 1956. A further suggestion was made that when the revised Part 1 was published a change was required in paragraph 15-502(a) to replace the comma with a period and delete all material following the comma. The Committee approved the recommendation. JUL 24 1956

1. The minutes of the 7/24/56 meeting were approved with the following modifications:

Item 4. Case 53-44 - Revision of Section XV - Contract Cost Principles Part I.

The case number was revised to read 56-29, and the second sentence was revised to read: "After considerable discussion, in which several suggestions were presented for revision of paragraphs 15-101, 15-102.1 and 15-102.2, the report was returned to the Air Force member of the Editing Subcommittee for redrafting, with the request that a revised report be presented for consideration by 31 July 1956. JUL 31 1956

7. Case 53-44 - ision of Part 2, Section XV. eport dated 21 June 1956 from the Tax Subcommittee, recommending certain changes in proposed paragraph 15-204.2(y) of the latest draft of Part 2, Section XV, was discussed. It was determined that the paragraph should not include a reference to "taxes of foreign governments" since the award of cost-reimbursement type contracts by local procuring activities to foreign contractors occurred so infrequently that this matter should be covered on a case-by-case basis when awards are made to foreign contractors. In the revised draft of the paragraph submitted by the Tax Subcommittee in subparagraph (1) the question was raised as to whether defense would reimburse a contractor for taxes "accrued" in subparagraph (2) (ii) the question was raised as to the soundness of the statement, and in subparagraph (3) it was indicated that the last sentence should be a "proviso" sentence. The entire report was referred to the Part 2, Section XV Subcommittee for review, in coordination with the Tax Subcommittee, if necessary, and the request made that a report be submitted within 30 days. JUL 3 1956

13. Case 53-44 - Revision of ASPR 12-202 to Conform to Proposed ASPR 15-204.2(n) - (Overtime, Extra-Pay Shift and Multi-Shift Work). An Editing Subcommittee report dated 21 June 1956 submitted an edited version of a revised ASPR paragraph 12-202. The ASPR Committee discussed the details of this draft and made the following observations with respect to paragraph (b):

a. In line 3 it was suggested that there be added after the word "contractor," the following:

> ", and the contractor shall not be entitled to a price adjustment therefor,";

b. In subparagraph (ii) discussion concerned having the subparagraph commence "To the extent required by the contract"; and

c. Having the third from the last sentence read:

> "Such authorization shall generally be obtained prior to the use of overtime, extra-pay shifts, and multi-shifts."

It may also be necessary to delete the "s" from the phrase "extra-pay shifts" wherever it appears in the entire clause.

The Committee members desired to look into this matter further and, accordingly, the item will be discussed again at next week's meeting. JUL 3 1956

15. Case 53-44 - Revision of ASPR 12-202 to Conform to Proposed ASPR 15-204.2(n)—(Overtime, Extra-Pay Shift and Multi-Shift Work). The Secretary was requested to include this item on the agenda for the next meeting. In the interim the members will look further into the matter. JUL 10 1956

4. Case 53-44 - Revision of Section XV, Part 2. The Chairman announced that the Material Secretaries Council had decided that the subject of profit sharing, contributions and donations, and general research costs would receive the same treatment under the revised Part 2 as in the existing Section XV. It was determined that there was no objection to using the revised language concerning general research costs developed by the Editing Subcommittee; however, with respect to the negotiation criteria set forth in the edited version under general research costs, it was agreed that they would not appear in Part 2 but would be placed appropriately in Part 1 of Section XV. APR 17 1956

9. Case 53-44 - Revision of Section XV, Part 1. The Committee considered a memorandum from the Chairman recommending that when Section XV, Part 2, is revised that certain changes, as set forth, be made simultaneously in Part 1. It was determined that these recommendations be referred to the Editing Subcommittee with the further request that the Editing Subcommittee review the suggested placement of proposed paragraph 15-103. With respect to this latter point, it was agreed that the Committee had previously directed the placing of this material in Part 1, but in reconsidering, the question was presented as to whether it should not more properly be placed in Part 5. The Editing Subcommittee was requested to report within two weeks. MAY 1 1956

13. Case 53-44 - Revision of Part 2, Section XV - Contract Cost Principles. A report from the Editing Subcommittee, dated 26 April 1956, containing a final edited draft of subject was distributed to the members. In addition, a revised draft of a document containing the major unresolved issues with industry were also made available to the members. Both of these documents will be attached to an agenda item for the Material Secretaries Council in the very near future and the members were requested to give their concurrence to the documents to the Chairman by 4 May 1956. MAY 1 1956

12. Case 53-44 - Revision of ASPR 12-202 to Conform to Proposed ASPR 15-204.2(n) (Overtime, Extra-Pay Shift and Multi-Shift Work). A revision of the subject paragraph, developed by the Staff to conform with the proposed Section XV treatment of overtime, extra-pay shift and multi-shift work, was considered by the members and referred to the Editing Subcommittee for editing. The Editing Subcommittee was requested to present a report for consideration by 29 May 1956. MAY 8 1956

5. Case 53-44 - Revision of Part 2, Section XV. A representative of the Tax Subcommittee reported that the Subcommittee had noted several areas not explicitly covered by paragraph 15-204.2(y), entitled "Taxes," which could result in issues with contractors. In view of the current status of Section XV, the Committee requested the Tax Subcommittee to present their written comments in order that these potential deficiencies could be considered. JUN 5 1956

12. Case 56-29 - Revision of Section XV, Part 1.
Case 53-44 - Revision of ASPR 12-202 to Conform to Proposed ASPR 15-204.2(n) (Overtime, Extra-Pay Shift and Multi-Shift Work). The Chairman raised the question of when reports would be received from the Editing Subcommittee with respect to the subject problems. The Navy legal member advised that a report from the Editing Subcommittee on the two subject problems would be presented within one week. JUN 5 1956

1. The minutes of the 6/5/56 meeting were approved with the following modification:

Item 5. Case 53-44 - Revision of Part 2, Section XV. The last sentence was revised to add the words "for subsequent revision of Section XV." JUN 12 1956

Part 5 - Subjects Affecting Cost Which May Require Special Considerati

"Part 5 - Subjects Affecting Cost Which May Require Special Consideration.

15-500 Scope of Part. This Part enumerates certain subjects affecting cost which may require special consideration in connection with the negotiation or performance of cost-reimbursement type contracts and which are not specifically covered in Part 3, or Part 4, of this section.

15-501 Consideration Required. It is important that Contracting Officers and their negotiators consider the subjects enumerated in paragraph 15-502, and any other subjects not precluded by the provisions of Part 3, or Part 4 of this section (whichever part is applicable), for the purpose of (i) determining which subjects if any should be expressly provided for in a particular cost-reimbursement type contract, and (ii) incorporating appropriate clauses in the contract. Action taken with respect to any such subjects shall be reflected either in the contract or in the record of contract negotiations."

Part 6 - Cost Interpretations.

"Part 6 - Cost Interpretations
Delete balance of this Part and substitute therefor the word 'RESERVED'."

Part 7 - Facilities Contracts.

"15-700 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 the acquisition of industrial facilities to which the Government takes title under the contract. This Part also applies to clauses in any other cost-reimbursement type contracts or cost-reimbursement type subcontracts thereunder, which clauses provide for the acquisition of industrial facilities to which the Government takes title.

15-701 Applicability. Pending publication of the principles and standards to be incorporated in this Part, Parts 2, 3, or 4 shall be used to the extent appropriate in accordance with Departmental procedures."

The Committee was further advised that a change similar to the change made in Part 4 (15-403 (q)) would also have to be made in Part 3, 15-304 (g). The Committee concurred in such a change.

NOTE: Subsequent to the meeting the following change was received from the Editing Subcommittee for Part 3 - Research Contracts with Nonprofit Institutions:

"15-304 Examples of Items of Allowable Costs. . . .
(g) Pension plans in accordance with the principles and standards set forth in ASPR 15-204.2(q) and group health, accident and life insurance plans (but see paragraph 15-305(k)).

Action to develop a clean draft of Part 2, incorporating the changes approved to date, was deferred until after the Material Secretaries consider the existing three issues.

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15-204.2 ((1) Insurance and Indemnification. (Page 9). This subpa.-graph was revised to read as follows:

"15-204.2 (j) Insurance and Indemnification.
(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes securing the contractor against liabilities to third persons not compensated by insurance or otherwise."

15-204.2 (n) (1) and (6) Material Costs. Pages 11 and 12). Were revised to read:

"15-204.2 (n) Material Costs.
(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).

* * * * * * *

(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 the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is 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.**"

The Committee further considered proposed revisions of existing Parts of Section XV, together with a new proposed Part 7 covering Facilities Contracts, presented by the Editing Subcommittee, the revisions to be issued simultaneously with the issuance of the revised Part 2. The Committee approved the following revisions:

Part 4 - Construction Contracts.

"15-403 Examples of Items of Allowable Costs. . . . . .
(q) Pension plans in accordance with the principles and standards set forth in ASPR 15-204.2 (q) and group health, accident and life insurance plans (but see paragraph 15-404 (b), (d), and (m)).

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contractor's products, or other relevant circumstances.

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

15-200. The Committee approved a revision of the TITLE and the "Scope of Part" as quoted below:

"Part 2 - Supply, Service, and Research and Development Contracts, with Commercial Organizations

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."

15-204.2 (f) (2) Depreciation. (Page 7). This subparagraph was revised to read as quoted below:

"* * * * * * * * *

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

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

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

(iii) by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954.

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

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The Air Force withdrew its former request for consideration of additional language to be added to subparagraph (iii) which would, in effect, have provided that the depreciation allowable under a contract would not exceed the depreciation authorized under the Internal Revenue Code. This action was taken on the premise that the disadvantages of holding contract files open for an indeterminate period of time until final determinations of depreciation had been made by tax authorities or by the Courts outweighed the advantages sought by the additional language.

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4. Case 53-44 - Revision of Section XV. Consideration of the special areas subject to revision or review at the Special Meeting held 4/6/56 was undertaken in the following order:

15-204.2 (p) Patents. (Page 12). The last line of the edited draft, dated 29 March 1956, was revised to delete the words "by the Government" and substitute therefor the words "where title is conveyed to the Government."

15-204.2 (o) Overtime. (Page 12). The members were advised that the OASD (M&P) had no objections to revising ASPR paragraph 12-102 to be consistent with this paragraph. Accordingly, the Staff will prepare a revision of 12-102 for consideration.

15-203.5 General and Administrative Costs. (Pages 4 and 5). This paragraph was revised to read as quoted below:

"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)."

15-203.1 (b) General. (Page 3). This subparagraph was revised to read as follows:

"15-203.1 (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

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Page 21. 15-204.2 (aa) (1). The third word reading "contractor's" was deleted.

15-204.2 (bb). This paragraph was reserved. A Special Subcommittee was established to consider this problem as a special case, presenting a revised coverage on the subject of training costs. In taking this action the Special Subcommittee was requested to give consideration to inclusion of a reference on page 26 when their efforts are completed. The Subcommittee was further requested to coordinate their efforts with the OSD Office of Manpower Supply. Members designated to the Subcommittee were:

Army - To be designated

Navy - Mr. A. C. Sawallisch, ONM (Chairman)
Mr. James Ruttenberg, OCN
AF - Mr. P. M. Southwell, AFMPP
Mr. W. L. Latta, AFAUD

The Subcommittee was requested to present a report for consideration by 7 May 1956.

Page 22. Approved.

Page 23. Approved.

Page 24. 15-204.3 (i). The Committee deleted the reference in parentheses at the end of this paragraph. In taking this action, there was general agreement to specifying the period and amount in part 1 when rewritten, with an appropriate cross-reference.

Page 25. Approved.

Page 26. 15-204.3 (2) (xi). The words "special tooling costs" were deleted and the word "taxes" substituted therefor.

15-204.2 (2) (xii), Training Costs, was deleted in its entirety.

15-204.2 (2) (xiii), Travel Costs, was renumbered to (xii).

The Navy legal member called the Committee's attention to the Editing Subcommittee's report of 27 February 1956, in paragraph 4 of which the Subcommittee covered the subject of side agreements. It is understood that this matter had been the subject of discussion by the Procurement Secretaries in the spring of 1955.

With the above action, further consideration of this subject was deferred until the next meeting to be held 4/10/56.

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As revised the paragraph was referred to the Editing Subcommittee, with the request that the edited language be presented by the next regular meeting (10 April 1956).

15-204.2 (n) (6). The semicolon following the phrase "whichever is lower" was changed to a comma and the following language added:

> "unless factors other than price warrant allowance on the basis of the cost to the transferor;".

Page 12. 15-204.2 (n) (6). The word "either" appearing before (i) was deleted. The period at the end of the paragraph was changed to a comma and the following language was added:

> "whichever is lower, unless factors other than price warrant allowance on the basis of the cost to the transferor."

15-204.2 (o). The Staff will undertake action to determine whether a revision to paragraph 12-102 may be made in order that paragraph 12-102 be consistent with this paragraph.

15-204.2 (p). The Staff was requested to clear the need with the Patents Advisor of the inclusion of the words "or on behalf of" in the last line.

Page 13. Approved.

Page 14. 15-204.2 (q) (3) (iv). The Committee agreed to the inclusion of a note in the Minutes that under this paragraph the parties can agree to (A) or (B) for the individual periods under the contract.

15-204.2 (q) (3) (iv) (A). The second word "all" was deleted.

Page 15. 15-204.2 (q) (3) (iv) (B) (II). The words "or gains" were inserted after the word "credits" in the sixth from the last line.

Page 16. Approved.

Page 17. 15-204.2 (u). The words "such factors as" were inserted between the words "of" and "the" in the second line.

15-204.2 (v) (2). This paragraph was reserved.

Page 18. Approved, subject to deletion of brackets in 15-204.2 (v) (3).

Page 19. Approved.

Page 20. Approved.

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CONT'D NEXT PAGE

Page 4. Delete a comma in paragraph 15-203.3.

Paragraph 15-203.5. The Air Force member recommended that everything after the first two sentences of this paragraph be deleted. After considerable discussion this recommendation was rejected. However, subparagraph (i) was deleted in its entirety. Subparagraph (ii) was referred to the Audit members of the Section XV Subcommittee for clarification, with the request that the revised language be presented for consideration at the next regular meeting (10 April 1956). Final decision will be made on this paragraph after revised (ii) is reviewed.

Page 5. **Approved.**

Page 6. **Approved, reserving subparagraphs (d) and (e) of** 15-204.2.

Page 7. 15-204.2 (f) (2) (i) (ii) (iii). These subparagraphs were revised to read as follows:

> "(i) is computed upon the property cost basis used by the contractor for Federal income tax purposes (See Section 167 of the Internal Revenue Code of 1954); or
>
> (ii) in the case of nonprofit or tax exempt organizations, upon a cost basis which could have been used by the contractor for Federal income tax purposes had such organizations been subject to the payment of income taxes, and
>
> (iii) is computed by the consistent application to the assets conterned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954. In no event, however, shall a greater amount for depreciation be allowed than is authorized by the Internal Revenue Code."

The Navy member objected to the addition of the underscored language pending further study.

As revised, this paragraph was referred to the Editing Subcommittee for editing, with the request that the edited paragraph be presented for consideration by the next regular meeting (10 April 1956).

Page 8. Approved.

Page 9. Was approved, subject to further editing of the last sentence of paragraph 15-204.2 (j) (1), which was referred to the Editing Subcommittee with the request that the edited language be presented by the next regular meeting (10 April 1956).

Page 10. Approved, subject to the deletion of a comma in 15-204.2 (k) (1) (2).

Page 11. 15-204.2 (n) (1). This subparagraph was modified to add the following words in parentheses:

> "(for correction or defective work see the clause of the contract relating to 'Inspection and Correction of Defective Work')."

CONT'D NEXT PAGE

10. Case 53-44 - Revision of Section XV. Copies of two reports from the Editing Subcommittee dated 2 April 1956, with respect to the subject revision, re distributed to the members. the brief discussion that followed the distribution of the reports, the members agreed that the following documents, in addition to the two mentioned above, would be helpful in the consideration of this problem at the special meeting to be held Friday, 6 April 1956, at 1000 hours, in room 2-C-243, the Pentagon:

Report dated 27 February 1956 from the Editing Subcommittee
Report dated 9 March 1956 from the Editing Subcommittee
Report dated 29 March 1956 from the Editing Subcommittee
Report dated 1 November 1955 from the Section XV Subcommittee

It was agreed that consideration of the revised Section XV would be on the merits of the edited draft dated 29 March 1956.

In addition to the above, the Committee was in receipt of a separate report dated 3 April 1956 from the Section XV Subcommittee concerning the subject of profit sharing, contributions and donations, and general research costs. It was determined that these three subjects would not be considered at the meeting on Friday. APR 3 1956

1. Case 53-44 - Revision of Section XV. Representatives of the Section XV Subcommittee attended the meeting for discussion of the edited draft of Section XV dated 29 March 1956. Prior to considering the draft there was general agreement that no further editing would be undertaken other than those paragraphs specifically designated by the Committee. Consideration was then undertaken on a page by page basis, as follows:

Page 1. Paragraph 15-200. The Army and Air Force members questioned the inclusion of the phrase "commercial type accounting systems" without providing a definition for the phrase. After considerable discussion the Committee agreed to omit the phrase and to redraft the paragraph to provide that:

a. This part 2 applies where parts 3 and 4 do not apply,

b. The last sentence covering facilities should cover the following concept:

"It also does not apply to clauses in supply or service contracts which provide for the acquisition of industrial facilities by the contractor for the account of the Government," and

c. On the subject of facilities, establish a separate part stating that pending the development of this new part, part 2 would be used to the extent appropriate.

With this action, paragraph 15-200 was referred to the Editing Subcommittee for editing, with a request that the edited paragraph be presented for consideration at the next regular meeting to be held 10 April 1956. The remainder of page 1 was approved as written.

Page 2. Approved.

Page 3. Approved (other than the deletion of a comma in paragraph 15-203.2).

APR 6 1956

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53-44	Revision of Section XV, Contract Cost Principles	Editing	The members were advised a report on this problem would be presented by 14 February 1956.

JAN 31 1956

12. Case 53-44 - Revision of Section XV - Contract Cost Principles. A report of the Chairman of the Editing Subcommittee pointing up certain areas requiring resolution prior to final editing was noted and further consideration deferred until the next meeting. In the interim the Editing Subcommittee was requested to meet with the Section XV Subcommittee in an effort to resolve as many of the areas as possible and to report on their accomplishments at the 6 March 1956 meeting. FEB 28 1956

12. Case 53-44 - Revision of Section XV - Contract Cost Principles. The Chairman advised the members that the Editing Subcommittee was still studying the problem which had arisen with respect to "Pension Plans" and that it was contemplated a report would be presented in the near future. When the report is received the members will be contacted to determine the need of a special meeting to consider the problem. MAR 1956

5. Case 53-44 - Section XV - Contract Cost Principles. The Committee determined to hold a special meeting Friday, 16 March 1956, at 1100 hours, in room 2216, Main Navy Building, to consider the report of the Editing Subcommittee on this problem. MAR 13 1956

11. Case 53-44 - Revision of Section XV - Part 2. The Chairman of the Editing Subcommittee advised the members of the progress to date of the joint efforts of the Editing Subcommittee and the Section XV Subcommittee in completing the editing of Part 2 of Section X. In view of the Committee's action it was determined that no special meeting would be held Friday, 23 March 1956, to consider this problem but that the report, if available, would be considered at the next regular meeting. MAR 20 1956

The Army member expressed an inability to ascertain what the phrase "Commercial Type Accounting Systems" encompassed. In this connection he wished it made a matter of record that if the section is to be meaningful a definition of this phrase should be included.

13. Case 53-44 - Revision of Section XV, Part 2. The Chairman of the Editing Subcommittee advised that revised copies of this part jointly being considered by the Section XV Subcommittee and the Editing Subcommittee would be available by Friday, 30 March 1956. In this connection, the Chairman expressed a desire that the revised report could be considered at the next regular meeting to be held 3 April 1956.

The Chairman further advised the members that instructions to the Staff with respect to the three issues covering

Profit Sharing,
Contribution and Donation, and
General Research

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were to be accorded the same treatment now provided in the current Section XV.

4. Case 53-44 - Revision of Part 2, Section XV. A Staff proposal presenting a revision of paragraph 15-204.15, Insurance and Indemnification, was considered, approved after minor modification and referred to the Editing Subcommittee as shown below:

"15-204.15 INSURANCE AND INDEMNIFICATION.

a. Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative (see ASPR 10-501 for kinds of insurance ordinarily required), (2) any other insurance for which the contractor seeks reimbursement under the contract, and (3) liabilities to third persons not compensated by insurance or otherwise.

b. The contractor shall be reimbursed for (1) insurance required to be submitted for approval or required to be procured and maintained pursuant to ASPR 7-203.22 and (2) other insurance maintained by the contractor in connection with the performance of this contract if the types and extent of coverage are in accord with sound business practice and the rates are reasonable under the circumstances, subject to the following limitations or restrictions:

(i) Costs allowed for use and occupancy insurance will be limited so as to exclude coverage of profit, interest, federal income taxes, and any other items of expense unallowable under this part.

(ii) Costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are not allowable except to the extent that the Government may have approved or required such insurance or reserve.

(iii) Cost of a reserve for a self insurance program are allowable provided the program has been approved by the Military Department concerned.

(iv) Costs of insurance on the lives of officers, partners or proprietors, are not allowable except where such insurance is part of an employee plan which is not unduly restricted.

c. The obligation of the Government to indemnify the contractor will be allowable only to the extent expressly provided for in the contract (For example, see ASPR 7-203.22). Except as otherwise expressly provided in the contract, actual losses not reimbursed by insurance (through an approved self insurance program or otherwise), are not allowable."

In further considering paragraph 15-204.34(b)(i) the Committee questioned the advisability of providing for an allocation of cost to all general research work of the contractor if the concept of providing for an allowance of the cost is specifically covered in the contract. The Committee determined that as long as this concept is retained no provision for an allocation was required. Accordingly, subparagraph (A), reading as follows, was deleted:

~~"(A) To the extent such costs are allowed, they will be equitably allocated to all work of the contractor other than his independent general and related research."~~

With this action corrected copies of Part 2 of Section XV were distributed to the legal members for their respective members of the Editing Subcommittee in order that editing of the draft could be undertaken. The Editing Subcommittee was requested to provide a report for consideration by 13 January 1956.

DEC 1 2 1955

15-204.2[illegible] The seventh sentence was revised to read:

"If a contractor has but one or relatively few Government contracts, an appropriate contractual provision may be used to preserve the Government's interest by providing for retrospective accounting and any necessary adjustment to the pension plan cost incurred under the contract."

With this modification the paragraph was approved.

15-204.8 Contributions and Donations. Copies of the Air Force minority position with respect to this paragraph, which was isolated as an issue at the 11/22/55 meeting, were distributed to the members for presentation to the Material Secretaries and the Assistant Secretary of Defense (S&L) as an issue.

As modified by the ASPR Committee the Subcommittee report was referred to the Editing Subcommittee for editing. The Editing Subcommittee was requested to provide a report for consideration by 10 January 1956. To facilitate editing, the Staff will provide the members of the Editing Subcommittee with a clean draft of the report.

DEC 6 1955

2. Case 53-44 - Revision of Part 2, Section XV. In approving the minutes of the 12/6/55 meeting the Air Force requested that the last sentence under paragraph 15-204.35, Royalties and Other Costs for Use of Patents, be revised to express the concept in two sentences rather than one. Accordingly, this sentence was rephrased as follows:

"Charges for the use of patents, where the Government has a license or the right to free use of the patent are unallowable. Charges for the use of Patents where a patent has been adjudicated to be invalid are unallowable unless otherwise provided in the contract."

DEC 13 1955

The Subcommittee report of 1 November 1955 was further considered on a par ~aph basis, as follows:

15-203.3 presented by the Subcommittee was approved. A Staff proposal to revise this paragraph was rejected.

15-204.15 - Insurance and Indemnification. A revised outline of this paragraph developed by the Army legal member, was distributed to the members. Considerable discussion centered around the variance in the language of the first two sentences of subparagraph b. and the language contained in the clause, insurance - liability to third persons. The Committee requested the Subcommittee Chairman to redraft the entire paragraph to achieve consistency and a cross-reference of the clause and present same at the next meeting.

15-204.34b(i) Copies of a revision to this paragraph starting with the third sentence, developed by the Air Force member, were distributed to the members. The paragraph was then discussed at length. As a compromise the Committee revised (i) under paragraph b to read as follows and tentatively approved the paragraph, subject to editing, the Navy and Staff positions being reserved:

> "(i) General research is that type of research which is directed towards increase of knowledge in science. It is research where the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. The cost of Independent General Research (that which is not sponsored by a contract or grant or other arrangement) shall be allowed to the extent specifically provided in the contract.
>
> (A) To the extent such costs are allowed, they will be equitably allocated to all work of the contractor other than its independent general and related research.
>
> (B) Generally, the contractor shall be required to disclose to the Government the purposes and results of such independent general research.
>
> [illegible] shall be given [illegible]
>
> a. Scope, nature and quality of the contractor's independent general research program.
> b. The capability of the contractor in the particular research field.
> c. Benefits which may accrue to the Government.
> d. Comparison of size and cost of contractor's previous years' research programs.
> e. The proportion of the Government business to the contractor's total business."

In considering the paragraph the Committee also determined that the Government's position versus Industry's position with respect to general research should be presented to the Material Secretaries and the Assistant Secretary of Defense (S&L) as an issue with industry.

15-204.34b(ii) approved.

15-204.34c approved.

15-204.26c. The second sentence was revised to read:

> "Such costs may include excess contributions to the extent such contributions are claimed and allowed for Federal Income Tax purposes in the current taxable year."

With this modification the paragraph was approved.

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1. a. The minut of the 11/22/55 meeting were f ther modified as follows:

Item 3. Case 53-44 - Revision of Part 2, Section XV.

Paragraph 15-204.24. The paragraph was revised to read:

> "This item consists of the premium portion of overtime, extra pay shift and multi-shift payments to employees. Such premiums on direct labor may be classified as either direct or indirect labor costs, but the amount of such premiums should be separately identified. When direct labor costs is the base for distribution of overhead, such premiums shall not be included therein. Cost of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government. Cost of such premiums for indirect labor is allowable without prior approval, if reasonable, and the cost is allocated on a pro rata basis to commercial as well as Government work. See ASPR 12-102 for further information concerning the policy regarding such authorization. The amount of such premium cost charged on Government contracts shall be equitable in relation to the amount of such premium costs charged on non-Government work being concurrently performed in the Contractor's plant and the factors which necessitate the incurrence of the cost."

b. The minutes of the 11/29/55 meeting were approved with the following revisions:

Item 2 - Case 53-44 - Revision of Part 2, Section XV.

Paragraph 15-204.34b(i) was revised to read:

> "A proposed subparagraph c. presented by the Staff was considered and rejected. In lieu thereof the Committee suggested the insertion of the following first parenthetical expression in the third sentence of (i) which would read as follows:
>
> > "The allocable portion of 75% (or such other percentage as may be agreed upon and set forth in the contract schedule) of the allowable costs of a contractor's independent general research (that which is not sponsored by a contract or grant or other arrangement) shall be allowed in all cost-type contracts under the following conditions:"
>
> However, the positions of the Departmental members with respect to this change was reserved."

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2. Case 53-44 - . ision of Part 2, Section XV. ..ies of a memorandum from the Subcommittee Chairman presenting revisions of paragraphs 15-204.25, 15-204.29c, 15-204.34d and 15-204.35 were distributed to the members and the following action taken on the revised paragraphs:

15-204.25 was revised to read as follows:

"15-204.25 PATENT EXPENSES. This item relates to such expenses as costs leading to the issuance of patents, costs required to search the art and costs necessary to comply with invention disclosure provisions of the contract. The costs of searching the art in order to make invention disclosures, and of preparing disclosures and other reports, as required by the contract are allowable. The costs of preparing assignment and other papers in connection with the filing of a patent application by the Government and any other such costs are allowable, upon the written authorization of the contracting officer. The cost of research and development work is treated in 15-204.34. (See also paragraph 15-204.35)."

As revised the paragraph was approved, subject to editing.

15-204.29c reading as follows was approved:

"15-204.29 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER.

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

15-204.34d reading as follows was approved:

"15-204.34 RESEARCH AND DEVELOPMENT

d. Research and development costs (including amounts capitalized), regardless of the nature, which were incurred in accounting periods prior to the award of a particular military contract, will not be allocated to that contract unless allowable as pre-contract costs (Paragraph 15-204.28)."

15-204.35 reading as follows was approved:

"15-204.35 ROYALTIES AND OTHER COSTS FOR USE OF PATENTS.

This item covers amounts paid or payable for the right to use patents or inventions. Where the use of such a patent or invention is necessary for the proper performance of the contract and where the Government does not already have a license or other right to use such a patent or invention, the royalties, amortization of the cost of purchased patents or other purchased patent rights applicable to contract products or processes are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the contracting officer. Charges for the use of patents, where the Government has a license or the right to free use of the patent, or a patent has been adjudicated to be invalid, are unallowable unless otherwise provided in the contract."

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2. Case 53-44 - Revision of Part 2, Section XV. The Committee considered certain points in the Subcommittee draft that required action subsequent to that taken by the Committee in its 11/22/55 meeting. These points covered the following subparagraphs:

15-203.5 - The paragraph was revised and approved to read as follows:

> "The base period for allocation of indirect expenses should be representative of the period of contract performance and should be sufficiently long to avoid inequities in the allocation of costs, but in no event longer than the contractor's fiscal year."

15-204.8 - The Air Force member advised that the Air Force position for presentation to the Material Secretaries on this problem would be presented within one week.

15-204.25 -
15-204.34d -
15-204.35 - A memorandum from the Patents Subcommittee setting forth the views of the Patents Subcommittee with respect to these paragraphs was distributed to the members. After a brief discussion the problem was returned to the Section XV Subcommittee for further consideration in conjunction with the Patents representatives of the three Departments. The Section XV Subcommittee was requested to provide an interim report at the next meeting and a final report by 13 December 1955.

15-204.33b - Two alternative proposals to subparagraph b. of this subparagraph were distributed by the Navy member. After discussion the Committee adopted the proposal quoted below:

> "b. Unless specifically provided for otherwise in the contract, rentals specified in sale and lease-back agreements under (2) above are allowable only to the extent that such rentals do not exceed normal costs (such as depreciation, taxes, insurance and maintenance expenses) borne by the lessor which would have been incurred had the contractor retained legal title to the facilities."

15-204.34b(i) - A proposed subparagraph (c) presented by the Staff was considered and rejected. In lieu thereof the Committee inserted the following first parenthetical expression in the third sentence of (i), which reads as follows:

> "The allocable portion of 75% (or such other percentage as may be agreed upon and set forth in the contract schedule) of the allowable costs of a contractor's independent general research (that which is not sponsored by a contract or grant or other arrangement) shall be allowed in all cost-type contracts under the following conditions:"

15-204.15f - The Committee determined to place a period after the word "allowable," deleting the words "unless approved by the Department concerned," subject to editing. The Army legal member was requested to present revised phraseology for this paragraph f. for consideration at the next meeting.

15-203.3 - Consideration of this paragraph was deferred until the next meeting in order that the reaction of the Small Business interests could be obtained.

NOV 29 1955

1. The minutes of the 22 November 1955 meeting were approved with the following modifications:

Item 3. Case 53-44 - Revision of Part 2, Section XV. The first sentence was revised to read:

"In considering the Subcommittee report of 1 November 1955, and the undated Army Audit Agency report, the suggestion of the Chairman to consider the report on a paragraph basis was adopted."

The following paragraphs were accepted as presented by the Subcommittee:

15-202.1
15-202.2
15-202.3
15-203
15-203.1

Subparagraph 15-204.8. The first sentence was revised to read:

"The Air Force member stated that the problem will be particularly difficult in cases involving industries involved primarily in defense work, such as the aircraft industry. In those cases, contributions and donations, for all practical purposes will be made by the Government and not by the contractor, to such beneficiaries and in such amounts as is determined by the contractor. Therefore, the Air Force position is for continuing the disallowance as in the present ASPR."

Subparagraph 15-204.15. The quoted addition to subparagraph "a" was revised to read:

"The obligation of the Government to indemnify the contractor will be allowable only to the extent expressly provided for in the contract (for example, see ASPR 7-203.22)."

Subparagraph 15-204.18. A parenthetical expression was added at the end of the first sentence, as follows:

"(including the contractor's contributed portion under cost-sharing R&D contracts)."

With this addition the minutes were revised to read:

"The Committee adopted the Subcommittee position as clarified that the portion of cost-participation contracts not reimbursed by the Government under that contract not be allowed as a cost on other contracts."

15-204.26d. The penultimate word in the quotes was revised to read "reversionary."

15-204.28 - The second sentence of the paragraph on precontract costs was revised to place a period after the word "contract" and to delete the words "and may be limited to a period of time as well as to the type and amount of such costs."

The minutes were revised to read:

"The Committee accepted the draft as modified."

[redacted]

formula approach set forth in the draft but there was also a general feeling that an appropriate method of control be further explored."

NOV 29 19[illegible]

15-204.27 - The Committee accepted the draft as written.

15-204.28 - The Committee accepted the draft as written.

15-204.29 - With respect to subparagraph "c," the Committee adopted the position of the Subcommittee that such legal fees are not allowable.

15-204.30 - The Committee adopted the position of the Subcommittee that all profits and losses on disposition of plant, equipment or other capital assets be excluded in computing contract costs.

15-204.31 - The Committee adopted the Subcommittee position that specific provision in the contract of those reconversion expenses which are allowable appears the best method of assuring fair treatment of the interests of the Government and the Contractor.

15-204.32 - The Committee accepted the draft as written with the exception that the second sentence was revised to read as follows:

> "It further includes the costs of operating an aptitude and educational testing program, travel expenses of employees while engaged in recruiting personnel, and travel expenses of applicants for interviews for prospective employment."

15-204.33 - With respect to subparagraph "b," consideration was given to the change recommended by the American Institute of Accountants. Mr. Ruttenberg was requested to draft substitute language for submission to the Editing Subcommittee

15-204.34 - The Committee discussed at length the Subcommittee approach with respect to general research. There was general agreement in the formula approach set forth in the draft but there was also a general feeling that a dollar ceiling be coupled with such approach. Using this as a basic concept, the Staff was requested to develop a proposition for further consideration.

15-204.35 - The Committee adopted the position of the Subcommittee that payments of royalties to contractors should be circumscribed by contract provision or otherwise authorized by the Contracting Officer.

15-204.36 - The question was presented as to whether at least the protection afforded the Government in proposed ASPR 15-202.1 should not be provided. However, it appeared that the protection sought should be related to the "Inspection of Supplies and Correction of Defects" clause (ASPR 7-203.5c). The Army member recommended that the Editing Subcommittee give consideration to insertion of the word "consumer" after "training" in the phrase "and training personnel in the use,".

15-204.37 - The Committee accepted the draft as written.

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15-204.22 - The Committee concurred in the recommendation to include "accountants fees" immediately after "attorneys fee" in the second sentence of the paragraph.

15-204.23 - The Committee accepted the draft as written.

15-204.24 - The Committee adopted the Subcommittee position with respect to identification separately of shift premium and overtime. However, the paragraph was changed to read as follows:

"15-204.24 OVERTIME, EXTRA PAY SHIFT AND MULTI-SHIFT PREMIUMS. This item consists of the premium portion of extra pay and multi-shift payments to employees. Such premiums on direct labor may be classified as either direct or indirect labor costs, but the amount of overtime premium should be separately identified. When direct labor cost is the base for distribution of overhead, overtime premiums shall not be included therein. Cost of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government. Cost of such premiums for indirect labor is allowable without prior approval, if reasonable, and the cost is allocated on a pro rata basis to commercial as well as government work. See ASPR 12-102 for further information concerning the policy regarding such authorization. The amount of overtime and shift premium cost charged on Government contracts shall be equitable in relation to the amount of such premium costs charged on non-Government work being concurrently performed in the contractor's plant and the factors which necessitate the incurrence of the cost."

15-204.25 - The Committee deferred consideration of this paragraph and the parenthetical expression in 15-204.34d until the next meeting.

15-204.26 - The Committee accepted the draft as written with the exception of the following changes:

15-204.26c - The second sentence was revised to read as follows:

"Such costs may include excess contributions made in previous years to the extent such contributions are claimed and allowed for tax purposes in the current taxable period.

15-204.26d - The next to the last sentence was revised to read as follows:

"If a contractor has but one or relatively few Government contracts, an appropriate contractual provision may be used to preserve the Government's interest by providing retrospective accounting and refund of any necessary credits."

15-204.26e - This subparagraph was revised to read as follows:

"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 incurred under approved pension plans will be subject to consideration on an individual case ba

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13. Case 53-44 - Revision of Section XV. The member noted the designat. of Maj. J. O. Hunnicutt, Jr., DEP LCG, as Army member of the subject Subcommittee, vice Lt. Col. J. M. Railing, DEP LCG. FEB 1 1955

1. Case 53-44 - Revision of Section XV. Copies of a proposed DOD Instruction, developed by the Office of the CSD Comptroller, to provide guidance with respect to depreciation in keeping with Section 167(b) as limited by Section 167(c) of the Internal Revenue Code of 1954, subject to meeting the test of reasonableness, were distributed. After a brief discussion, the Committee concluded that it would be highly desirable to incorporate the policy in the Regulation, if possible, rather than have it published as a DOD Instruction. To achieve this end, the Section XV Subcommittee was requested to develop appropriate coverage of the proposed Instruction in Part 6 of Section XV, or submit recommendations as to other media for publication, including a recommendation with respect to the proper document for use for the other media.

In taking this action the Committee agreed that modification of the depreciation paragraph (15-204.9) to incorporate the principles of the proposed directive should be postponed until after receipt of comments from industry on the proposed Section.

The Subcommittee was requested to provide a report for consideration by 15 March 1955. MAR 1 1955

4. Case 53-44 - Revision of Section XV, ASPR. A report from the Section XV Subcommittee, presenting a proposed depreciation - cost interpretation for inclusion in Part 6 of Section XV, was concurred in in principle, subject to editing. In taking this action the members noted three areas requiring further consideration:

a. Effective date.
b. Inclusion of the text of Section 167 of the Internal Revenue Code of 1954, and
c. Omission of any reference to "true" depreciation.

The above areas were referred to the Editing Subcommittee for consideration in conjunction with editing the proposal. The Staff volunteered to develop a cross-reference to "true" depreciation for consideration by the Editing Subcommittee. The Editing Subcommittee was requested to provide a report for consideration by 29 March 1955. MAR 1 1955

10. Case 53-44 - Depreciation Cost Interpretation for Inclusion in Part 6, Section XV ASPR. A report from the Editing Subcommittee, presenting the subject interpretation, was discussed at length. The report was returned for reconsideration. While the Committee did not finally determine its position, the Editing Subcommittee should redevelop the project along the following lines:

a. Applicability of the interpretation. In the absence of a specific agreement the interpretation applies to all "open" contracts.

b. With respect to the assets involved. Undertake interpretation, thinking in terms of the description of the assets covered, utilizing therefore the provisions of the statute.

Consider again the desirability of quoting or paraphrasing such of the statute as will render the depreciation cost interpretation generally understandable in itself. APR 5 1955

15-204.38 - The Committee accepted the draft as written with the exception that the Army member recommended that the Editing Subcommittee consider revising the definition of "special tooling" to conform with that currently being proposed by the Section XIII Subcommittee.

15-204.39 - The Committee adopted the Air Force minority position with respect to subparagraph 15-204.39a(3), and that of the Subcommittee on 15-204.39b.

15-204.40 - The Committee adopted the Subcommittee position with respect to the non-allowability of costs incident to exhibitions.

15-204.41 - The Committee accepted the draft as written.

15-204.42 - The Committee accepted the draft as written with the excpetion that the Army member requested that the Editing Subcommittee consider that line 5 of the second paragraph be revised to read: "* * * provided the contractor follows a consistent procedure which provides for equitable results in this respect."

NOV 22 1954

15-204.43 - The Committee accepted the draft as written.

With respect to the third observation set forth in the first page of the Subcommittee report, the conclusion was reached that Departmental implementing instructions should follow within a reasonable time the publishing of Part 2, Section XV. The Committee also determined that final consideration of Part 2 would be given at a subsequent meeting, but as soon as possible.

6. Case 53-44 - ision of Section XV. The memb s noted copies of the comments received from industry on the proposed re..sion of the subject Section. The Committee Chairman requested the Departmental members to impress upon their respective Subcommittee members the need for expeditious completion of this project. JUL 2 6 1955

15. Case 53-44- Revision of ASPR Section XV. The members noted an interim progress report from the subject Subcommittee, included on the agenda. The Committee extended the time for a final report until 27 October 1955. OCT 4 1955

see agenda for this date

3. Case 53-44 - Revision of Part 2, Section XV. Consideration of a report from the Section XV Subcommittee, presenting a revision of Part 2, Section XV, was deferred at the request of the Air Force member until the meeting of 22 November 1955. NOV 8 1955

3. Case 53-44 - Revision of Part 2, Section XV. In considering the Subcommittee report, the suggestion of the Chairman to consider the report on a paragraph basis was adopted. The action of the Committee resulted in the following:

15-200 - In considering the industry position that a statement be included to the effect that Section XV is not applicable to fixed-price contracts, including those with price redetermination provisions, the question was presented as to whether it was necessary to preclude the application of the principles to certain types of contracts. It was stated that a separate Part for Section XV will be developed to cover facilities contracts. The Committee determined that the "Notes and Filing Instructions" covering the ASPR Change which will include Part 2 should contain a note that the use of the principles is not precluded in connection with facilities contracts pending publication of that Part of Section XV which will cover facilities contracts.

15-201 - The Committee adopted the Subcommittee position that the new criterion "significant deviation in the established practices of the contractor which substantially increase the contract costs" is only one of the factors affecting allowability of costs and does not take anything away from the contractor.

15-202 - Accepted the draft as written.

15-203.2 - Discussion centered around the parenthetical phrase "(including independent research projects)" as set forth in 15-203.2, the Air Force recommendation with respect thereto, and the relationship of the phrase to 15-204.34c. It was the determination of the Committee that the stated phrase should be deleted and that "(see ASPR 15-204.34c)" should be inserted in lieu thereof. The Committee also determined that the second parenthetical phrase in 15-203.2 "(exclusive of overtime premium)" should be changed to read "(exclusive of overtime, extra pay, and multi-shift premium)".

NOV 22 1955

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15-204.10 - The Committee accepted the draft as written.

15-204.11 - The Committee adopted the Subcommittee position that entertainment expense should not be allowed and that there was no conflict between this paragraph and 15-204.10 and 15-204.40.

15-204.12-14 - The Committee accepted the draft as written.

15-204.15 - In accordance with the point expressed by the Army member, the Committee determined that subparagraph "a" should provide some coverage with respect to indemnification. It was decided that proposed subparagraph "g" should be deleted and that such coverage, revised to read as follows, should be inserted at the end of subparagraph "a".

"The cost of indemnification will be allowable only to the extent expressly provided for in the contract (for example, see ASPR 7-203.22)."

It was also determined that subparagraph "c" should be revised to read as follows:

"c. The costs of insurance or any reserve covering the risk of loss or damage to Government-owned property are not allowable except to the extent that the Government may have approved or required such insurance or reserve."

With these changes, and especially that concerning indemnification, the Editing Subcommittee should review the paragraph with respect to coverage given these cost elements.

15-204.16 - The Committee adopted the Subcommittee position that interest be an unallowable cost.

15-204.17 - The Committee accepted the draft as written.

15-204.18 - The Committee adopted the Subcommittee position that the portion of cost-participation contracts not reimbursed by the Government under that contract not be allowed as a cost on other contracts.

15-204.19 - The Committee adopted the Subcommittee position that any recognition of cost of deferred maintenance expenses through contract provision is proper.

15-204.20 - The Committee accepted the draft as written.

15-204.21 - The Committee adopted the Subcommittee position that cash discounts not be considered as financial income. The Air Force member withdrew the Air Force minority position concerning subparagraph "b." With respect to subparagraph "d," the Committee concluded the subparagraph should consist of only the first sentence as set forth in the draft. The Committee also adopted the Subcommittee position with respect to the non-allowability of the cost of write-down of inventory value.

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15-203.3 - The Committee discussed the proposition of whether any selling expense is properly allocable to a Government contract. There was no question that selling and distribution expenses as related to sales of the products of a company to commercial customers should not be allowed. The Committee concluded that the paragraph as written should remain, subject to the Staff discussing the proposition with the Small Business Advisor to the Assistant Secretary of Defense (S&L).

15-203.4 - The Committee considered that the listing of illustrative factors to be considered in determining whether a method of distributing general and administrative expenses was helpful and should remain in the paragraph.

15-203.5 - The Committee concurred in the Subcommittee position that there was no inconsistency between this paragraph and 15-203(b). The paragraph was, however, revised to read as follows:

> "The base period for allocation of indirect expenses should be representative of the period of contract performance and should be sufficiently long to avoid inequities in the allocation of costs."

15-204 - The Committee accepted the paragraph as written.

15-204.1 - The Committee adopted the Subcommittee position that the proposed instructions with respect to allowance of costs of advertising were not too restrictive.

15-204.2-5 - The Committee accepted the draft as written on these paragraphs.

15-204.6 - The decision with respect to the DOD position on profit sharing is expected within the near future.

15-204.7 - The Committee accepted the draft as written.

15-204.8 - The Air Force member stated that because experience had demonstrated the difficulty of controlling these expenses it was the position of the Air Force that contributions and donations not be allowable as costs. The Air Force was requested to present its revised position to be used in connection with the presentation of an item for decision by the Material Secretaries and the Assistant Secretary of Defense (S&L).

15-204.9 - With respect to subparagraph "e," the Navy member withdrew the Navy minority position. In the discussion which followed, the Committee determined that the following should be inserted as the third sentence in subparagraph "e":

> "The remaining undepreciated amount shall be only the normal depreciation remaining after the end of the 'true depreciation' period and shall not include any amount of unrecovered normal or 'true depreciation' allowable during the 'true depreciation' period."

The Editing Subcommittee may improve upon the verbiage of the concept expressed in the insertion.

CONT'D NEXT PAGE

5. Case 53-41 Depreciation Cost Interpretation for Inclusion in Part 6, Section XV ASPR. A report from the Editing Subcommittee was briefly discussed and further consideration deferred until the next meeting to permit the Editing Subcommittee to consider an alternative redraft of paragraph 15-602.1, which is quoted below:

> "15-602.1 Applicability and Effective Date. This cost interpretation pertains to ASPR 15-204 (d), 15-205 (b) and 15-205 (o). It is effective with respect to existing and future contracts; provided that, as regards existing contracts this interpretation shall not be applicable in any case where there is an express agreement in writing that a different interpretation shall be applicable." MAY 5 1955

2. Case 53-44 - Depreciation Cost Interpretation for Inclusion in Part 6, Section XV ASPR. A redraft of the proposed paragraph 15-602.1, Applicability and Effective Date, was distributed to the members. After discussion the redraft was slightly modified and approved. The Committee further modified the last sentence of paragraph 15-602.2. Subject to these modifications, the Committee approved the Cost Interpretation for printing. In taking this action the Committee concurred in the issuance of a Press Release announcing the Cost Interpretation, by the Staff, and in the Departments promulgating the Interpretation within their Departments prior to its publication in the Regulation. The Interpretation, as approved, is quoted below:

> "15-602 - Depreciation.
>
> 15-602.1 - Applicability and Effective Date. This cost interpretation pertains to ASPR 15-204(d), 15-205(b) and 15-205(o). It is applicable with respect to all cost-reimbursement type contracts placed on and after 1 June 1955 and, also, to all existing cost-reimbursement type contracts not completed at that date except as to predetermined overhead rates or fixed amounts of overhead which have finally been agreed upon for particular periods. However, the foregoing sentence does not supersede any express agreement in writing that a different interpretation shall be applicable.
>
> 15-602.2 - Allowances for Depreciation. Allowances for depreciation (other than "true depreciation") as provided in Section 167 of the Internal Revenue Code of 1954, subject to the limitations set forth in paragraph 15-602.3, shall be acceptable for contract costing purposes. Allowances for "true depreciation," as that term is defined in DOD Instruction 4105.34 of 1 July 1954, shall be in accordance with said Instruction, and shall be exclusive of other methods of depreciation with respect to the assets involved in the determination of "true depreciation."
>
> 15-602.3 - Interpretation. Depreciation computed in accordance with paragraph 15-602.2 above is allowable provided it meets the test of reasonableness and allocability to defense contracts and other applicable provisions of this Section. Meeting these tests may depend upon whether (i) the depreciation allowance in the particular case is acceptable for tax purposes, and (ii) the costing of defense contracts is on a basis consistent with the costing of the contractor's non-defense work and is so reflected in its books and records." MAY 10 1955

1. The minutes of the 12/21/54 meeting were approved with the following modifications.

[redacted]

First sentence. Prior to discussion of certain issues in which positions had been reserved, it was generally agreed that the following would be presented to the Procurement Secretaries, as a group, for information and resolution where appropriate:

a. Major differences with industry.

c. Those areas in which the Services are not in accord.

15-204.6 - Compensation for Personal Services.
The Committee reviewed the proposal of the Subcommittee as contained in their report of December 15, 1954 and agreed that the proposed subparagraph (c) should be changed as follows:

15-204.6 (e), (f) and (g).
The Air Force nonacceptance of the principle set forth in these subparagraphs results in classifying this as an issue. (The issue, briefly stated, being whether contractor payments pursuant to Profit Sharing and Stock Bonus Plans determined by profits are merely compensation measured by profits and are allowable for reimbursement, or whether payments pursuant to such plans are distribution of profits and therefore are not reimbursable as costs.) To be resolved by the Assistant Secretary of Defense (S&L) in conjunction with the Procurement Secretaries.

[redacted]

15-204.9 - Depreciation.
The Committee considered comments of the Subcommittee relative to the effect of new revenue legislation (Section 167 of the Internal Revenue Code of 1954) on the existing provisions of Section XV. It was generally agreed that the ASPR provision remain unchanged, that a press release be arranged on the topic for information to the public, and that contemporaneously with the press release, appropriate instructions be promulgated to field audit personnel.

15-204.9 (e) b.
"The contractor may elect to use normal depreciation rather than the "true depreciation" as determined by the Emergency Facilities Board. However, the method chosen after such determination of "true depreciation" must be followed consistently throughout the life of the emergency facilities."

15-204.27 (f) - Pension and Retirement Plans.
After considerable discussion of reversion credits and the methods by which arrangements can be made that are equitable to the Government, there was general agreement that the paragraph remain as written, but that the attention of the Assistant Secretary of Defense, OASD (S&L), and the Procurement Secretaries be directed to the difficulty of this issue. It is also to be explained that part of the draft will be issued as an instruction, as it is not appropriate as a cost principle. The Navy member agreed to frame the issue, to be inclusive of mass severence pay, and forward copies thereof to the Army and the Air Force.

15-204.41 - Taxes.
(a) (1) After the third word "taxes" of the subparagraph add ("including state income taxes.")

NOTE: Underscoring denotes change.

7. Case 53-44 Revision of Section XV. Prior discussion of certain issues in which positions had been reserved, it was generally agreed that the following would be presented to the Procurement Secretaries, as a group, for information:

a. Major past differences with industry,

b. Those areas involving a change from the current ASPR position, and

c. Those areas in which we are not according to industry the treatment desired by them.

The members then commenced discussion of the following subparagraphs:

15-204.4 - Cafeterias, Dining Rooms and Other Food Services. Principle modified and agreed to.

15-204.6 - Compensation for Personal Services. The Committee reviewed the proposal of the Subcommittee and agreed that the proposed subparagraph (c) should be changed as follows:

a. At the end of the introduction to subparagraph c., change the colon to a comma and add the following:

"in addition to those set forth in subparagraph (d) (1), (2), (7), and (g) below:"

b. Revise subparagraph (iii) to read as follows:

"for allowance purposes, the cost of stock options will be amortized equally over an appropriate period from the date the option is exercised depending upon the terms of the option agreement."

The members accepted the proposal of the Subcommittee to delete the second sentence of 15-204.6 (d) (2).

15-204.6 (e) and (f). The Air Force nonacceptance of the principle set forth in these subparagraphs results in classifying this as an issue (the issue, briefly stated, being whether contractor costs in Profit Sharing and Stock Bonus Plans are merely compensation measured by profits and are allowable for reimbursement, or whether such plans are distribution of profits) to be resolved by the Assistant Secretary of Defense (S&L) in conjunction with the Procurement Secretaries.

DEC 21 1954

(continued)

15-204.3[illegible] b (1) (iii) - General Research.

15-204.38 - Severance Pay.

15-204.41 - Taxes.

The members further determined to delete from the revision, paragraph 15-204.40 - Strikes and Lockouts - Expenses of.

In addition to the above issues the Subcommittee was requested to clarify the language contained in the following subparagraphs:

15-204.22 - Materials and Supplies.

Subparagraph b - re discounts, and

Subparagraph d - re pricing of materials in stock where replacement cost differs significantly from book cost.

A Staff proposal presenting a depreciation cost interpretation giving effect to the new revenue legislation, presented for interim use pending the promulgation of the revised Section XV, was discussed at length and referred to the Section XV Subcommittee for redevelopment, with a request that a report be provided by 21 December 1954.

The subject of clearing the proposed revision with the Comptroller General's office was discussed. It was concluded that it would be highly desirable to informally present a copy to the GAO at the same time the proposal is referred to industry for comment. NOV 30 1954

DEC 2 1954

3 DEC 6 1954 A. B. C.

1. a. The minutes of the 11/30/54 Regular Meeting, and the Special Meetings held 12/2/54 and 12/6/54, were approved with the following modifications:

- Item 5. Case 53-44 - Revision of Section XV - Contract Cost Principles. The entry 15-204.14 - Profit Sharing, in the second paragraph, was revised to read:

"15-204.14 - Fringe Benefits (Profit Sharing)"

The fourth paragraph was revised to insert a subparagraph e, as follows:

"Subparagraph e - Intercompany or Interdivisional Sales or Transfers," in lieu of subparagraph b.

The fifth paragraph was revised to read as follows:

"A Staff proposal presenting a depreciation cost interpretation giving effect to the new revenue legislation, presented for interim use pending the promulgation of the revised Section XV, was discussed at length, agreed to in principle, and referred to the Section XV Subcommittee for redevelopment, with a request that a report be provided by 21 December 1954."

DEC 14 1954

4. The minutes of the 10/26/54 meeting were approved with the following modification:

Item 2. Case 53-44 - Revision of Section XV - Cost Principles. The last sentence was revised to read:

"The Air Force tentatively approved the principles for the purpose of going forward but reserved the right to review both areas when a final Subcommittee report is issued."

(Underscoring denotes change). NOV 2 1954

6. Case 53-44 - Revision of Section XV, Contract Cost Principles. The Air Force member presented the problem of the allowability for reimbursement of contract costs under cost-reimbursement type contracts and as to the recognition in price under fixed-price contracts of depreciation on plant and equipment computed in accordance with the Internal Revenue Act of 1954. The members recognized the issue, but indicated that coverage had been considered by the Section XV Subcommittee in developing Part II of Section XV. Members will consider this Part at the 11/30/54 meeting. NOV 17 1954

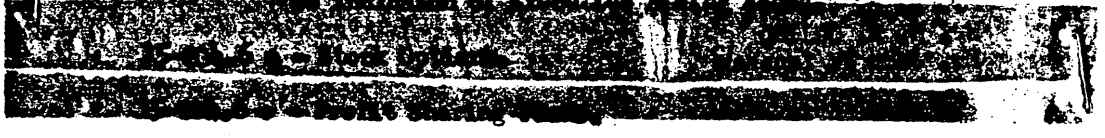
5. Case 53-44 - Revision of Section XV - Contract Cost Principles. Consideration of a report from the Subcommittee, presenting the latest draft of Part 2, Section XV, revised in the light of comments received from the military departments and guidance from the Committee, began with the discussion of the purpose of considering the report. It was agreed that this review would highlight two types of issues for resolution prior to forwarding the revision to industry for comment. These are:

a. Issues in which the Departmental positions are unknown and which may be resolved by the Committee at a subsequent meeting, and

b. Issues where the Departmental positions are known which will require resolution by the Assistant Secretary of Defense (S&L) in conjunction with the Procurement Secretaries.

The members undertook consideration of the Subcommittee report on a page by page basis. Issues for further consideration appeared in the following subparagraphs:

15-204.4 - Cafeterias, Dining Rooms and other Food Services -



15-204.6 f - Stock Bonus Plans.

15-204.8 - Contributions and Donations.

15-204.9 - Depreciation.

15-204.14 - Profit Sharing.

15-204.16 e - Insurance - Officers, Partners, or Proprietors.

15-204.17 - Interest and Other Financial Expenses.

15-204.27 f - Pension and Retirement Plans. (In connection with this issue, the Navy member urged that consideration be given to the deletion of pension reversion credits and mass severance pay from the cost principles, presenting the proposal of the coverage of these subjects to industry in a separate paper, stating that both these items were deleted on the premise that one offsets the other. However, if industry insists on one, the Government will insist on the

2. Case 53-44 - Revision of Section XV - Contract Cost Principles. The Section XV Subcommittee was present and submitted a written and oral report on the activities of the Subcommittee to date. Several features of the Section XV revision were discussed. It was agreed that greater emphasis should be placed on the revision and the Subcommittee will meet two days a week to expedite completions. The target date of 1 June 1954 was established for completion of the Subcommittee's work. APR 27 1954

3. Case 53-44 - Revision of Section XV - Contract Cost Principles. The members noted and approved a progress report from the subject Subcommittee requesting an extension of the target date for the completion of the project until 22 June 1954. JUN 1 1954

12. Case 53-44 - Revision of ASPR, Section XV, Part 2. A report from the Section XV Subcommittee presenting the subject revision was concurred in by the members for the purpose of securing comments from the Technical Services, Bureau and Commands. Departmental comments are to be received by 1 August 1954 JUN 22 1954

9. Case 53-44 - Revision of Section XV. The members noted the designation of Mr. G. A. Connatser, AFAUD, as the Air Force member of the subject Subcommittee, vice Mr. A. B. Thomas, AFAUD. AUG 24 1954

7. Case 52-37 - Section VII - Clauses, Price Revision Clauses.
Case 53-64 - Tax Credits - Downward Contract Price Revision.
Case 53-44 - Revision of Section XV. The members noted the designation of Mr. P. M. Southwell, AFMPE, as the Air Force member of the subject Subcommittees, vice Lt. Col. H. T. Critchlow, AFMPE. AUG 24 1954

2. Case 53-44 - Revision of Section XV - Cost Principles. The Committee considered the issues raised in the Section XV Subcommittee report as follows:

a. Should costs of profit sharing plans be allowable to the extent recommended by the proponents in the report?

b. Should costs of stock bonus plans be allowable?

c. Should costs of independent research and development be allowable?

Both a. and b. were answered in the affirmative. Major discussion was directed toward the fact that although such plans are generally called "profit sharing" they are in reality additional compensation measured by earnings. Accordingly, in drafting this principle, the latter fact will be emphasized.

With respect to issue c., it was determined that "related research" should be allowable if "applicable to the product or product line." As to "general research," a division was made as follows:

(1) Allowable if (i) the contractor's business is predominantly commercial (i.e., 75% or more), (ii) such costs are also allocated to commercial work, (iii) the contractor submits reports of work accomplished and, (iv) the costs are reasonable.

(2) If the contractor's business is not predominantly commercial, specific provision must be made in the contract for such costs. It was recommended that negotiations for such costs be handled centrally in each Department so that greater uniformity can be attained.

The Air Force reserved the right to review both areas when a final Subcommittee report is issued. OCT 26 1954

21. Case 53-44 - Revision of Section XV - Contract Cost Principles. Copies of Parts 1 and 2 of the proposed revision of Section XV, revised by the Subcommittee pursuant to receipt of service comments, were distributed to the members. The members were further advised that Parts 3 and 4 were currently in the process of being reproduced and that copies would be provided the members as soon as they become available. NOV 24 1953

10. Case 53-44 - Revision of Section XV - Contract Cost Principles. Copies of Parts 3 and 4 were distributed to the members. The members were further advised that the Subcommittee report was currently being prepared and that copies would be provided the members as soon as the report became available. DEC 1 1953

11. Case 53-44 - Revision of Section XV - Contract Cost Principles. The members noted a report of the subject Subcommittee presenting Parts 1, 2, 3 and 4 of the subject revision together with the comments of the Office of the Deputy Comptroller for Accounting Policy, OSD, outlining the Comptroller's position with respect to the issues unresolved by the Subcommittee. Consideration of the reports were deferred pending the development of Departmental positions with respect to the reports. DEC 8 1953

6. Case 53-44 - Revision of Section XV. Mr. Warren Webster, Jr., Director of Procurement and Production Policies, OASD (S&L), informed the members that following discussions with the Assistant Secretary of Defense (Comptroller) it was agreed that the ASPR Committee should immediately undertake:

a. Recasting of the Subcommittee report in the format of the present Section XV. Part

b. Deletion of the pricing and accounting data.

c. The revision to be applicable only to cost-type contracts.

d. Upon completion of the cost principles for cost-type contracts, to immediately undertake the development of cost principles applicable for fixed-price contracts.

The task was assigned to the Section XV Subcommittee for accomplishment.

The members were further advised that the Subcommittee effort, after approval by the ASPR Committee, would be coordinated with the Office of the Assistant Secretary of Defense (Comptroller) prior to industrial coordination.

In undertaking this task the Subcommittee was to consider all existing departmental papers that would have a bearing on this subject and endeavor to complete their assignment on an expedited basis. FEB 9 1954

19. Case 53-44 - Proposed Revision of Section XV - Contract Cost Principles. The Chairman read to the members a memorandum, signed by the Staff Director, Purchasing and Contracting Policies Division, for the Director of Procurement & Production Policies, with respect to the agreement reached by a panel of DOD and Services representatives with the Assistant Secretary of Defense (Comptroller) concerning the format of the revision to Section XV. A copy of the memorandum is attached as Inclosure 1. MAR 9 1954

11. Case 53-44 - Revision of Section XV - Contract Cost Principles. The members expressed concern over the apparent delayed progress of the subject Subcommittee and discussed the feasibility of more frequent meetings of that Subcommittee in an effort to effect a timely resolution of this problem. It was agreed that the subject Subcommittee would present a report for consideration at the 4/27/54 meeting setting forth the accomplishments to date toward revision of Section XV. It was further agreed that an invitation would be extended to the members of the subject Subcommittee to be present at the 4/27/54 meeting for a discussion of their progress in this development. APR 20 1954

5. Case 53-44 - Revision of Section XV - Contract Cost Principles. During a brief discussion of the proposed revision of paragraph 15-313.15, developed by the Tax Subcommittee, the Committee members were advised that the Section XV Subcommittee had considered the proposal in their revision of Section XV. The members were further advised that the Section XV Subcommittee accepted the report in substance and that it would be included, with minor modification, in the final draft of Part 3, Section XV. The members agreed that in an effort to conserve time the Subcommittee report will be forwarded by the Committee members, upon receipt, to the Technical Services, Bureaus and Commands for comments, with a suspense date of three weeks from date of receipt of the report. The forwarding of the Subcommittee report in this manner does not imply Committee approval. AUG 11 1953

12. Case 53-44 - Revision of Section XV. The members noted Parts 1, 2 and 3 of the proposed revision, copies of which were forwarded to the departments for comments by the technical services, bureaus and commands on 8/26/53. SEP 1 1953

11. Case 53-44 - Revision of Section XV - Contract Cost Principles. The members noted a report from the Patents Subcommittee commenting on the proposed revision dated 16 September 1953, together with a supplemental report from the Patents Subcommittee dated 17 September 1953, which the staff had referred to the Section XV Subcommittee for consideration. SEP 22 1953

17. Case 53-44 - Revision of Section XV.

a. The members noted Part 4 of Section XV, developed by the Subcommittee, which was forwarded to the Departments for comments, with a request that comments be presented by 21 October 1953.

b. Consideration of the issue as to whether Section XV should be incorporated in price redetermination clauses on a mandatory or optional basis was deferred until the next meeting at the request of the Office of the Deputy Comptroller for Accounting Policy, OSD. OCT 6 1953

4. Case 53-44 - Revision of Section XV. The Section XV Subcommittee entered the meeting for discussion of the problem of whether Section XV should provide for the specific inclusion by contract provision of the revised cost principles in contracts containing price redetermination or incentive provisions. It was determined to reserve action on this issue until the Subcommittee could present specific contract language for consideration. The tentative conclusion was that the clause should read that the principles were applicable to such contracts as a guide only. The changes and the clause are to be presented for consideration at the 10/20/53 meeting. OCT 13 1953

3. Case 53-44 - Revision of Section XV. The Section XV Subcommittee entered the meeting for discussion of the problem of whether the revised Section XV would be incorporated by reference in all price redetermination and incentive clauses and, if so, what type of contract provision was appropriate for the purpose. After a prolonged discussion with the members of the Subcommittee and a representative of the Deputy Comptroller's Office the Committee determined that there be no reference to Section XV in these clauses. The Comptroller's representative did not concur with the Committee's decision. The proposed wording to accomplish this concept was approved by the members. A special Group was designated to set forth in writing, substantiation on the position for non-inclusion and the representative of the Deputy Comptroller's Office will provide his written views for mandatory inclusion. These documents will ultimately be forwarded to a higher level for resolution of the issue.

Members designated to the Special ASPR Group to develop the Committee's position were:

Army - Brig. Gen. W. R. Allen, OS G-4
Navy - Mr. G. C. Bannerman, ONM (Chairman)
AF - Col. Thos. W. Ryan, AFMPE

OCT 20 1953

19. Case 53-44 - Revision of Section XV - Contract Cost Principles. The members were informed by the Munitions Board member that pursuant to conversations between Adm. Ring and Mr. Bordner, agreement was reached on the following method of going forward with the further development of a revised Section XV:

The ASPR Committee would undertake, on an accelerated basis, the further development of the revision, using as a starting point

[redacted]

Assistant Comptroller for Accounting Policy, OSD. The Committee agreed that the Subcommittee's initial consideration should be with respect to the basic concepts of the proposal, including the approach for use in fixed-price contracts. It was further agreed that consideration of the Deputy Comptroller's proposal would be divided in the following order:

a. Parts 1 and 2, and

b. Part 3.

The members designated to the Subcommittee to undertake the study were:

MB - Mr. H. H. Gallup (Chairman)
Army - (Proc.) Lt. Col. J. M. Railing, GS G-4
(Accounting) (To be designated)
Navy - Mr. E. T. Cook, S&A
Mr. A. C. Sawallisch, ONM
AF - Lt. Col. H. T. Critchlow, AFMPE
OSD - (To be designated)

JUN 9 1953

16. Case 53-44 - Revision of Section XV - Contract Cost Principles. The Chairman advised the members that Mr. Howard Wright and Mr. K. K. Kilgore had been designated OSD representatives to the subject Subcommittee.

Subsequent to the meeting Mr. R. M. Kee was designated Army Accounting representative to the subject Subcommittee. JUN 16 1953

11. Case 53-44 - Revision of Section XV - Contract Cost Principles. The members noted the designation of Mr. A. B. Thomas, AFAUD, as an additional Air Force member of the subject Subcommittee. JUN 30 1953

2. Case 53-44 - Revision of Section XV. The members noted a report from the Subcommittee, which presented the Subcommittee's recommendations on Parts 1 and 2 of the Deputy Comptroller's proposal to revise Section XV. The members were informed that further discussions between the Special Assistant to the Secretary (Admiral Ring) and the Deputy Comptroller for Accounting Policy were being scheduled to review the Committee treatment of this Revision. JUL 7 1953

13. Case 53-44 - Revision of Section XV - Contract Cost Principles. The members noted a memorandum from the Chairman of the Section XV Subcommittee, which recommended that paragraph 15-313.15 be referred to the Tax Subcommittee for consideration on an accelerated basis, and that the staff had referred the problem to the Tax Subcommittee for consideration and recommendation, with a request that a report be provided by 8/4/53. JUL 28 195

NEWS RELEASE

PLEASE NOTE DATE

DEPARTMENT OF DEFENSE
OFFICE OF PUBLIC INFORMATION
Washington 25, D. C.

NO. 456-55

IMMEDIATE RELEASE — MAY 12, 1955 — LI 5-6700 Ext. 53201 53176

Case 53-44

DEPRECIATION PARAGRAPH INCLUDED IN ASPR COST INTERPRETATION

A cost interpretation paragraph, relating to depreciation, will be included as part of Section XV of the Armed Services Procurement Regulation, effective June 1, 1955, Thomas P. Pike, Assistant Secretary of Defense (Supply and Logistics), announced today.

The new paragraph, 15-602, which will be published by the Government Printing Office as Revision of the ASPR, follows:

"15-602 - Depreciation.

"15-602.1 - Applicability and Effective Date. This cost interpretation pertains to ASPR 15-204(d), 15-205(b) and 15-205(o). It is applicable with respect to all cost-reimbursement type contracts placed on and after 1 June 1955 and, also, to all existing cost-reimbursement type contracts not completed at that date except as to predetermined overhead rates or fixed amounts of overhead which have finally been agreed upon for particular periods. However, the foregoing sentence does not supersede any express agreement in writing that a different interpretation shall be applicable.

"15-602.2 - Allowances for Depreciation. Allowances for depreciation (other than "true depreciation") as provided in Section 167 of the Internal Revenue Code of 1954, subject to the limitations set forth in paragraph 15-602.3, shall be acceptable for contract costing purposes. Allowances for "true depreciation", as that term is defined in DOD Instruction 4105.34 of 1 July 1954, shall be in accordance with said Instruction, and shall be exclusive of other methods of depreciation with respect to the assets involved in the determination of "true depreciation."

"15-602.3 - Interpretation. Depreciation computed in accordance with paragraph 15-602.2 above is allowable provided it meets the test of reasonableness and allocability to defense contracts and other applicable provisions of this Section. Meeting these tests may depend upon whether (i) the depreciation allowance in the particular case is acceptable for tax purposes, and (ii) the costing of defense contracts is on a basis consistent with the costing of the contractor's non-defense work and is so reflected in its books and records."

E N D

15 August 1956

MEMORANDUM FOR: CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44 - Section XV - 15-204.2(aa)
Training and Educational Costs

Pursuant to Item 3 of ASPR minutes of 7 August 1956, the Editing Committee has edited the subject material, as set forth in Tab A.

C. W. Wilkinson
Lt. Colonel, JAGC
Chairman
Army Member

John Green
Navy Member
(absent)

John W. Perry
Air Force Member

Incl: Tab A

DEPARTMENT OF THE NAVY
OFFICE OF NAVAL MATERIAL
WASHINGTON 25,D. C.

M36/ACS:ll
2 August 1956

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

Subj: Case 53-44 - Special Subcommittee ASPR 15-204.2(bb) Training and Educational Expense

Ref: (a) Report of Subcommittee of 12 July 1956

Encl: (1) Proposed language for ASPR 15-204.2(bb)

1. Reference (a) was considered by the ASPR Committee at their meeting on 31 July 1956. A number of recommendations were made which the subcommittee has endeavored to incorporate in enclosure (1).

2. It is probable that subparagraph e of enclosure (1) will also be included in ASPR 15-204.3 - Unallowable Costs and referenced back to ASPR 15-204.2(bb).

3. The enclosure has not been coordinated with the Office of the Secretary of Defense, Office of Manpower Supply, it being the understanding of the Subcommittee that the ASPR Committee would do so.

A. C. Sawallisch, Chairman

Committee Members

Mr. Paul H. Southwell, AFMPP
Mr. Thos. B. Worsley, Army Ord.
Mr. W. L. Latta, AFAUD
Mr. James Ruttenberg, NAVCOMPT(CAD)

15-204.2(bb) - Training and Educational Expenses

a. The costs of preparation and maintenance of a program of instruction at non-college level designed to increase the vocational effectivenss of employees include the salaries of the director of training and staff, training materials and textbooks when the training program is conducted by the contractor; and tuition, fees, training materials, and textbooks, when the training is of a non-college level in institutions conducted by other than the contractor. Such costs are allowable. In both instances, costs may include salaries or wages of trainees during regular working hours.

b. The costs of part-time technical, engineering and scientific education, related to the job requirements of bona fide employees, at an under-graduate or post-graduate college level are allowable as follows:

1. Tuition, fees, training materials and textbooks; or, in lieu of tuition, instructors' salaries and the related share of indirect expense, provided that the sum thereof is not in excess of the tuition which would have been paid to the participating educational institution.

2. Straight-time compensation of employees for time spent attending classes not in excess of a total of 156 hours per year where circumstances do not permit the operation of classes after regular working hours.

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

d. Maintenance expense and normal depreciation or fair rental on facilities owned or leased by the contractor are allowable to the extent that such facilities are used under programs falling within a or b, above.

e. The costs of training and education of other than bona fide employees are not allowable.

f. Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships, are considered a s contributions and will be treated as provided under ASPR 15-204.3(c).

Enclosure 1

DEPARTMENT OF THE NAVY
OFFICE OF NAVAL MATERIAL
WASHINGTON 25, D. C.

M36/ACS:11

12 July 1956

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

Subj: Case 53-44 - Special Subcommittee ASPR 15-204.2(bb) Training and Educational Expense

Encl: (1) Proposed draft as agreed upon by Mr. W. L. Latta, AFAUD; Mr. James Ruttenberg, Navy CAD, and A. C. Sawallisch, Navy ONM.
(2) Discussions in support of enclosure (1).
(3) Proposed draft of Memorandum to the Secretary of Defense or other competent authority for ruling on the disputed portion.
(4) Proposed draft as agreed upon by Mr. Paul Southwell, AFMPP; Mr. Thomas B. Worsley, Army Ord, and Mr. Albert Kay, Office of ASTSECDEF(MANPOWER & RESERVE.)
(5) Discussion in support of enclosure (4).
(6) Proposed Section ASPR 15-204.2(bb) presented by Mr. Ken Borgen, Navy Industrial Manpower, and discussion in support thereof.

1. The Special Subcommittee appointed by the ASPR Committee on 6 April 1956 to consider the problem of extent to which Training and Educational Costs should be allowed is unable to come to complete agreement and the diverse opinions are being presented to the ASPR Committee for resolution.

2. Agreement has been reached, with some differences in language, to allow the costs of (i) vocational training, whether it be "in-plant" or in vocational or trade schools, i.e., the training of welders, electricians, machine operators, etc., and (ii) training of a short term nature which is necessary to meet an immediate, clearly defined need of the contractor in connection with a specific engineering, production or administrative problem. The latter type of training may be in the plants or laboratories of other contractors or of the Government, or in technical institutions as well as in trade or vocational schools.

3. The essential difference concerns the allowability of costs for college and post-graduate courses in the sciences and engineering in a curriculum leading to higher academic degrees rather than to meet an immediate need of the contractor. Enclosures (1), (2) and (3) present the position of the group which is of the opinion that there is no existing Department of Defense policy which permits the acceptance of such costs and are of the further opinion that policy making in this field, being of a National interest, should be undertaken by those in the Government chargedwith respect to education and training rather than

by purchasing and accounting personnel. Enclosures (4) and (5) present the position of the group which would allow such costs, together with standards and limitations for allowability thereof. Enclosure (6) is a draft of proposed ASPR Section 15-204.2(bb) submitted by Mr. Ken Borgen, Navy Industrial Manpower.

A. C. SAWALLISCH, CHAIRMAN

Committee Members

Mr. W. L. Latta, AFAUD
Mr. James Ruttenberg, Navy CAD
Mr. Paul M. Southwell, AFMPP
Mr. Thos. B. Worsley, Army Ord.

Coordinated with:

Mr. Albert Kay, OASD(MP&R)
Mr. Ken Borgen, Navy Industrial Manpower

15-204.2(bb) Training and Educational Expense.

(a) Vocational training is that type of training, generally of a short term nature, which is necessary to meet an immediate, clearly defined need of the contractor, such as training to overcome a particular engineering, production, or administrative problem. It may be carried on in plant, in trade or vocational schools or in technical institutions. The costs of preparing and carrying out vocational training courses may include the salaries or wages of the training director and staff; training material and text books when the program is controlled by the contractor, and the salaries or wages of trainees for time spent during regular working hours. Costs may also include the salaries or wages of trainees for time spent duringregular working hours, travel, tuition, laboratory fees, training materials and text books when the training is carried out in vocational, trade or technical training institutions. Such costs are allowable when reasonable and properly allocated to all work of the contractor.

(b) The costs of educational and general training programs of a type aimed primarily at increasing the general educational or skill level of trainees, rather than solving immediate specific problems are not allowable. This includes the general area of long range management, executive or professional training programs and scholarships, fellowships or other emoluments to employees or others.

DISCUSSIONS IN SUPPORT OF ENCLOSURE (1)

1. It is the opinion of the undersigned that under existing policies there should be separate treatments for expenses in connection with vocational training; i.e., training of supervisors, machine operators, welders, electricians, etc. and the education in technological fields of engineers, scientists, etc.

2. It has long been the practice of industry to support the expense of vocational training. This practice had its recognized acceptance in the guild and apprentice systems which have for years been a part of union agreements. An acceleration of this practice was instituted during World War II when the shortage of skilled workmen and foremen became acute and the Armed Services established a policy of accepting a pro-rata portion of such costs in connection with Defense contracting. It is the opinion of the undersigned that that practice should be continued and that it be made clear that training costs in vocational or technical training schools also be acceptable in order to give identical support in those instances where smallfirms find it impratical to conduct "in-plant" vocational or technical training.

3. While the undersigned do not question the need for development of more and better engineering and scientific personnel, they do not consider that the policy heretofore followed in regard to vocational training expenses should be automatically applied to educational costs in the professional and academic fields without a delineation of policy by competent authority. If one uses current newspaper, magazine and company publication stories as basis for judgement, these costs are going to be substantial and their acceptance in cost-type contracting would make their acceptance in redeterminable and incentive type contracting almost mandatory.

4. A proposed paragraph ASPR 15-204.2(bb) is attached as enclosure (1) which would allow the cost of the type training discussed in paragraph 2 above and not allow the costs of the type discussed in paragraph 3 above. It is in connection with the type of costs discussed in paragraph 3 above that the Committee cannot come to agreement. Enclosure (3) is a draft of a memorandum which the ASPR Committee may wish to submit to competent authority for a statement of policy.

Enclosure (2)

MEMORANDUM FOR THE SECRETARY OF DEFENSE

Subj: Employee Educational Costs Incurred by Defense Contractors

1. The stepped-up production requirements during World War II created a demand for skilled craftsmen such as welders, electricians, etc. that could be met only by extensive training courses, most of which were conducted on an "in-plant" basis. A policy to accept such training costs in connection with Defense contracts was established and has been continued.

2. The current demand by industry for more and more engineers and scientists to produce the highly technical military items now in use and to carry out the extensive research and development programs is well known. A recent study by the Phoenix, Arizona, Chamber of Commerce stated that this years graduating class would fall short by 50,000 men. In an effort to meet this demand numerous educational programs, both graduate and undergraduate are being instituted and given financial support by industry and our procuring activities are faced with the problem of how much, if any, of the costs of such programs should be allowed in the costing or pricing of Defense contracts. The following excerpts are taken from an article on the subject in the May 26 "Business Week."

"Many companies have set up programs to send a few of their more highly talented engineers to graduate schools full-time. Others are planning to send their engineers to special graduate courses a few hours a week, on company time. Some are trying to persuade graduate school facilities to set up off-campus schools for their engineers by offering to build facilities and pay instructors."

Convair Division of General Dynamics Corporation is working hard to persuade the University of California regents to set up a graduate school at San Diego and "guarantees students for the center, has promised aid in funds, equipment, and pay for the faculty. Unofficial estimates put the cost of building the center at close to $4 million."

General Electric is just establishing a program which "will send 20 engineers to Syracuse University and 40 to Rensselaer Polytechnic Institute to work for their doctorates. It will pay the cost of their tuition and books, put them on the company pay roll and they will get seniority and credit for any benefits that might accrue to them."

Syracuse University is operating three branches; one at Griffs Air Force Base at Rome, NewYork, for Air Force engineers and General Electric engineers from a nearby plant; the second and third at Endicott and Poughkeepsie, New York, for I.B.M. engineers. The Air Force and IBM supply classrooms on their own properties and the two companies and the Air Force foot the bills for faculty salaries, travel and overhead.

Enclosure (3)

Rensselaer Polytechnic is operating a graduate school near Hartford, Connecticut, in facilities provided by United Aircraft Corporation. 80% of the students are United Aircraft Corporation employees and the United Aircraft Corporation is underwriting the experiment for five years. The cost to the company is about $1,000 a year per student.

A recent Raytheon Manufacturing Company plant publication announced availability to their science and engineering employees of educational grants at M.I.T. and Harvard. Grants willcover full tuition, fees, book allowance and a monthly salary of $240 while in residence at the school. Undergraduate students are also considered if working for a science or engineering degree and plan to join the company upon graduation.

3. Obviously, the costs to industry for support of these programs will become significant, particularly in the aviation, guided missile, electronic, nuclear physics and other highly technical fields where the shortage of engineers and scientists is greatest, and it is in those fields where the military departments are the principal customers. Assuming, therefore, that such costs were accepted, even on an allocated basis, substantial dollars appropriated for the purchase of Defense material would be spent in support of educational programs.

4. It is well known that the present National policy is to encourage industry, colleges, universities, and foundations to give support to any program designed to increase the quantity and quality of engineering and scientific personnel. It has not been noted, however, that any Government financial support has been made available for the furtherance of such programs. A number of questions therefore present themselves in connection with the possible acceptance of such costs in our contracting.

a. If it is determined that the National interest requires a Government subsidy for engineering and scientific education, should the subsidy be administered through private contractors, thereby working to their individual competitive advantage, including a profit on their participation in the program, or should it be administered directly by the Government.

b. If participation is to be through the allowance of the cost in Defense contracting should such support be limited to (i) specific fields and, if so, which fields; (ii) which types of cost should be allowable, i.e., tuition, laboratory fees, salaries paid to instructors, text books, compensation of students while in attendance, cost of scholarships, etc; (iii) should Defense participation be limited to a specified ratio of total contract costs?

5. Procurement and audit policies and procedures in this area are greatly in need. It is my opinion, however, that some basic policy which could be prescribed from answers to the question proposed above must first be established. Since this is an area coming within the purview of your office, I will greatly appreciate an expression from you as to the policy we should pursue.

15-204.2(bb) - Training and Educational Expenses

a. Preparation and maintenance of a program of instruction designed to increase the vocational effectiveness of employees include the salaries of the director of training and staff, training materials and textbooks when the training program is conducted by the contractor; and tuition, fees, training materials, and textbooks, when the training is of a non-college level in institutions conducted by other than the contractor. In both instances, costs may include salaries or wages of trainees during regular working hours.

b. Part-time technical, engineering and scientific education at an under-graduate or post-graduate college level as follows:

1. Tuition, fees, training materials and textbooks.

2. Where circumstances do not permit education after paid working hours, regular employee compensation is also allowable for instruction not in excess of a total of 156 hours per year.

c. Tuition, fees, training materials and textbooks (but not subsistence, salary, or any other emoluments) in connection with scientific and engineering education of bona fide employees on a full-time basis at a post-graduate college level for a total period not to exceed one school year. In unusual cases where required by military technology, the period may be extended.

/d. The costs of training and education of other than bona fide employees, including scholarships and fellowships, are not allowable./*

* This paragraph could be transferred to part of Section XV covering unallowable costs.

Discussion in Support of Enclosure (4)

The undersigned representatives of Army and Air Force join in the following staff report and recommendations. These are concurred in on a staff basis by the representative of the Office of the Assistant Secretary of Defense (MP&R).

It is the opinion of the undersigned that the ASPR Committee desires a recommendation of policy regarding allowance of the expenses for training technical, engineering and scientific personnel as well as "vocational training," i.e., training of machinists, welders, electricians, etc. The undersigned feel that the ASPR Subcommittee on Training Costs was assigned the task of developing and proposing a policy on a staff basis, and was not expected to side-step the issue by requesting higher authority itself to do the ground-work toward establishing said policy. This is made amply clear in "Instructions to and Duties of ASPR Subcommittees," dated 30 August 1955.

It seems to the undersigned that the group presenting Enclosures (1), (2), and (3) base their thinking on the unrealistic position that the training of welders is more important than the training of scientific and engineering personnel. We believe this position is untenable from the standpoint of assuring the delivery of high quality end-items on a timely basis. The national need for a substantial increase in quality and quantity of scientific personnel is too well known to require elaboration. The President and other principal officials of the Executive Branch have expressed concern over the problem as a key factor in maintaining technological supremacy. Objective measures of industry's needs are reflected in the classified sections of the daily newspapers and in industry's frantic efforts to recruit the graduates of engineering schools.

In the face of these shortages, industry has in the last few years fostered college and post-graduate level training of their own employees as the most immediate and direct way of meeting their production problems, and the demand for products of ever increasing quality and complexity. This is particularly true in military applications of nucleonics, aeronautics and electronics.

As a matter of general principle, it seems to us that costs incurred in such a training program are valid costs of production which will result in better performance on military contracts. The proposed policy set forth in Enclosure (4) is designed in best interests of the Government, with due consideration of fairness and equity to industry. It does not allow all educational and training costs at the college and post-graduate training level. It takes due account of commercial practice in today's situation. At the same time, it limits and defines the allowability of such costs and requires the contractor to bear his own share thereof.

There appears to be agreement between the group presenting Enclosures (1), (2), and (3) and group presenting Enclosures (4) and (5) regarding allowability of costs of non-collegiate training.

The major point at issue is the allowability of costs of college and post-graduate level scientific and engineering training. Paragraphs b and c of Enclosure (4) place limits upon the allowability of such training, whether it be part-time or full-time. Paragraph b defines the types of expenses allowable and the amount of part-time training for which an employee may be compensated. Essentially, it allows for costs of tuition, fees, training materials and textbooks, because the most common practice is for education after paid working hours. Where circumstances do not permit education during paid working hours, regular employee compensation is also allowable not in excess of 156 hours per year. This is the approximate equivalent of one 3-hour course per week.

Paragraph c of Enclosure (4) deals with scientific and engineering education on a full-time basis. It recognizes that such arrangements are occasionally necessary, but prescribes reasonable limits of allowability. It limits reimbursability to bona fide employee; to training in scientific and engineering areas; to post-graduate training alone; and total reimbursement to one school year unless required in unusual cases by military technology. Most important, it limits Government payments to the educational expense alone, (i.e., to tuition, fees, etc.,), leaving the contractor to incur the cost of compensation. Since the Government's costs in these very special instances will be on the order of a pro-rated part of $1,000 per year, while the contractor's share for compensation is likely to be at least of an order of $5,000 per year (typical salary of an inexperienced engineer), it is felt that contractors will not incur such costs unless there is some positive benefit.

In general, it is felt that the distinction made in Enclosure (1) and (2) between long range and immediate needs is a fictitious one. The need for more and better scientific and engineering personnel - and the educational programs designed to meet such needs - is in a real sense immediate. It is just as immediate and certainly more important than the need for training welders, from the standpoint of obtaining the complex military equipment needed in today's situation. Actually, the government is in many cases allowing costs of college and post-graduate training, but not on a uniform basis and certainly with no clearly defined limitations and standards.

The undersigned therefore recommend the adoption of the policy set forth in Enclosure (4) for incorporation in ASPR 15-204.2 (bb), "Training and Educational Expenses."

/s/ Thomas B. Worsley
Thomas B. Worsley, Army

/s/ Paul M. Southwell
Paul M. Southwell, Air Force
Procurement Member

/s/ Albert Kay
Albert Kay, OASD (MP&R)

15-204.2(bb) - Training and Educational Expenses

a. Preparation and maintenance of a program of instruction designed to increase the vocational effectiveness of employees include the salaries of the director of training and staff, training materials and textbooks when the training program is conducted by the contractor; and tuition, fees, training materials, and textbooks, when the training is of a non-college level in institutions conducted by other than the contractor. Inboth instances, allowable costs may include salaries or wages of trainees during regular working hours.

b. Certain part-time technical, engineering and scientific training costs of a college level are allowable in cases where the training is required for contract performance and is directly related to the job requirements of the employee as follows:

(1) Tuition, fees, training materials and textbooks.

(2) Employee compensation is allowable during regular working hours for instruction not in excess of a total of 156 hours per year in cases where circumstances do not permit training after paid working hours.

c. The costs of general educational programs of a college level, including scholarships and fellowships, and the costs of training and education of other than bona fide employees are not allowable.

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The above appears to me to be in line with industry practice, reasonable, equitable, and to provide incentive to contractors for the economical use of Government funds in that rigid limitations are established for payment of costs of training of engineering and scientific personnel in terms of relation to contract performance.

/s/ [illegible]

OGC/GWM:ag
6 July 1956

MEMORANDUM FOR THE ASPR COMMITTEE

Subj: ASPR Case 53-44 -- Revision of Section XV, Contract Cost Principles

1. The editing and reproduction of Part 1 of Section XV have been completed and this edited Part is attached hereto.

2. In editing this Part, the Editing Subcommittee considered it preferable to place the material set forth in proposed ASPR 15-102.2 in Part 1 rather than add it to Part 5 which would become unnecessary to retain when Parts 3, 4, and 7 are developed on the same bases as the proposed new Part 2.

3. The edited Part 2 of Section XV, dated 20 April 1956, was furnished to you with memorandum of 26 April 1956 and was subsequently corrected as indicated in the memorandum of May 7, 1956 to the Secretary of the ASPR Committee.

4. The Editing Subcommittee recommends that the attached Part 1 be released for publication simultaneously with Part 2.

Charles W. Wilkinson Lt. Colonel, SS JAG Army Member	George W. Markey, Jr. Navy Member Chairman	John W. Perry Air Force Member

Encl.

SECTION XV

CONTRACT COST PRINCIPLES

15-000 Scope of Section. This Section sets forth principles and standards for the determination and allowance of costs in connection with the performance of cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder.

PART 1 - GENERAL

15-101 Applicability. Subject to ASPR 15-102, the provisions of Part 2, Part 3, Part 4, or Part 7 of this Section (whichever Part is applicable) shall be followed in connection with all cost-reimbursement type contracts (including cost-reimbursement subcontracts thereunder); however, when deemed by the Head of a Procuring Activity concerned to be more suitable for a particular contract, Part 2 may be followed in place of Parts 3, 4, or 7 (and see ASPR, Section III, Part 7, as to negotiated overhead rates). The term "cost-reimbursement type contract," as used throughout this Section, includes cost contracts, cost-sharing contracts, cost-plus-a-fixed-fee contracts, cost-plus-incentive-fee contracts, and the cost-reimbursement portion of time-and-materials or other contracts (see ASPR 3-404 and 3-405.1).

15-102 Contract Provisions.

15-102.1 General. Part 2, Part 3, Part 4, or Part 7 of this Section (whichever is applicable) shall be made a part of every contract of the type referred to in ASPR 15-101, by setting forth the appropriate Part in the contract, appending it to the contract, or incorporating it by reference in the contract; however:

(i) any such contract may expressly make unallowable any item of cost which would otherwise be allowable under the Part of this Section which is made a part of the contract; and

(ii) any contract subject to Part 3 or 4 (including those made subject thereto by Part 7) may expressly provide for the allowability of any of the kinds of costs referred to in Part 5 of this Section unless any such cost is expressly excluded under Part 3 or 4 (whichever is applicable).

21 June 1956

MEMORANDUM FOR: CHAIRMAN, ASPR COMMITTEE

SUBJECT: Revision of Part 2, Section XV (Case 53-44)

1. This Memorandum, commenting upon proposed paragraph 15-204.2(y) concerning the reimbursement of taxes for certain cost contracts, is submitted in compliance with the assignment by your Committee of 5 June 1956.

2. This Memorandum represents the unanimous opinion of the Tax Subcommittee.

3. It is recommended that the first sentence of subparagraph (1) include a reference to taxes of foreign governments, inasmuch as Part 2 of Section XV is sometimes incorporated into contracts requiring performance in foreign areas. Such contracts sometimes do not have special tax clauses or have uncomprehensive ones. The first sentence of subparagraph (1) should read:

"Taxes are charges levied by Federal, State, local, and foreign governments."

4. The last two sentences of subparagraph (2) should be revised as follows:

"Reasonable expenses of any administrative or judicial proceeding instituted or defended by the contractor, pursuant to the instructions or with the approval of the Contracting Officer, for the benefit of the Government are allowable costs. Interest and penalties incurred by the contractor also are allowable, either (i) if incurred by following the instructions of the Contracting Officer, or (ii) in the absence of instructions from the Contracting Officer, if incurred without the fault or negligence of the contractor."

SUBJECT: Revision of Part 2, Section XV (Case 53-44)

This language will permit the reimbursement of costs of litigation and of interest and penalties in a number of situations where such costs are incurred for the benefit of the Government and without any fault of the contractor. As the paragraph now reads, there is serious doubt whether reimbursement would be allowed in a number of typical circumstances, including the following: (1) for interest and penalties incurred by a contractor for nonpayment of a tax where the Contracting Officer had not adopted a position, the nonpayment was reasonable, and the taxing authority made a typical belated assessment which included interest and penalties; (2) for costs incurred by a contractor in defending a suit for collection of tax brought by a taxing authority, in contrast with a suit for refund; (3) for costs incurred by a contractor in taking reasonable action pending receipt of instructions from the Contracting Officer. The suggested language will make the reimbursement of costs of litigation and of interest and penalties parallel, insofar as possible, to the treatment of these costs in the proposed tax clauses for fixed price contracts.

5. It is recommended that the following sentence be added to subparagraph (3):

> "Any interest actually paid or credited to a contractor incident to a refund of tax, interest and penalty shall be paid or credited to the Government only to the extent that such interest accrued over the period during which the contractor had been reimbursed by the Government for the taxes, interest, and penalties."

The purpose of this provision is self-evident. However, it is a refinement that may be deemed unnecessary for cost contracts.

6. For your convenience, there is attached hereto a copy of proposed paragraph 15-204.2(y) as the Tax Subcommittee recommends that it be amended.

Mark H. Berens

MARK H. BERENS
1st Lt., JAGC
Acting Chairman, Tax Subcommittee

Incl. - Draft of paragraph
15-204.2(y)

Proposed paragraph 15-204.2(y) as recommended by Tax Subcommittee

(y) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(g));

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

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

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

Subpara (y) Taxes (cont'd)

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

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

~~Reasonable costs of any such proceeding instituted by the contractor at the direction of the contracting officer are allowable. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are also allowable.~~ [Reasonable expenses of any administrative or judicial proceeding instituted or defended by the contractor, pursuant to the instructions or with the approval of the Contracting Officer, for the benefit of the Government are allowable costs. Interest and penalties incurred by the contractor also are allowable, either (i) if incurred by following the instructions of the Contracting Officer, or (ii) in the absence of instructions from the Contracting Officer, if incurred without the fault or negligence of the contractor.]

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

OGC/JG:clc 21 June 1956

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

Subj: Revision of ASPR 12-202 to Conform to Proposed ASPR 15-204.2(n) (Overtime, Extra-Pay Shift and Multi-Shift Work) - Case 53-44

1. Pursuant to Item 12 of ASPR Minutes of 8 May 1956, the subject material has been edited as set forth in TAB A.

2. In ASPR 12-102(b), the Edited Committee has deleted the word "generally", thus requiring prior authorization for premium work in all post-award instances, so that subparagraph (b) is now consistent with the concept adopted in ASPR 15-204.2(n).

3. Inasmuch as the draft submitted to the Editing Committee desired the word "firm" to be inserted "wherever language is intended to apply only to firm fixed-price contracts," the Editing Committee has appropriately added fixed-price incentive contracts in (b)(ii); but did not feel that it was the intent of the subject matter to include fixed-price contracts with escalation in (b)(ii), as well.

Lt. Col. Charles W. Wilkinson
Army Member

John Green
Chairman
Navy Member

John W. Perry
Air Force Member

Incl. TAB A

OGC/JG:c1c
6/20/56

ASPR Case 53-44

12-102 Overtime, Extra-Pay Shifts, and Multi-Shift Work. (a) Contracts shall be performed, so far as possible, without the use of overtime, extra-pay shifts, or multi-shifts. Overtime, extra-pay shifts, and multi-shifts when required shall, to the extent possible, be limited to, and be the minimum required for, the accomplishment of the specific work. In the negotiation of contracts, the use of overtime, extra-pay shifts, and multi-shifts is a factor to be considered by the contracting officer along with other factors listed in ASPR 3-101. Prior to the authorization of overtime, extra-pay shifts, and multi-shifts, whether in pre-award negotiation or specific post-award instances, consideration shall be given to the practicability of using other sources for the furnishing of all or a portion of the supplies or services.

(b) In the case of firm fixed-price contracts or fixed-price contracts with escalation, the responsibility for the use of overtime, extra-pay shifts, and multi-shifts shall rest with the contractor except to the extent specifically provided for in the contract. In the case of:

(i) cost-reimbursement type contracts; and

(ii) redeterminable fixed-price contracts and fixed-price incentive contracts, to the extent required by the contracting officer;

authorization from the Government for the use of overtime, extra-pay shifts, and multi-shifts must be obtained if any premium direct labor costs are to

TAB A

be considered under the contract. approval should generally Such ~~authorization shall~~ be obtained prior to the use of overtime, extra-pay shifts, and multi-shifts. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable and allocated on a pro rata basis to commercial as well as Government work. For further requirements, see ASPR 15-204.2(n). Nothing herein shall be construed to authorize the premium portion of overtime, extra-pay shift and multi-shift payments where the contractor is already obligated under the contract to meet the ~~desired~~ required delivery schedule without the right to additional compensation.

(c) In the absence of evidence to the contrary, a Department in authorizing overtime, extra-pay shifts, or multi-shifts may generally rely upon the representation of the contractor that such authorization will not adversely affect the performance of other defense contracts. However, where two or more Departments have current contracts at a single facility so scheduled that the authorization of overtime, extra-pay shifts, or multi-shifts by one Department may adversely affect the performance of a contract or contracts of another Department, the Department desiring to give such authorization shall obtain the prior assent of the other Departments concerned. Such assent shall be given wherever possible. In any case where disagreement exists between the Departments concerned, either Department may refer the problem to the Assistant Secretary of Defense (Supply and Logistics) for decision.

2 May 1956

MEMORANDUM FOR THE ASPR COMMITTEE

SUBJECT: Revision of ASPR 12-102 to Conform to Proposed ASPR 15-204.2(n) (Overtime, Extra-Pay Shift and Multi-Shift Work) Case 53-44

As requested at the April 6 meeting (see Item 1, Minutes, April 6 Mtg), the Staff has examined ASPR 12-102 to determine whether any revision thereof is necessary to conform to the proposed cost principle relating to the above subject.

It is concluded that a change should be made in ASPR 12-102(a) to indicate that in cost-reimbursement type contracts, prior approval is required for allowability of costs incurred in the payment of premium wages for direct labor, while such approval is not required in the case of similar payments for indirect labor.

It is proposed that ASPR 12-102(a) be revised to read substantially as set forth in Tab A (in which deletions are interlined and additions are enclosed within brackets).

It is also recommended that the following editorial changes be made in ASPR 12-202 at the same time:

a. Substitute the words "Department of Defense" for "each Department" in stating the policy.

b. Insert the word "-reimbursement" after "cost" wherever reference is made to "cost type contracts" or similar expressions.

c. Insert the word "firm" in front of the words "fixed-price contracts" wherever language is intended to apply only to firm fixed-price contracts.

d. Change initial capital letters of such words as "Contractor" and "Contracting Officers" to conform to current editing rules.

e. Include a cross-reference to ASPR 15-204.2(n).

W. K. Ghormley
Brigadier General, USA
Chairman, ASPR Committee

Attachment

COMPOSITE DRAFT OF ASPR 12-102
SHOWING RECOMMENDED CHANGES

12-102 Overtime, Extra-Pay Shifts and Multi-Shift Work. It shall be the policy of ~~each~~ [the] Department [of Defense] that contracts will be performed, so far as practicable, without the use of overtime, extra-pay shifts, or multi-shifts. Overtime, extra-pay shifts, and multi-shifts when required shall, to the extent practicable, be limited to and be the minimum required for, the accomplishment of the specific work.

(a) In the negotiation of contracts, the use of overtime, extra-pay shifts, and multi-shifts is to be considered a factor by the ~~Contracting Officer~~ [contracting officer] along with other factors listed in ASPR 3-101. Subsequent to the placing of a [firm] fixed-price contract, the responsibility for the use of overtime, extra-pay shifts, and multi-shifts will generally rest with the ~~Contractor~~ [contractor]. On cost [-reimbursement] type contracts, and to the extent required by the ~~Contracting Officer~~ [contracting officer] on redeterminable fixed price contracts, however, the authorization from the Government for the use of overtime, extra-pay shifts, and multi-shifts must be obtained to sustain the charge of any premium [direct] labor costs to the contract. Such authorizations shall generally be obtained prior to the use of overtime, extra-pay shifts, and multi-shifts. [The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work. Further requirements for allowability of such costs are set forth in ASPR 15-204.2(n).] Prior to the authorization of overtime, extra-pay shifts, and multi-shifts, whether in

pre-award negotiation or specific post-award instances consideration should be given to the practicability of using other sources for the furnishing of all or a portion of the supplies or services.

(b) Where two or more Departments have current contracts at a single facility, so scheduled that the authorization of overtime, extra-pay shifts, or multi-shifts by one Department will adversely affect the performance of a contract or contracts of another Department, the Department concerned will wherever practicable agree in advance as to the authorization of such work. Ordinarily, in the absence of evidence to the contrary, a Department in authorizing overtime, extra-pay shifts, or multi-shifts may rely upon a representation of the ~~Contractor~~ [contractor] that such authorization will not adversely affect the performance of other defense contracts. In any case where disagreement exists between the Departments concerned, either Department may refer the problem to the Assistant Secretary of Defense (Supply and Logistics) for decision.

(c) The policy stated above shall not be construed to limit the use of or payment for emergency overtime work as may be required. Nothing herein shall be construed to authorize payment for overtime, extra-pay shifts and multi-shifts where, under an existing contract, the ~~Contractor~~ [contractor] is already obligated without the right to additional compensation therefor to meet the desired delivery schedule, even though it is necessary for such a contractor to use overtime, extra-pay shifts or multi-shifts to meet such schedule.

OGC/GWM:lwt
26 April 1956

MEMORANDUM TO CHAIRMAN, ASPR COMMITTEE

Subj: ASPR Case 53-44 - Revision of Section XV Contract Cost Principles

1. The editing and reproduction of Part 2, Section XV, have been completed and a copy of the edited Part is attached hereto.

2. The edited part includes the Staff version of the previously reserved proposed ASPR 15-204.2(d), as revised at the ASPR Committee meeting of Tuesday, April 24, 1956, by the insertion of the words "under any such plan" in the last sentence of this paragraph after the word "allowable." It is understood that this paragraph is subject to the statement to be included in the notes and filing instructions in accordance with the action taken by the Material Secretaries on Action Paper No. 15 (Summary of Meeting No. 25 - Department of Defense Material Secretaries Council, 12 April 1956); and, also, that its inclusion in Part 2 is without prejudice to the respective Departmental positions with respect to the subject matter covered.

3. The following minor editing refinements have been made in the attached draft:

15-200 — Fifth line, the insertion of a comma after "subcontractors."

15-204.2(k) — First, second, and third lines of first sentence, commas replaced to clarify parenthetical aspect of the relative clause.

15-204.2(x) — First line, insertion of quotation marks around the term "special tooling" for purposes of consistent treatment based on action with respect to proposed ASPR 15-204.2(d) referred to above.

— Last complete line, comma deleted.

15-204.3(b) — Fourth line, the insertion of a comma in the parenthetical sentence after the word "programs."

15-204.3(k) — Third line, the word "or" corrected to "of."

George W. Markey, Jr.

GEORGE W. MARKEY, JR.
Navy Member
Chairman

NEWS RELEASE

PLEASE NOTE DATE

DEPARTMENT OF DEFENSE
OFFICE OF PUBLIC INFORMATION
Washington 25, D. C.

NO. 456-55

IMMEDIATE RELEASE — MAY 12, 1955 — LI 5-6700 Ext. 53201 53176

Case 53-44

DEPRECIATION PARAGRAPH INCLUDED IN ASPR COST INTERPRETATION

A cost interpretation paragraph, relating to depreciation, will be included as part of Section XV of the Armed Services Procurement Regulation, effective June 1, 1955, Thomas P. Pike, Assistant Secretary of Defense (Supply and Logistics), announced today.

The new paragraph, 15-602, which will be published by the Government Printing Office as Revision of the ASPR, follows:

"15-602 - Depreciation.

"15-602.1 - Applicability and Effective Date. This cost interpretation pertains to ASPR 15-204(d), 15-205(b) and 15-205(o). It is applicable with respect to all cost-reimbursement type contracts placed on and after 1 June 1955 and, also, to all existing cost-reimbursement type contracts not completed at that date except as to predetermined overhead rates or fixed amounts of overhead which have finally been agreed upon for particular periods. However, the foregoing sentence does not supersede any express agreement in writing that a different interpretation shall be applicable.

"15-602.2 - Allowances for Depreciation. Allowances for depreciation (other than "true depreciation") as provided in Section 167 of the Internal Revenue Code of 1954, subject to the limitations set forth in paragraph 15-602.3, shall be acceptable for contract costing purposes. Allowances for "true depreciation", as that term is defined in DOD Instruction 4105.34 of 1 July 1954, shall be in accordance with said Instruction, and shall be exclusive of other methods of depreciation with respect to the assets involved in the determination of "true depreciation."

"15-602.3 - Interpretation. Depreciation computed in accordance with paragraph 15-602.2 above is allowable provided it meets the test of reasonableness and allocability to defense contracts and other applicable provisions of this Section. Meeting these tests may depend upon whether (i) the depreciation allowance in the particular case is acceptable for tax purposes, and (ii) the costing of defense contracts is on a basis consistent with the costing of the contractor's non-defense work and is so reflected in its books and records."

E N D

15 August 1956

MEMORANDUM FOR: CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44 - Section XV - 15-204.2(aa)
Training and Educational Costs

Pursuant to Item 3 of ASPR minutes of 7 August 1956, the Editing Committee has edited the subject material, as set forth in Tab A.

C. W. Wilkinson
Lt. Colonel, JAGC
Chairman
Army Member

John Green
Navy Member
(absent)

John W. Perry
Air Force Member

Incl: Tab A

DEPARTMENT OF THE NAVY
OFFICE OF NAVAL MATERIAL
WASHINGTON 25,D. C.

M36/ACS:ll
2 August 1956

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

Subj: Case 53-44 - Special Subcommittee ASPR 15-204.2(bb) Training and Educational Expense

Ref: (a) Report of Subcommittee of 12 July 1956

Encl: (1) Proposed language for ASPR 15-204.2(bb)

1. Reference (a) was considered by the ASPR Committee at their meeting on 31 July 1956. A number of recommendations were made which the subcommittee has endeavored to incorporate in enclosure (1).

2. It is probable that subparagraph e of enclosure (1) will also be included in ASPR 15-204.3 - Unallowable Costs and referenced back to ASPR 15-204.2(bb).

3. The enclosure has not been coordinated with the Office of the Secretary of Defense, Office of Manpower Supply, it being the understanding of the Subcommittee that the ASPR Committee would do so.

A. C. Sawallisch, Chairman

Committee Members

Mr. Paul H. Southwell, AFMPP
Mr. Thos. B. Worsley, Army Ord.
Mr. W. L. Latta, AFAUD
Mr. James Ruttenberg, NAVCOMPT(CAD)

15-204.2(bb) - Training and Educational Expenses

a. The costs of preparation and maintenance of a program of instruction at non-college level designed to increase the vocational effectivenss of employees include the salaries of the director of training and staff, training materials and textbooks when the training program is conducted by the contractor; and tuition, fees, training materials, and textbooks, when the training is of a non-college level in institutions conducted by other than the contractor. Such costs are allowable. In both instances, costs may include salaries or wages of trainees during regular working hours.

b. The costs of part-time technical, engineering and scientific education, related to the job requirements of bona fide employees, at an under-graduate or post-graduate college level are allowable as follows:

1. Tuition, fees, training materials and textbooks; or, in lieu of tuition, instructors' salaries and the related share of indirect expense, provided that the sum thereof is not in excess of the tuition which would have been paid to the participating educational institution.

2. Straight-time compensation of employees for time spent attending classes not in excess of a total of 156 hours per year where circumstances do not permit the operation of classes after regular working hours.

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

d. Maintenance expense and normal depreciation or fair rental on facilities owned or leased by the contractor are allowable to the extent that such facilities are used under programs falling within a or b, above.

e. The costs of training and education of other than bona fide employees are not allowable.

f. Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships, are considered a s contributions and will be treated as provided under ASPR 15-204.3(c).

Enclosure 1

DEPARTMENT OF THE NAVY
OFFICE OF NAVAL MATERIAL
WASHINGTON 25, D. C.

M36/ACS:11

12 July 1956

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

Subj: Case 53-44 - Special Subcommittee ASPR 15-204.2(bb) Training and Educational Expense

Encl: (1) Proposed draft as agreed upon by Mr. W. L. Latta, AFAUD; Mr. James Ruttenberg, Navy CAD, and A. C. Sawallisch, Navy ONM.
(2) Discussions in support of enclosure (1).
(3) Proposed draft of Memorandum to the Secretary of Defense or other competent authority for ruling on the disputed portion.
(4) Proposed draft as agreed upon by Mr. Paul Southwell, AFMPP; Mr. Thomas B. Worsley, Army Ord, and Mr. Albert Kay, Office of ASTSECDEF(MANPOWER & RESERVE.)
(5) Discussion in support of enclosure (4).
(6) Proposed Section ASPR 15-204.2(bb) presented by Mr. Ken Borgen, Navy Industrial Manpower, and discussion in support thereof.

1. The Special Subcommittee appointed by the ASPR Committee on 6 April 1956 to consider the problem of extent to which Training and Educational Costs should be allowed is unable to come to complete agreement and the diverse opinions are being presented to the ASPR Committee for resolution.

2. Agreement has been reached, with some differences in language, to allow the costs of (i) vocational training, whether it be "in-plant" or in vocational or trade schools, i.e., the training of welders, electricians, machine operators, etc., and (ii) training of a short term nature which is necessary to meet an immediate, clearly defined need of the contractor in connection with a specific engineering, production or administrative problem. The latter type of training may be in the plants or laboratories of other contractors or of the Government, or in technical institutions as well as in trade or vocational schools.

3. The essential difference concerns the allowability of costs for college and post-graduate courses in the sciences and engineering in a curriculum leading to higher academic degrees rather than to meet an immediate need of the contractor. Enclosures (1), (2) and (3) present the position of the group which is of the opinion that there is no existing Department of Defense policy which permits the acceptance of such costs and are of the further opinion that policy making in this field, being of a National interest, should be undertaken by those in the Government chargedwith respect to education and training rather than

by purchasing and accounting personnel. Enclosures (4) and (5) present the position of the group which would allow such costs, together with standards and limitations for allowability thereof. Enclosure (6) is a draft of proposed ASPR Section 15-204.2(bb) submitted by Mr. Ken Borgen, Navy Industrial Manpower.

A. C. SAWALLISCH, CHAIRMAN

Committee Members

Mr. W. L. Latta, AFAUD
Mr. James Ruttenberg, Navy CAD
Mr. Paul M. Southwell, AFMPP
Mr. Thos. B. Worsley, Army Ord.

Coordinated with:

Mr. Albert Kay, OASD(MP&R)
Mr. Ken Borgen, Navy Industrial Manpower

15-204.2(bb) Training and Educational Expense.

(a) Vocational training is that type of training, generally of a short term nature, which is necessary to meet an immediate, clearly defined need of the contractor, such as training to overcome a particular engineering, production, or administrative problem. It may be carried on in plant, in trade or vocational schools or in technical institutions. The costs of preparing and carrying out vocational training courses may include the salaries or wages of the training director and staff; training material and text books when the program is controlled by the contractor, and the salaries or wages of trainees for time spent during regular working hours. Costs may also include the salaries or wages of trainees for time spent duringregular working hours, travel, tuition, laboratory fees, training materials and text books when the training is carried out in vocational, trade or technical training institutions. Such costs are allowable when reasonable and properly allocated to all work of the contractor.

(b) The costs of educational and general training programs of a type aimed primarily at increasing the general educational or skill level of trainees, rather than solving immediate specific problems are not allowable. This includes the general area of long range management, executive or professional training programs and scholarships, fellowships or other emoluments to employees or others.

DISCUSSIONS IN SUPPORT OF ENCLOSURE (1)

1. It is the opinion of the undersigned that under existing policies there should be separate treatments for expenses in connection with vocational training; i.e., training of supervisors, machine operators, welders, electricians, etc. and the education in technological fields of engineers, scientists, etc.

2. It has long been the practice of industry to support the expense of vocational training. This practice had its recognized acceptance in the guild and apprentice systems which have for years been a part of union agreements. An acceleration of this practice was instituted during World War II when the shortage of skilled workmen and foremen became acute and the Armed Services established a policy of accepting a pro-rata portion of such costs in connection with Defense contracting. It is the opinion of the undersigned that that practice should be continued and that it be made clear that training costs in vocational or technical training schools also be acceptable in order to give identical support in those instances where smallfirms find it impratical to conduct "in-plant" vocational or technical training.

3. While the undersigned do not question the need for development of more and better engineering and scientific personnel, they do not consider that the policy heretofore followed in regard to vocational training expenses should be automatically applied to educational costs in the professional and academic fields without a delineation of policy by competent authority. If one uses current newspaper, magazine and company publication stories as basis for judgement, these costs are going to be substantial and their acceptance in cost-type contracting would make their acceptance in redeterminable and incentive type contracting almost mandatory.

4. A proposed paragraph ASPR 15-204.2(bb) is attached as enclosure (1) which would allow the cost of the type training discussed in paragraph 2 above and not allow the costs of the type discussed in paragraph 3 above. It is in connection with the type of costs discussed in paragraph 3 above that the Committee cannot come to agreement. Enclosure (3) is a draft of a memorandum which the ASPR Committee may wish to submit to competent authority for a statement of policy.

Enclosure (2)

MEMORANDUM FOR THE SECRETARY OF DEFENSE

Subj: Employee Educational Costs Incurred by Defense Contractors

1. The stepped-up production requirements during World War II created a demand for skilled craftsmen such as welders, electricians, etc. that could be met only by extensive training courses, most of which were conducted on an "in-plant" basis. A policy to accept such training costs in connection with Defense contracts was established and has been continued.

2. The current demand by industry for more and more engineers and scientists to produce the highly technical military items now in use and to carry out the extensive research and development programs is well known. A recent study by the Phoenix, Arizona, Chamber of Commerce stated that this years graduating class would fall short by 50,000 men. In an effort to meet this demand numerous educational programs, both graduate and undergraduate are being instituted and given financial support by industry and our procuring activities are faced with the problem of how much, if any, of the costs of such programs should be allowed in the costing or pricing of Defense contracts. The following excerpts are taken from an article on the subject in the May 26 "Business Week."

"Many companies have set up programs to send a few of their more highly talented engineers to graduate schools full-time. Others are planning to send their engineers to special graduate courses a few hours a week, on company time. Some are trying to persuade graduate school facilities to set up off-campus schools for their engineers by offering to build facilities and pay instructors."

Convair Division of General Dynamics Corporation is working hard to persuade the University of California regents to set up a graduate school at San Diego and "guarantees students for the center, has promised aid in funds, equipment, and pay for the faculty. Unofficial estimates put the cost of building the center at close to $4 million."

General Electric is just establishing a program which "will send 20 engineers to Syracuse University and 40 to Rensselaer Polytechnic Institute to work for their doctorates. It will pay the cost of their tuition and books, put them on the company pay roll and they will get seniority and credit for any benefits that might accrue to them."

Syracuse University is operating three branches; one at Griffs Air Force Base at Rome, NewYork, for Air Force engineers and General Electric engineers from a nearby plant; the second and third at Endicott and Poughkeepsie, New York, for I.B.M. engineers. The Air Force and IBM supply classrooms on their own properties and the two companies and the Air Force foot the bills for faculty salaries, travel and overhead.

Enclosure (3)

Rensselaer Polytechnic is operating a graduate school near Hartford, Connecticut, in facilities provided by United Aircraft Corporation. 80% of the students are United Aircraft Corporation employees and the United Aircraft Corporation is underwriting the experiment for five years. The cost to the company is about $1,000 a year per student.

A recent Raytheon Manufacturing Company plant publication announced availability to their science and engineering employees of educational grants at M.I.T. and Harvard. Grants willcover full tuition, fees, book allowance and a monthly salary of $240 while in residence at the school. Undergraduate students are also considered if working for a science or engineering degree and plan to join the company upon graduation.

3. Obviously, the costs to industry for support of these programs will become significant, particularly in the aviation, guided missile, electronic, nuclear physics and other highly technical fields where the shortage of engineers and scientists is greatest, and it is in those fields where the military departments are the principal customers. Assuming, therefore, that such costs were accepted, even on an allocated basis, substantial dollars appropriated for the purchase of Defense material would be spent in support of educational programs.

4. It is well known that the present National policy is to encourage industry, colleges, universities, and foundations to give support to any program designed to increase the quantity and quality of engineering and scientific personnel. It has not been noted, however, that any Government financial support has been made available for the furtherance of such programs. A number of questions therefore present themselves in connection with the possible acceptance of such costs in our contracting.

a. If it is determined that the National interest requires a Government subsidy for engineering and scientific education, should the subsidy be administered through private contractors, thereby working to their individual competitive advantage, including a profit on their participation in the program, or should it be administered directly by the Government.

b. If participation is to be through the allowance of the cost in Defense contracting should such support be limited to (i) specific fields and, if so, which fields; (ii) which types of cost should be allowable, i.e., tuition, laboratory fees, salaries paid to instructors, text books, compensation of students while in attendance, cost of scholarships, etc; (iii) should Defense participation be limited to a specified ratio of total contract costs?

5. Procurement and audit policies and procedures in this area are greatly in need. It is my opinion, however, that some basic policy which could be prescribed from answers to the question proposed above must first be established. Since this is an area coming within the purview of your office, I will greatly appreciate an expression from you as to the policy we should pursue.

15-204.2(bb) - Training and Educational Expenses

a. Preparation and maintenance of a program of instruction designed to increase the vocational effectiveness of employees include the salaries of the director of training and staff, training materials and textbooks when the training program is conducted by the contractor; and tuition, fees, training materials, and textbooks, when the training is of a non-college level in institutions conducted by other than the contractor. In both instances, costs may include salaries or wages of trainees during regular working hours.

b. Part-time technical, engineering and scientific education at an under-graduate or post-graduate college level as follows:

1. Tuition, fees, training materials and textbooks.

2. Where circumstances do not permit education after paid working hours, regular employee compensation is also allowable for instruction not in excess of a total of 156 hours per year.

c. Tuition, fees, training materials and textbooks (but not subsistence, salary, or any other emoluments) in connection with scientific and engineering education of bona fide employees on a full-time basis at a post-graduate college level for a total period not to exceed one school year. In unusual cases where required by military technology, the period may be extended.

/d. The costs of training and education of other than bona fide employees, including scholarships and fellowships, are not allowable./*

* This paragraph could be transferred to part of Section XV covering unallowable costs.

Discussion in Support of Enclosure (4)

The undersigned representatives of Army and Air Force join in the following staff report and recommendations. These are concurred in on a staff basis by the representative of the Office of the Assistant Secretary of Defense (MP&R).

It is the opinion of the undersigned that the ASPR Committee desires a recommendation of policy regarding allowance of the expenses for training technical, engineering and scientific personnel as well as "vocational training," i.e., training of machinists, welders, electricians, etc. The undersigned feel that the ASPR Subcommittee on Training Costs was assigned the task of developing and proposing a policy on a staff basis, and was not expected to side-step the issue by requesting higher authority itself to do the ground-work toward establishing said policy. This is made amply clear in "Instructions to and Duties of ASPR Subcommittees," dated 30 August 1955.

It seems to the undersigned that the group presenting Enclosures (1), (2), and (3) base their thinking on the unrealistic position that the training of welders is more important than the training of scientific and engineering personnel. We believe this position is untenable from the standpoint of assuring the delivery of high quality end-items on a timely basis. The national need for a substantial increase in quality and quantity of scientific personnel is too well known to require elaboration. The President and other principal officials of the Executive Branch have expressed concern over the problem as a key factor in maintaining technological supremacy. Objective measures of industry's needs are reflected in the classified sections of the daily newspapers and in industry's frantic efforts to recruit the graduates of engineering schools.

In the face of these shortages, industry has in the last few years fostered college and post-graduate level training of their own employees as the most immediate and direct way of meeting their production problems, and the demand for products of ever increasing quality and complexity. This is particularly true in military applications of nucleonics, aeronautics and electronics.

As a matter of general principle, it seems to us that costs incurred in such a training program are valid costs of production which will result in better performance on military contracts. The proposed policy set forth in Enclosure (4) is designed in best interests of the Government, with due consideration of fairness and equity to industry. It does not allow all educational and training costs at the college and post-graduate training level. It takes due account of commercial practice in today's situation. At the same time, it limits and defines the allowability of such costs and requires the contractor to bear his own share thereof.

There appears to be agreement between the group presenting Enclosures (1), (2), and (3) and group presenting Enclosures (4) and (5) regarding allowability of costs of non-collegiate training.

The major point at issue is the allowability of costs of college and post-graduate level scientific and engineering training. Paragraphs b and c of Enclosure (4) place limits upon the allowability of such training, whether it be part-time or full-time. Paragraph b defines the types of expenses allowable and the amount of part-time training for which an employee may be compensated. Essentially, it allows for costs of tuition, fees, training materials and textbooks, because the most common practice is for education after paid working hours. Where circumstances do not permit education during paid working hours, regular employee compensation is also allowable not in excess of 156 hours per year. This is the approximate equivalent of one 3-hour course per week.

Paragraph c of Enclosure (4) deals with scientific and engineering education on a full-time basis. It recognizes that such arrangements are occasionally necessary, but prescribes reasonable limits of allowability. It limits reimbursability to bona fide employee; to training in scientific and engineering areas; to post-graduate training alone; and total reimbursement to one school year unless required in unusual cases by military technology. Most important, it limits Government payments to the educational expense alone, (i.e., to tuition, fees, etc.,), leaving the contractor to incur the cost of compensation. Since the Government's costs in these very special instances will be on the order of a pro-rated part of $1,000 per year, while the contractor's share for compensation is likely to be at least of an order of $5,000 per year (typical salary of an inexperienced engineer), it is felt that contractors will not incur such costs unless there is some positive benefit.

In general, it is felt that the distinction made in Enclosure (1) and (2) between long range and immediate needs is a fictitious one. The need for more and better scientific and engineering personnel - and the educational programs designed to meet such needs - is in a real sense immediate. It is just as immediate and certainly more important than the need for training welders, from the standpoint of obtaining the complex military equipment needed in today's situation. Actually, the government is in many cases allowing costs of college and post-graduate training, but not on a uniform basis and certainly with no clearly defined limitations and standards.

The undersigned therefore recommend the adoption of the policy set forth in Enclosure (4) for incorporation in ASPR 15-204.2 (bb), "Training and Educational Expenses."

/s/ Thomas B. Worsley
Thomas B. Worsley, Army

/s/ Paul M. Southwell
Paul M. Southwell, Air Force
Procurement Member

/s/ Albert Kay
Albert Kay, OASD (MP&R)

15-204.2(bb) - Training and Educational Expenses

a. Preparation and maintenance of a program of instruction designed to increase the vocational effectiveness of employees include the salaries of the director of training and staff, training materials and textbooks when the training program is conducted by the contractor; and tuition, fees, training materials, and textbooks, when the training is of a non-college level in institutions conducted by other than the contractor. Inboth instances, allowable costs may include salaries or wages of trainees during regular working hours.

b. Certain part-time technical, engineering and scientific training costs of a college level are allowable in cases where the training is required for contract performance and is directly related to the job requirements of the employee as follows:

(1) Tuition, fees, training materials and textbooks.

(2) Employee compensation is allowable during regular working hours for instruction not in excess of a total of 156 hours per year in cases where circumstances do not permit training after paid working hours.

c. The costs of general educational programs of a college level, including scholarships and fellowships, and the costs of training and education of other than bona fide employees are not allowable.

- - - - -

The above appears to me to be in line with industry practice, reasonable, equitable, and to provide incentive to contractors for the economical use of Government funds in that rigid limitations are established for payment of costs of training of engineering and scientific personnel in terms of relation to contract performance.

/s/ [illegible]

OGC/GWM:ag
6 July 1956

MEMORANDUM FOR THE ASPR COMMITTEE

Subj: ASPR Case 53-44 -- Revision of Section XV, Contract Cost Principles

1. The editing and reproduction of Part 1 of Section XV have been completed and this edited Part is attached hereto.

2. In editing this Part, the Editing Subcommittee considered it preferable to place the material set forth in proposed ASPR 15-102.2 in Part 1 rather than add it to Part 5 which would become unnecessary to retain when Parts 3, 4, and 7 are developed on the same bases as the proposed new Part 2.

3. The edited Part 2 of Section XV, dated 20 April 1956, was furnished to you with memorandum of 26 April 1956 and was subsequently corrected as indicated in the memorandum of May 7, 1956 to the Secretary of the ASPR Committee.

4. The Editing Subcommittee recommends that the attached Part 1 be released for publication simultaneously with Part 2.

Charles W. Wilkinson Lt. Colonel, SS JAG Army Member	George W. Markey, Jr. Navy Member Chairman	John W. Perry Air Force Member

Encl.

SECTION XV

CONTRACT COST PRINCIPLES

15-000 Scope of Section. This Section sets forth principles and standards for the determination and allowance of costs in connection with the performance of cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder.

PART 1 - GENERAL

15-101 Applicability. Subject to ASPR 15-102, the provisions of Part 2, Part 3, Part 4, or Part 7 of this Section (whichever Part is applicable) shall be followed in connection with all cost-reimbursement type contracts (including cost-reimbursement subcontracts thereunder); however, when deemed by the Head of a Procuring Activity concerned to be more suitable for a particular contract, Part 2 may be followed in place of Parts 3, 4, or 7 (and see ASPR, Section III, Part 7, as to negotiated overhead rates). The term "cost-reimbursement type contract," as used throughout this Section, includes cost contracts, cost-sharing contracts, cost-plus-a-fixed-fee contracts, cost-plus-incentive-fee contracts, and the cost-reimbursement portion of time-and-materials or other contracts (see ASPR 3-404 and 3-405.1).

15-102 Contract Provisions.

15-102.1 General. Part 2, Part 3, Part 4, or Part 7 of this Section (whichever is applicable) shall be made a part of every contract of the type referred to in ASPR 15-101, by setting forth the appropriate Part in the contract, appending it to the contract, or incorporating it by reference in the contract; however:

(i) any such contract may expressly make unallowable any item of cost which would otherwise be allowable under the Part of this Section which is made a part of the contract; and

(ii) any contract subject to Part 3 or 4 (including those made subject thereto by Part 7) may expressly provide for the allowability of any of the kinds of costs referred to in Part 5 of this Section unless any such cost is expressly excluded under Part 3 or 4 (whichever is applicable).

21 June 1956

MEMORANDUM FOR: CHAIRMAN, ASPR COMMITTEE

SUBJECT: Revision of Part 2, Section XV (Case 53-44)

1. This Memorandum, commenting upon proposed paragraph 15-204.2(y) concerning the reimbursement of taxes for certain cost contracts, is submitted in compliance with the assignment by your Committee of 5 June 1956.

2. This Memorandum represents the unanimous opinion of the Tax Subcommittee.

3. It is recommended that the first sentence of subparagraph (1) include a reference to taxes of foreign governments, inasmuch as Part 2 of Section XV is sometimes incorporated into contracts requiring performance in foreign areas. Such contracts sometimes do not have special tax clauses or have uncomprehensive ones. The first sentence of subparagraph (1) should read:

"Taxes are charges levied by Federal, State, local, and foreign governments."

4. The last two sentences of subparagraph (2) should be revised as follows:

"Reasonable expenses of any administrative or judicial proceeding instituted or defended by the contractor, pursuant to the instructions or with the approval of the Contracting Officer, for the benefit of the Government are allowable costs. Interest and penalties incurred by the contractor also are allowable, either (i) if incurred by following the instructions of the Contracting Officer, or (ii) in the absence of instructions from the Contracting Officer, if incurred without the fault or negligence of the contractor."

SUBJECT: Revision of Part 2, Section XV (Case 53-44)

This language will permit the reimbursement of costs of litigation and of interest and penalties in a number of situations where such costs are incurred for the benefit of the Government and without any fault of the contractor. As the paragraph now reads, there is serious doubt whether reimbursement would be allowed in a number of typical circumstances, including the following: (1) for interest and penalties incurred by a contractor for nonpayment of a tax where the Contracting Officer had not adopted a position, the nonpayment was reasonable, and the taxing authority made a typical belated assessment which included interest and penalties; (2) for costs incurred by a contractor in defending a suit for collection of tax brought by a taxing authority, in contrast with a suit for refund; (3) for costs incurred by a contractor in taking reasonable action pending receipt of instructions from the Contracting Officer. The suggested language will make the reimbursement of costs of litigation and of interest and penalties parallel, insofar as possible, to the treatment of these costs in the proposed tax clauses for fixed price contracts.

5. It is recommended that the following sentence be added to subparagraph (3):

> "Any interest actually paid or credited to a contractor incident to a refund of tax, interest and penalty shall be paid or credited to the Government only to the extent that such interest accrued over the period during which the contractor had been reimbursed by the Government for the taxes, interest, and penalties."

The purpose of this provision is self-evident. However, it is a refinement that may be deemed unnecessary for cost contracts.

6. For your convenience, there is attached hereto a copy of proposed paragraph 15-204.2(y) as the Tax Subcommittee recommends that it be amended.

Mark H. Berens

MARK H. BERENS
1st Lt., JAGC
Acting Chairman, Tax Subcommittee

Incl. - Draft of paragraph
15-204.2(y)

Proposed paragraph 15-204.2(y) as recommended by Tax Subcommittee

(y) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(g));

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

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

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

Subpara (y) Taxes (cont'd)

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

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

~~Reasonable costs of any such proceeding instituted by the contractor at the direction of the contracting officer are allowable. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are also allowable.~~ [Reasonable expenses of any administrative or judicial proceeding instituted or defended by the contractor, pursuant to the instructions or with the approval of the Contracting Officer, for the benefit of the Government are allowable costs. Interest and penalties incurred by the contractor also are allowable, either (i) if incurred by following the instructions of the Contracting Officer, or (ii) in the absence of instructions from the Contracting Officer, if incurred without the fault or negligence of the contractor.]

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

OGC/JG:clc 21 June 1956

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

Subj: Revision of ASPR 12-202 to Conform to Proposed ASPR 15-204.2(n) (Overtime, Extra-Pay Shift and Multi-Shift Work) - Case 53-44

1. Pursuant to Item 12 of ASPR Minutes of 8 May 1956, the subject material has been edited as set forth in TAB A.

2. In ASPR 12-102(b), the Edited Committee has deleted the word "generally", thus requiring prior authorization for premium work in all post-award instances, so that subparagraph (b) is now consistent with the concept adopted in ASPR 15-204.2(n).

3. Inasmuch as the draft submitted to the Editing Committee desired the word "firm" to be inserted "wherever language is intended to apply only to firm fixed-price contracts," the Editing Committee has appropriately added fixed-price incentive contracts in (b)(ii); but did not feel that it was the intent of the subject matter to include fixed-price contracts with escalation in (b)(ii), as well.

Lt. Col. Charles W. Wilkinson
Army Member

John Green
Chairman
Navy Member

John W. Perry
Air Force Member

Incl. TAB A

OGC/JG:c1c
6/20/56

ASPR Case 53-44

12-102 Overtime, Extra-Pay Shifts, and Multi-Shift Work. (a) Contracts shall be performed, so far as possible, without the use of overtime, extra-pay shifts, or multi-shifts. Overtime, extra-pay shifts, and multi-shifts when required shall, to the extent possible, be limited to, and be the minimum required for, the accomplishment of the specific work. In the negotiation of contracts, the use of overtime, extra-pay shifts, and multi-shifts is a factor to be considered by the contracting officer along with other factors listed in ASPR 3-101. Prior to the authorization of overtime, extra-pay shifts, and multi-shifts, whether in pre-award negotiation or specific post-award instances, consideration shall be given to the practicability of using other sources for the furnishing of all or a portion of the supplies or services.

(b) In the case of firm fixed-price contracts or fixed-price contracts with escalation, the responsibility for the use of overtime, extra-pay shifts, and multi-shifts shall rest with the contractor except to the extent specifically provided for in the contract. In the case of:

(i) cost-reimbursement type contracts; and

(ii) redeterminable fixed-price contracts and fixed-price incentive contracts, to the extent required by the contracting officer;

authorization from the Government for the use of overtime, extra-pay shifts, and multi-shifts must be obtained if any premium direct labor costs are to

TAB A

be considered under the contract. approval should generally Such ~~authorization shall~~ be obtained prior to the use of overtime, extra-pay shifts, and multi-shifts. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable and allocated on a pro rata basis to commercial as well as Government work. For further requirements, see ASPR 15-204.2(n). Nothing herein shall be construed to authorize the premium portion of overtime, extra-pay shift and multi-shift payments where the contractor is already obligated under the contract to meet the ~~desired~~ required delivery schedule without the right to additional compensation.

(c) In the absence of evidence to the contrary, a Department in authorizing overtime, extra-pay shifts, or multi-shifts may generally rely upon the representation of the contractor that such authorization will not adversely affect the performance of other defense contracts. However, where two or more Departments have current contracts at a single facility so scheduled that the authorization of overtime, extra-pay shifts, or multi-shifts by one Department may adversely affect the performance of a contract or contracts of another Department, the Department desiring to give such authorization shall obtain the prior assent of the other Departments concerned. Such assent shall be given wherever possible. In any case where disagreement exists between the Departments concerned, either Department may refer the problem to the Assistant Secretary of Defense (Supply and Logistics) for decision.

2 May 1956

MEMORANDUM FOR THE ASPR COMMITTEE

SUBJECT: Revision of ASPR 12-102 to Conform to Proposed ASPR 15-204.2(n) (Overtime, Extra-Pay Shift and Multi-Shift Work) Case 53-44

As requested at the April 6 meeting (see Item 1, Minutes, April 6 Mtg), the Staff has examined ASPR 12-102 to determine whether any revision thereof is necessary to conform to the proposed cost principle relating to the above subject.

It is concluded that a change should be made in ASPR 12-102(a) to indicate that in cost-reimbursement type contracts, prior approval is required for allowability of costs incurred in the payment of premium wages for direct labor, while such approval is not required in the case of similar payments for indirect labor.

It is proposed that ASPR 12-102(a) be revised to read substantially as set forth in Tab A (in which deletions are interlined and additions are enclosed within brackets).

It is also recommended that the following editorial changes be made in ASPR 12-202 at the same time:

a. Substitute the words "Department of Defense" for "each Department" in stating the policy.

b. Insert the word "-reimbursement" after "cost" wherever reference is made to "cost type contracts" or similar expressions.

c. Insert the word "firm" in front of the words "fixed-price contracts" wherever language is intended to apply only to firm fixed-price contracts.

d. Change initial capital letters of such words as "Contractor" and "Contracting Officers" to conform to current editing rules.

e. Include a cross-reference to ASPR 15-204.2(n).

W. K. Ghormley
Brigadier General, USA
Chairman, ASPR Committee

Attachment

COMPOSITE DRAFT OF ASPR 12-102
SHOWING RECOMMENDED CHANGES

12-102 Overtime, Extra-Pay Shifts and Multi-Shift Work. It shall be the policy of ~~each~~ [the] Department [of Defense] that contracts will be performed, so far as practicable, without the use of overtime, extra-pay shifts, or multi-shifts. Overtime, extra-pay shifts, and multi-shifts when required shall, to the extent practicable, be limited to and be the minimum required for, the accomplishment of the specific work.

(a) In the negotiation of contracts, the use of overtime, extra-pay shifts, and multi-shifts is to be considered a factor by the ~~Contracting Officer~~ [contracting officer] along with other factors listed in ASPR 3-101. Subsequent to the placing of a [firm] fixed-price contract, the responsibility for the use of overtime, extra-pay shifts, and multi-shifts will generally rest with the ~~Contractor~~ [contractor]. On cost [-reimbursement] type contracts, and to the extent required by the ~~Contracting Officer~~ [contracting officer] on redeterminable fixed price contracts, however, the authorization from the Government for the use of overtime, extra-pay shifts, and multi-shifts must be obtained to sustain the charge of any premium [direct] labor costs to the contract. Such authorizations shall generally be obtained prior to the use of overtime, extra-pay shifts, and multi-shifts. [The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work. Further requirements for allowability of such costs are set forth in ASPR 15-204.2(n).] Prior to the authorization of overtime, extra-pay shifts, and multi-shifts, whether in

pre-award negotiation or specific post-award instances consideration should be given to the practicability of using other sources for the furnishing of all or a portion of the supplies or services.

(b) Where two or more Departments have current contracts at a single facility, so scheduled that the authorization of overtime, extra-pay shifts, or multi-shifts by one Department will adversely affect the performance of a contract or contracts of another Department, the Department concerned will wherever practicable agree in advance as to the authorization of such work. Ordinarily, in the absence of evidence to the contrary, a Department in authorizing overtime, extra-pay shifts, or multi-shifts may rely upon a representation of the ~~Contractor~~ [contractor] that such authorization will not adversely affect the performance of other defense contracts. In any case where disagreement exists between the Departments concerned, either Department may refer the problem to the Assistant Secretary of Defense (Supply and Logistics) for decision.

(c) The policy stated above shall not be construed to limit the use of or payment for emergency overtime work as may be required. Nothing herein shall be construed to authorize payment for overtime, extra-pay shifts and multi-shifts where, under an existing contract, the ~~Contractor~~ [contractor] is already obligated without the right to additional compensation therefor to meet the desired delivery schedule, even though it is necessary for such a contractor to use overtime, extra-pay shifts or multi-shifts to meet such schedule.

OGC/GWM:lwt
26 April 1956

MEMORANDUM TO CHAIRMAN, ASPR COMMITTEE

Subj: ASPR Case 53-44 - Revision of Section XV Contract Cost Principles

1. The editing and reproduction of Part 2, Section XV, have been completed and a copy of the edited Part is attached hereto.

2. The edited part includes the Staff version of the previously reserved proposed ASPR 15-204.2(d), as revised at the ASPR Committee meeting of Tuesday, April 24, 1956, by the insertion of the words "under any such plan" in the last sentence of this paragraph after the word "allowable." It is understood that this paragraph is subject to the statement to be included in the notes and filing instructions in accordance with the action taken by the Material Secretaries on Action Paper No. 15 (Summary of Meeting No. 25 - Department of Defense Material Secretaries Council, 12 April 1956); and, also, that its inclusion in Part 2 is without prejudice to the respective Departmental positions with respect to the subject matter covered.

3. The following minor editing refinements have been made in the attached draft:

15-200 — Fifth line, the insertion of a comma after "subcontractors."

15-204.2(k) — First, second, and third lines of first sentence, commas replaced to clarify parenthetical aspect of the relative clause.

15-204.2(x) — First line, insertion of quotation marks around the term "special tooling" for purposes of consistent treatment based on action with respect to proposed ASPR 15-204.2(d) referred to above.

— Last complete line, comma deleted.

15-204.3(b) — Fourth line, the insertion of a comma in the parenthetical sentence after the word "programs."

15-204.3(k) — Third line, the word "or" corrected to "of."

George W. Markey, Jr.

GEORGE W. MARKEY, JR.
Navy Member
Chairman

OGC/GWM:lwt
20 April 1956

Part 2 - Supply, Service, and Research and Development Contracts, with Commercial Organizations

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.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (i) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

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

15-201.3 Credits. The applicable portion of income, rebates, allowances, and other credits received by or accruing to the contractor which is related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

15-202 Direct Costs.

15-202.1 General. Items of cost which are readily identifiable with (i) a contract, or (ii) other work of the contractor, should be charged directly to the contract or other work with which identified. This principle may be applied to items of cost, such as freight, travel, communications, and engineering services, as well as materials and productive labor, but when used must be applied consistently to all work of the contractor. When the accounting expense of direct costing of minor items would exceed the

resulting benefits, individual items, which otherwise would be treated as direct costs, may be treated as indirect costs. Each element of direct cost is subject to the limitations of this Part as to allowability.

15-202.2 Direct Material Costs. Direct material costs include the cost of raw materials, purchased items, and items supplied from stock, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically identifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable. Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable only to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

15-203 Indirect Costs.

15-203.1 General. (a) Items of cost which are incurred for common or joint objectives, and which are not readily subject to treatment as direct costs in accordance with ASPR 15-202, should be accumulated for accounting purposes by logical cost groupings and charged by a process of allocation. Each element of indirect cost is subject to the limitations of this Part as to allowability.

(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.

(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 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.

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 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. 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. 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.

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 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below. These applications govern whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

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.

All other advertising costs are unallowable.

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

(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.

(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.

(e) Depreciation.

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

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

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

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

(iii) by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954.

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

(3) Where a contractor has received a determination of "true depreciation" from an Emergency Facilities Depreciation Board relating to an emergency facility covered by a certificate of necessity, it may elect to use either normal or "true" depreciation. However, the method elected must be followed consistently throughout the life of the emergency facility. Where an election is made to use normal depreciation, the amount thereof shall be computed in accordance with (2) above. Where an election is made to use "true depreciation," the amount allowable as depreciation:

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

(ii) after the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life (but see (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.

(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. Use charges for assets not fully depreciated on the contractor's books are unallowable.

(f) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred, in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(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.

(h) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition

to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor which constitutes, in effect, an implied agreement on the contractor's part (but see (d) above, and (i)(3)(v), (p) and (w) below).

(i) Insurance and Indemnification.

(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes securing the contractor against liabilities to third persons not compensated by insurance or otherwise.

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

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

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

(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 unallowable except to the extent that the Government shall have approved or required such insurance or reserve;

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

(v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(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.

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

(k) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable (but see ASPR 15-204.3(e)). Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis.

(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.

(l) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

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

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

are allowable.

(m) Material Costs.

(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.

(5) Reasonable charges or credits arising from a difference 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 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 sales price to its most favored customer.

(n) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government and may be classified as either direct or indirect labor costs. When direct labor cost is the base for distribution of overhead, such premiums shall not be included in that base. When such premiums are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work.

(o) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. 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) and (v) below.)

(p) Pension Plans.

(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, either the 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 plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P. L. 591, 83rd Cong., 2d 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 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) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall 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) in determining the net 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 —

(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 adjustment 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.

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

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

(1) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(g)).

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

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

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

(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 agreement.

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

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

(u) Research and Development Costs.

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

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable 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.

(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 allowable as precontract costs (see ASPR 15-204.3(j)).

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

(w) Severance Pay.

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

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

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

(ii) abnormal or mass severance payments actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of the 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.

(x) Special Tooling Costs. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling acquired for performance of the contract are allowable and shall be charged directly thereto.

(y) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(g));

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

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

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

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

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

Reasonable costs of any such proceeding instituted by the contractor at the direction of the contracting officer are allowable. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are also allowable.

(3) Any refund of taxes, interest, or penalties, and any payment to the contractor of interest thereon, attributable to taxes, interest, or penalties which were allowed as contract costs, shall be credited or paid to the Government in the manner directed by the Government.

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

(1) Memberships. Costs of membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(aa) Training Costs. Reserved.

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

(cc) Travel Costs.

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

(2) Travel costs incurred in the normal course of overall administration of the business and applicable to the entire business are allowable. 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.

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

(dd) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

(i) ASPR 15-204.3(f);

(ii) ASPR 15-204.3(j); and

(iii) ASPR 15-204.3(l).

15-204.3 Unallowable Costs.

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

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs, see ASPR 15-204.2(i).)

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

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

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

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

(g) Interest and Other Financial Costs. Interest (however represented), bond discounts, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of the prospectus, costs of preparation and issuance of stock rights, and costs related thereto are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in ASPR 15-204.2(y) (but see ASPR 15-204.2(dd)(1)).

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

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

(j) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract.

(k) Profits and Losses on Dispostion of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments, shall be excluded in computing contract costs (but see ASPR 15-204.2(e)(2) as to basis for depreciation).

(l) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately

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 unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(m) General.

(1) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

(i) Advertising Costs, ASPR 15-204.2(a), last sentence;

(ii) Depreciation, ASPR 15-204.2(e)(4), and (5), last sentence;

(iii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(r)(3), first sentence;

(iv) Recruiting Costs, ASPR 15-204.2(s), last sentence;

(v) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(v), both provisos; and

(vi) Taxes, ASPR 15-204.2(y)(1)(i) through (iv).

(2) Certain other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

(i) Civil Defense Costs, ASPR 15-204.2(c), last sentence;

(ii) Compensation for Personal Services, ASPR 15-204.2(d) (5);

(iii) Depreciation, ASPR 15-204.2(e)(5), first sentence;

(iv) Food Service Costs and Credits, ASPR 15-204.2(g), last sentence;

(v) Insurance and Indemnification, ASPR 15-204.2(i)(3)(iii) and (iv), and (4);

(vi) Maintenance and Repair Costs, ASPR 15-204.2(k)(2);

(vii) Overtime, Extra-Pay Shift, and Multi-Shift Premiums, ASPR 15-204.2(n), second sentence;

(viii) Patent Costs, ASPR 15-204.2(o), second sentence;

(ix) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(r)(3), last sentence;

(x) Rental Costs (Including Sale and Leaseback of Facilities), ASPR 15-204.2(t)(3);

(xi) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(v);

(xii) Taxes, ASPR 15-204.2(y)(2); and

(xiii) Travel Costs, ASPR 15-204.2(cc)(4).

NEWS RELEASE

PLEASE NOTE DATE

DEPARTMENT OF DEFENSE
OFFICE OF PUBLIC INFORMATION
Washington 25, D. C.

NO. 456-55

IMMEDIATE RELEASE — MAY 12, 1955 — LI 5-6700 Ext. 53201 53176

Case 53-44

DEPRECIATION PARAGRAPH INCLUDED IN ASPR COST INTERPRETATION

A cost interpretation paragraph, relating to depreciation, will be included as part of Section XV of the Armed Services Procurement Regulation, effective June 1, 1955, Thomas P. Pike, Assistant Secretary of Defense (Supply and Logistics), announced today.

The new paragraph, 15-602, which will be published by the Government Printing Office as Revision of the ASPR, follows:

"15-602 - Depreciation.

"15-602.1 - Applicability and Effective Date. This cost interpretation pertains to ASPR 15-204(d), 15-205(b) and 15-205(o). It is applicable with respect to all cost-reimbursement type contracts placed on and after 1 June 1955 and, also, to all existing cost-reimbursement type contracts not completed at that date except as to predetermined overhead rates or fixed amounts of overhead which have finally been agreed upon for particular periods. However, the foregoing sentence does not supersede any express agreement in writing that a different interpretation shall be applicable.

"15-602.2 - Allowances for Depreciation. Allowances for depreciation (other than "true depreciation") as provided in Section 167 of the Internal Revenue Code of 1954, subject to the limitations set forth in paragraph 15-602.3, shall be acceptable for contract costing purposes. Allowances for "true depreciation", as that term is defined in DOD Instruction 4105.34 of 1 July 1954, shall be in accordance with said Instruction, and shall be exclusive of other methods of depreciation with respect to the assets involved in the determination of "true depreciation."

"15-602.3 - Interpretation. Depreciation computed in accordance with paragraph 15-602.2 above is allowable provided it meets the test of reasonableness and allocability to defense contracts and other applicable provisions of this Section. Meeting these tests may depend upon whether (i) the depreciation allowance in the particular case is acceptable for tax purposes, and (ii) the costing of defense contracts is on a basis consistent with the costing of the contractor's non-defense work and is so reflected in its books and records."

E N D

15 August 1956

MEMORANDUM FOR: CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44 - Section XV - 15-204.2(aa)
Training and Educational Costs

Pursuant to Item 3 of ASPR minutes of 7 August 1956, the Editing Committee has edited the subject material, as set forth in Tab A.

C. W. Wilkinson
Lt. Colonel, JAGC
Chairman
Army Member

John Green
Navy Member
(absent)

John W. Perry
Air Force Member

Incl: Tab A

DEPARTMENT OF THE NAVY
OFFICE OF NAVAL MATERIAL
WASHINGTON 25,D. C.

M36/ACS:ll
2 August 1956

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

Subj: Case 53-44 - Special Subcommittee ASPR 15-204.2(bb) Training and Educational Expense

Ref: (a) Report of Subcommittee of 12 July 1956

Encl: (1) Proposed language for ASPR 15-204.2(bb)

1. Reference (a) was considered by the ASPR Committee at their meeting on 31 July 1956. A number of recommendations were made which the subcommittee has endeavored to incorporate in enclosure (1).

2. It is probable that subparagraph e of enclosure (1) will also be included in ASPR 15-204.3 - Unallowable Costs and referenced back to ASPR 15-204.2(bb).

3. The enclosure has not been coordinated with the Office of the Secretary of Defense, Office of Manpower Supply, it being the understanding of the Subcommittee that the ASPR Committee would do so.

A. C. Sawallisch, Chairman

Committee Members

Mr. Paul H. Southwell, AFMPP
Mr. Thos. B. Worsley, Army Ord.
Mr. W. L. Latta, AFAUD
Mr. James Ruttenberg, NAVCOMPT(CAD)

15-204.2(bb) - Training and Educational Expenses

a. The costs of preparation and maintenance of a program of instruction at non-college level designed to increase the vocational effectivenss of employees include the salaries of the director of training and staff, training materials and textbooks when the training program is conducted by the contractor; and tuition, fees, training materials, and textbooks, when the training is of a non-college level in institutions conducted by other than the contractor. Such costs are allowable. In both instances, costs may include salaries or wages of trainees during regular working hours.

b. The costs of part-time technical, engineering and scientific education, related to the job requirements of bona fide employees, at an under-graduate or post-graduate college level are allowable as follows:

1. Tuition, fees, training materials and textbooks; or, in lieu of tuition, instructors' salaries and the related share of indirect expense, provided that the sum thereof is not in excess of the tuition which would have been paid to the participating educational institution.

2. Straight-time compensation of employees for time spent attending classes not in excess of a total of 156 hours per year where circumstances do not permit the operation of classes after regular working hours.

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

d. Maintenance expense and normal depreciation or fair rental on facilities owned or leased by the contractor are allowable to the extent that such facilities are used under programs falling within a or b, above.

e. The costs of training and education of other than bona fide employees are not allowable.

f. Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships, are considered a s contributions and will be treated as provided under ASPR 15-204.3(c).

Enclosure 1

DEPARTMENT OF THE NAVY
OFFICE OF NAVAL MATERIAL
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12 July 1956

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

Subj: Case 53-44 - Special Subcommittee ASPR 15-204.2(bb) Training and Educational Expense

Encl: (1) Proposed draft as agreed upon by Mr. W. L. Latta, AFAUD; Mr. James Ruttenberg, Navy CAD, and A. C. Sawallisch, Navy ONM.
(2) Discussions in support of enclosure (1).
(3) Proposed draft of Memorandum to the Secretary of Defense or other competent authority for ruling on the disputed portion.
(4) Proposed draft as agreed upon by Mr. Paul Southwell, AFMPP; Mr. Thomas B. Worsley, Army Ord, and Mr. Albert Kay, Office of ASTSECDEF(MANPOWER & RESERVE.)
(5) Discussion in support of enclosure (4).
(6) Proposed Section ASPR 15-204.2(bb) presented by Mr. Ken Borgen, Navy Industrial Manpower, and discussion in support thereof.

1. The Special Subcommittee appointed by the ASPR Committee on 6 April 1956 to consider the problem of extent to which Training and Educational Costs should be allowed is unable to come to complete agreement and the diverse opinions are being presented to the ASPR Committee for resolution.

2. Agreement has been reached, with some differences in language, to allow the costs of (i) vocational training, whether it be "in-plant" or in vocational or trade schools, i.e., the training of welders, electricians, machine operators, etc., and (ii) training of a short term nature which is necessary to meet an immediate, clearly defined need of the contractor in connection with a specific engineering, production or administrative problem. The latter type of training may be in the plants or laboratories of other contractors or of the Government, or in technical institutions as well as in trade or vocational schools.

3. The essential difference concerns the allowability of costs for college and post-graduate courses in the sciences and engineering in a curriculum leading to higher academic degrees rather than to meet an immediate need of the contractor. Enclosures (1), (2) and (3) present the position of the group which is of the opinion that there is no existing Department of Defense policy which permits the acceptance of such costs and are of the further opinion that policy making in this field, being of a National interest, should be undertaken by those in the Government chargedwith respect to education and training rather than

by purchasing and accounting personnel. Enclosures (4) and (5) present the position of the group which would allow such costs, together with standards and limitations for allowability thereof. Enclosure (6) is a draft of proposed ASPR Section 15-204.2(bb) submitted by Mr. Ken Borgen, Navy Industrial Manpower.

A. C. SAWALLISCH, CHAIRMAN

Committee Members

Mr. W. L. Latta, AFAUD
Mr. James Ruttenberg, Navy CAD
Mr. Paul M. Southwell, AFMPP
Mr. Thos. B. Worsley, Army Ord.

Coordinated with:

Mr. Albert Kay, OASD(MP&R)
Mr. Ken Borgen, Navy Industrial Manpower

15-204.2(bb) Training and Educational Expense.

(a) Vocational training is that type of training, generally of a short term nature, which is necessary to meet an immediate, clearly defined need of the contractor, such as training to overcome a particular engineering, production, or administrative problem. It may be carried on in plant, in trade or vocational schools or in technical institutions. The costs of preparing and carrying out vocational training courses may include the salaries or wages of the training director and staff; training material and text books when the program is controlled by the contractor, and the salaries or wages of trainees for time spent during regular working hours. Costs may also include the salaries or wages of trainees for time spent duringregular working hours, travel, tuition, laboratory fees, training materials and text books when the training is carried out in vocational, trade or technical training institutions. Such costs are allowable when reasonable and properly allocated to all work of the contractor.

(b) The costs of educational and general training programs of a type aimed primarily at increasing the general educational or skill level of trainees, rather than solving immediate specific problems are not allowable. This includes the general area of long range management, executive or professional training programs and scholarships, fellowships or other emoluments to employees or others.

DISCUSSIONS IN SUPPORT OF ENCLOSURE (1)

1. It is the opinion of the undersigned that under existing policies there should be separate treatments for expenses in connection with vocational training; i.e., training of supervisors, machine operators, welders, electricians, etc. and the education in technological fields of engineers, scientists, etc.

2. It has long been the practice of industry to support the expense of vocational training. This practice had its recognized acceptance in the guild and apprentice systems which have for years been a part of union agreements. An acceleration of this practice was instituted during World War II when the shortage of skilled workmen and foremen became acute and the Armed Services established a policy of accepting a pro-rata portion of such costs in connection with Defense contracting. It is the opinion of the undersigned that that practice should be continued and that it be made clear that training costs in vocational or technical training schools also be acceptable in order to give identical support in those instances where smallfirms find it impratical to conduct "in-plant" vocational or technical training.

3. While the undersigned do not question the need for development of more and better engineering and scientific personnel, they do not consider that the policy heretofore followed in regard to vocational training expenses should be automatically applied to educational costs in the professional and academic fields without a delineation of policy by competent authority. If one uses current newspaper, magazine and company publication stories as basis for judgement, these costs are going to be substantial and their acceptance in cost-type contracting would make their acceptance in redeterminable and incentive type contracting almost mandatory.

4. A proposed paragraph ASPR 15-204.2(bb) is attached as enclosure (1) which would allow the cost of the type training discussed in paragraph 2 above and not allow the costs of the type discussed in paragraph 3 above. It is in connection with the type of costs discussed in paragraph 3 above that the Committee cannot come to agreement. Enclosure (3) is a draft of a memorandum which the ASPR Committee may wish to submit to competent authority for a statement of policy.

Enclosure (2)

MEMORANDUM FOR THE SECRETARY OF DEFENSE

Subj: Employee Educational Costs Incurred by Defense Contractors

1. The stepped-up production requirements during World War II created a demand for skilled craftsmen such as welders, electricians, etc. that could be met only by extensive training courses, most of which were conducted on an "in-plant" basis. A policy to accept such training costs in connection with Defense contracts was established and has been continued.

2. The current demand by industry for more and more engineers and scientists to produce the highly technical military items now in use and to carry out the extensive research and development programs is well known. A recent study by the Phoenix, Arizona, Chamber of Commerce stated that this years graduating class would fall short by 50,000 men. In an effort to meet this demand numerous educational programs, both graduate and undergraduate are being instituted and given financial support by industry and our procuring activities are faced with the problem of how much, if any, of the costs of such programs should be allowed in the costing or pricing of Defense contracts. The following excerpts are taken from an article on the subject in the May 26 "Business Week."

"Many companies have set up programs to send a few of their more highly talented engineers to graduate schools full-time. Others are planning to send their engineers to special graduate courses a few hours a week, on company time. Some are trying to persuade graduate school facilities to set up off-campus schools for their engineers by offering to build facilities and pay instructors."

Convair Division of General Dynamics Corporation is working hard to persuade the University of California regents to set up a graduate school at San Diego and "guarantees students for the center, has promised aid in funds, equipment, and pay for the faculty. Unofficial estimates put the cost of building the center at close to $4 million."

General Electric is just establishing a program which "will send 20 engineers to Syracuse University and 40 to Rensselaer Polytechnic Institute to work for their doctorates. It will pay the cost of their tuition and books, put them on the company pay roll and they will get seniority and credit for any benefits that might accrue to them."

Syracuse University is operating three branches; one at Griffs Air Force Base at Rome, NewYork, for Air Force engineers and General Electric engineers from a nearby plant; the second and third at Endicott and Poughkeepsie, New York, for I.B.M. engineers. The Air Force and IBM supply classrooms on their own properties and the two companies and the Air Force foot the bills for faculty salaries, travel and overhead.

Enclosure (3)

Rensselaer Polytechnic is operating a graduate school near Hartford, Connecticut, in facilities provided by United Aircraft Corporation. 80% of the students are United Aircraft Corporation employees and the United Aircraft Corporation is underwriting the experiment for five years. The cost to the company is about $1,000 a year per student.

A recent Raytheon Manufacturing Company plant publication announced availability to their science and engineering employees of educational grants at M.I.T. and Harvard. Grants willcover full tuition, fees, book allowance and a monthly salary of $240 while in residence at the school. Undergraduate students are also considered if working for a science or engineering degree and plan to join the company upon graduation.

3. Obviously, the costs to industry for support of these programs will become significant, particularly in the aviation, guided missile, electronic, nuclear physics and other highly technical fields where the shortage of engineers and scientists is greatest, and it is in those fields where the military departments are the principal customers. Assuming, therefore, that such costs were accepted, even on an allocated basis, substantial dollars appropriated for the purchase of Defense material would be spent in support of educational programs.

4. It is well known that the present National policy is to encourage industry, colleges, universities, and foundations to give support to any program designed to increase the quantity and quality of engineering and scientific personnel. It has not been noted, however, that any Government financial support has been made available for the furtherance of such programs. A number of questions therefore present themselves in connection with the possible acceptance of such costs in our contracting.

a. If it is determined that the National interest requires a Government subsidy for engineering and scientific education, should the subsidy be administered through private contractors, thereby working to their individual competitive advantage, including a profit on their participation in the program, or should it be administered directly by the Government.

b. If participation is to be through the allowance of the cost in Defense contracting should such support be limited to (i) specific fields and, if so, which fields; (ii) which types of cost should be allowable, i.e., tuition, laboratory fees, salaries paid to instructors, text books, compensation of students while in attendance, cost of scholarships, etc; (iii) should Defense participation be limited to a specified ratio of total contract costs?

5. Procurement and audit policies and procedures in this area are greatly in need. It is my opinion, however, that some basic policy which could be prescribed from answers to the question proposed above must first be established. Since this is an area coming within the purview of your office, I will greatly appreciate an expression from you as to the policy we should pursue.

15-204.2(bb) - Training and Educational Expenses

a. Preparation and maintenance of a program of instruction designed to increase the vocational effectiveness of employees include the salaries of the director of training and staff, training materials and textbooks when the training program is conducted by the contractor; and tuition, fees, training materials, and textbooks, when the training is of a non-college level in institutions conducted by other than the contractor. In both instances, costs may include salaries or wages of trainees during regular working hours.

b. Part-time technical, engineering and scientific education at an under-graduate or post-graduate college level as follows:

1. Tuition, fees, training materials and textbooks.

2. Where circumstances do not permit education after paid working hours, regular employee compensation is also allowable for instruction not in excess of a total of 156 hours per year.

c. Tuition, fees, training materials and textbooks (but not subsistence, salary, or any other emoluments) in connection with scientific and engineering education of bona fide employees on a full-time basis at a post-graduate college level for a total period not to exceed one school year. In unusual cases where required by military technology, the period may be extended.

/d. The costs of training and education of other than bona fide employees, including scholarships and fellowships, are not allowable./*

* This paragraph could be transferred to part of Section XV covering unallowable costs.

Discussion in Support of Enclosure (4)

The undersigned representatives of Army and Air Force join in the following staff report and recommendations. These are concurred in on a staff basis by the representative of the Office of the Assistant Secretary of Defense (MP&R).

It is the opinion of the undersigned that the ASPR Committee desires a recommendation of policy regarding allowance of the expenses for training technical, engineering and scientific personnel as well as "vocational training," i.e., training of machinists, welders, electricians, etc. The undersigned feel that the ASPR Subcommittee on Training Costs was assigned the task of developing and proposing a policy on a staff basis, and was not expected to side-step the issue by requesting higher authority itself to do the ground-work toward establishing said policy. This is made amply clear in "Instructions to and Duties of ASPR Subcommittees," dated 30 August 1955.

It seems to the undersigned that the group presenting Enclosures (1), (2), and (3) base their thinking on the unrealistic position that the training of welders is more important than the training of scientific and engineering personnel. We believe this position is untenable from the standpoint of assuring the delivery of high quality end-items on a timely basis. The national need for a substantial increase in quality and quantity of scientific personnel is too well known to require elaboration. The President and other principal officials of the Executive Branch have expressed concern over the problem as a key factor in maintaining technological supremacy. Objective measures of industry's needs are reflected in the classified sections of the daily newspapers and in industry's frantic efforts to recruit the graduates of engineering schools.

In the face of these shortages, industry has in the last few years fostered college and post-graduate level training of their own employees as the most immediate and direct way of meeting their production problems, and the demand for products of ever increasing quality and complexity. This is particularly true in military applications of nucleonics, aeronautics and electronics.

As a matter of general principle, it seems to us that costs incurred in such a training program are valid costs of production which will result in better performance on military contracts. The proposed policy set forth in Enclosure (4) is designed in best interests of the Government, with due consideration of fairness and equity to industry. It does not allow all educational and training costs at the college and post-graduate training level. It takes due account of commercial practice in today's situation. At the same time, it limits and defines the allowability of such costs and requires the contractor to bear his own share thereof.

There appears to be agreement between the group presenting Enclosures (1), (2), and (3) and group presenting Enclosures (4) and (5) regarding allowability of costs of non-collegiate training.

The major point at issue is the allowability of costs of college and post-graduate level scientific and engineering training. Paragraphs b and c of Enclosure (4) place limits upon the allowability of such training, whether it be part-time or full-time. Paragraph b defines the types of expenses allowable and the amount of part-time training for which an employee may be compensated. Essentially, it allows for costs of tuition, fees, training materials and textbooks, because the most common practice is for education after paid working hours. Where circumstances do not permit education during paid working hours, regular employee compensation is also allowable not in excess of 156 hours per year. This is the approximate equivalent of one 3-hour course per week.

Paragraph c of Enclosure (4) deals with scientific and engineering education on a full-time basis. It recognizes that such arrangements are occasionally necessary, but prescribes reasonable limits of allowability. It limits reimbursability to bona fide employee; to training in scientific and engineering areas; to post-graduate training alone; and total reimbursement to one school year unless required in unusual cases by military technology. Most important, it limits Government payments to the educational expense alone, (i.e., to tuition, fees, etc.,), leaving the contractor to incur the cost of compensation. Since the Government's costs in these very special instances will be on the order of a pro-rated part of $1,000 per year, while the contractor's share for compensation is likely to be at least of an order of $5,000 per year (typical salary of an inexperienced engineer), it is felt that contractors will not incur such costs unless there is some positive benefit.

In general, it is felt that the distinction made in Enclosure (1) and (2) between long range and immediate needs is a fictitious one. The need for more and better scientific and engineering personnel - and the educational programs designed to meet such needs - is in a real sense immediate. It is just as immediate and certainly more important than the need for training welders, from the standpoint of obtaining the complex military equipment needed in today's situation. Actually, the government is in many cases allowing costs of college and post-graduate training, but not on a uniform basis and certainly with no clearly defined limitations and standards.

The undersigned therefore recommend the adoption of the policy set forth in Enclosure (4) for incorporation in ASPR 15-204.2 (bb), "Training and Educational Expenses."

/s/ Thomas B. Worsley
Thomas B. Worsley, Army

/s/ Paul M. Southwell
Paul M. Southwell, Air Force
Procurement Member

/s/ Albert Kay
Albert Kay, OASD (MP&R)

15-204.2(bb) - Training and Educational Expenses

a. Preparation and maintenance of a program of instruction designed to increase the vocational effectiveness of employees include the salaries of the director of training and staff, training materials and textbooks when the training program is conducted by the contractor; and tuition, fees, training materials, and textbooks, when the training is of a non-college level in institutions conducted by other than the contractor. Inboth instances, allowable costs may include salaries or wages of trainees during regular working hours.

b. Certain part-time technical, engineering and scientific training costs of a college level are allowable in cases where the training is required for contract performance and is directly related to the job requirements of the employee as follows:

(1) Tuition, fees, training materials and textbooks.

(2) Employee compensation is allowable during regular working hours for instruction not in excess of a total of 156 hours per year in cases where circumstances do not permit training after paid working hours.

c. The costs of general educational programs of a college level, including scholarships and fellowships, and the costs of training and education of other than bona fide employees are not allowable.

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The above appears to me to be in line with industry practice, reasonable, equitable, and to provide incentive to contractors for the economical use of Government funds in that rigid limitations are established for payment of costs of training of engineering and scientific personnel in terms of relation to contract performance.

/s/ [illegible]

OGC/GWM:ag
6 July 1956

MEMORANDUM FOR THE ASPR COMMITTEE

Subj: ASPR Case 53-44 -- Revision of Section XV, Contract Cost Principles

1. The editing and reproduction of Part 1 of Section XV have been completed and this edited Part is attached hereto.

2. In editing this Part, the Editing Subcommittee considered it preferable to place the material set forth in proposed ASPR 15-102.2 in Part 1 rather than add it to Part 5 which would become unnecessary to retain when Parts 3, 4, and 7 are developed on the same bases as the proposed new Part 2.

3. The edited Part 2 of Section XV, dated 20 April 1956, was furnished to you with memorandum of 26 April 1956 and was subsequently corrected as indicated in the memorandum of May 7, 1956 to the Secretary of the ASPR Committee.

4. The Editing Subcommittee recommends that the attached Part 1 be released for publication simultaneously with Part 2.

Charles W. Wilkinson Lt. Colonel, SS JAG Army Member	George W. Markey, Jr. Navy Member Chairman	John W. Perry Air Force Member

Encl.

SECTION XV

CONTRACT COST PRINCIPLES

15-000 Scope of Section. This Section sets forth principles and standards for the determination and allowance of costs in connection with the performance of cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder.

PART 1 - GENERAL

15-101 Applicability. Subject to ASPR 15-102, the provisions of Part 2, Part 3, Part 4, or Part 7 of this Section (whichever Part is applicable) shall be followed in connection with all cost-reimbursement type contracts (including cost-reimbursement subcontracts thereunder); however, when deemed by the Head of a Procuring Activity concerned to be more suitable for a particular contract, Part 2 may be followed in place of Parts 3, 4, or 7 (and see ASPR, Section III, Part 7, as to negotiated overhead rates). The term "cost-reimbursement type contract," as used throughout this Section, includes cost contracts, cost-sharing contracts, cost-plus-a-fixed-fee contracts, cost-plus-incentive-fee contracts, and the cost-reimbursement portion of time-and-materials or other contracts (see ASPR 3-404 and 3-405.1).

15-102 Contract Provisions.

15-102.1 General. Part 2, Part 3, Part 4, or Part 7 of this Section (whichever is applicable) shall be made a part of every contract of the type referred to in ASPR 15-101, by setting forth the appropriate Part in the contract, appending it to the contract, or incorporating it by reference in the contract; however:

(i) any such contract may expressly make unallowable any item of cost which would otherwise be allowable under the Part of this Section which is made a part of the contract; and

(ii) any contract subject to Part 3 or 4 (including those made subject thereto by Part 7) may expressly provide for the allowability of any of the kinds of costs referred to in Part 5 of this Section unless any such cost is expressly excluded under Part 3 or 4 (whichever is applicable).

21 June 1956

MEMORANDUM FOR: CHAIRMAN, ASPR COMMITTEE

SUBJECT: Revision of Part 2, Section XV (Case 53-44)

1. This Memorandum, commenting upon proposed paragraph 15-204.2(y) concerning the reimbursement of taxes for certain cost contracts, is submitted in compliance with the assignment by your Committee of 5 June 1956.

2. This Memorandum represents the unanimous opinion of the Tax Subcommittee.

3. It is recommended that the first sentence of subparagraph (1) include a reference to taxes of foreign governments, inasmuch as Part 2 of Section XV is sometimes incorporated into contracts requiring performance in foreign areas. Such contracts sometimes do not have special tax clauses or have uncomprehensive ones. The first sentence of subparagraph (1) should read:

"Taxes are charges levied by Federal, State, local, and foreign governments."

4. The last two sentences of subparagraph (2) should be revised as follows:

"Reasonable expenses of any administrative or judicial proceeding instituted or defended by the contractor, pursuant to the instructions or with the approval of the Contracting Officer, for the benefit of the Government are allowable costs. Interest and penalties incurred by the contractor also are allowable, either (i) if incurred by following the instructions of the Contracting Officer, or (ii) in the absence of instructions from the Contracting Officer, if incurred without the fault or negligence of the contractor."

SUBJECT: Revision of Part 2, Section XV (Case 53-44)

This language will permit the reimbursement of costs of litigation and of interest and penalties in a number of situations where such costs are incurred for the benefit of the Government and without any fault of the contractor. As the paragraph now reads, there is serious doubt whether reimbursement would be allowed in a number of typical circumstances, including the following: (1) for interest and penalties incurred by a contractor for nonpayment of a tax where the Contracting Officer had not adopted a position, the nonpayment was reasonable, and the taxing authority made a typical belated assessment which included interest and penalties; (2) for costs incurred by a contractor in defending a suit for collection of tax brought by a taxing authority, in contrast with a suit for refund; (3) for costs incurred by a contractor in taking reasonable action pending receipt of instructions from the Contracting Officer. The suggested language will make the reimbursement of costs of litigation and of interest and penalties parallel, insofar as possible, to the treatment of these costs in the proposed tax clauses for fixed price contracts.

5. It is recommended that the following sentence be added to subparagraph (3):

> "Any interest actually paid or credited to a contractor incident to a refund of tax, interest and penalty shall be paid or credited to the Government only to the extent that such interest accrued over the period during which the contractor had been reimbursed by the Government for the taxes, interest, and penalties."

The purpose of this provision is self-evident. However, it is a refinement that may be deemed unnecessary for cost contracts.

6. For your convenience, there is attached hereto a copy of proposed paragraph 15-204.2(y) as the Tax Subcommittee recommends that it be amended.

Mark H. Berens

MARK H. BERENS
1st Lt., JAGC
Acting Chairman, Tax Subcommittee

Incl. - Draft of paragraph
15-204.2(y)

Proposed paragraph 15-204.2(y) as recommended by Tax Subcommittee

(y) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(g));

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

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

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

Subpara (y) Taxes (cont'd)

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

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

~~Reasonable costs of any such proceeding instituted by the contractor at the direction of the contracting officer are allowable. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are also allowable.~~ [Reasonable expenses of any administrative or judicial proceeding instituted or defended by the contractor, pursuant to the instructions or with the approval of the Contracting Officer, for the benefit of the Government are allowable costs. Interest and penalties incurred by the contractor also are allowable, either (i) if incurred by following the instructions of the Contracting Officer, or (ii) in the absence of instructions from the Contracting Officer, if incurred without the fault or negligence of the contractor.]

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

OGC/JG:clc 21 June 1956

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

Subj: Revision of ASPR 12-202 to Conform to Proposed ASPR 15-204.2(n) (Overtime, Extra-Pay Shift and Multi-Shift Work) - Case 53-44

1. Pursuant to Item 12 of ASPR Minutes of 8 May 1956, the subject material has been edited as set forth in TAB A.

2. In ASPR 12-102(b), the Edited Committee has deleted the word "generally", thus requiring prior authorization for premium work in all post-award instances, so that subparagraph (b) is now consistent with the concept adopted in ASPR 15-204.2(n).

3. Inasmuch as the draft submitted to the Editing Committee desired the word "firm" to be inserted "wherever language is intended to apply only to firm fixed-price contracts," the Editing Committee has appropriately added fixed-price incentive contracts in (b)(ii); but did not feel that it was the intent of the subject matter to include fixed-price contracts with escalation in (b)(ii), as well.

Lt. Col. Charles W. Wilkinson
Army Member

John Green
Chairman
Navy Member

John W. Perry
Air Force Member

Incl. TAB A

OGC/JG:c1c
6/20/56

ASPR Case 53-44

12-102 Overtime, Extra-Pay Shifts, and Multi-Shift Work. (a) Contracts shall be performed, so far as possible, without the use of overtime, extra-pay shifts, or multi-shifts. Overtime, extra-pay shifts, and multi-shifts when required shall, to the extent possible, be limited to, and be the minimum required for, the accomplishment of the specific work. In the negotiation of contracts, the use of overtime, extra-pay shifts, and multi-shifts is a factor to be considered by the contracting officer along with other factors listed in ASPR 3-101. Prior to the authorization of overtime, extra-pay shifts, and multi-shifts, whether in pre-award negotiation or specific post-award instances, consideration shall be given to the practicability of using other sources for the furnishing of all or a portion of the supplies or services.

(b) In the case of firm fixed-price contracts or fixed-price contracts with escalation, the responsibility for the use of overtime, extra-pay shifts, and multi-shifts shall rest with the contractor except to the extent specifically provided for in the contract. In the case of:

(i) cost-reimbursement type contracts; and

(ii) redeterminable fixed-price contracts and fixed-price incentive contracts, to the extent required by the contracting officer;

authorization from the Government for the use of overtime, extra-pay shifts, and multi-shifts must be obtained if any premium direct labor costs are to

TAB A

be considered under the contract. approval should generally Such ~~authorization shall~~ be obtained prior to the use of overtime, extra-pay shifts, and multi-shifts. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable and allocated on a pro rata basis to commercial as well as Government work. For further requirements, see ASPR 15-204.2(n). Nothing herein shall be construed to authorize the premium portion of overtime, extra-pay shift and multi-shift payments where the contractor is already obligated under the contract to meet the ~~desired~~ required delivery schedule without the right to additional compensation.

(c) In the absence of evidence to the contrary, a Department in authorizing overtime, extra-pay shifts, or multi-shifts may generally rely upon the representation of the contractor that such authorization will not adversely affect the performance of other defense contracts. However, where two or more Departments have current contracts at a single facility so scheduled that the authorization of overtime, extra-pay shifts, or multi-shifts by one Department may adversely affect the performance of a contract or contracts of another Department, the Department desiring to give such authorization shall obtain the prior assent of the other Departments concerned. Such assent shall be given wherever possible. In any case where disagreement exists between the Departments concerned, either Department may refer the problem to the Assistant Secretary of Defense (Supply and Logistics) for decision.

2 May 1956

MEMORANDUM FOR THE ASPR COMMITTEE

SUBJECT: Revision of ASPR 12-102 to Conform to Proposed ASPR 15-204.2(n) (Overtime, Extra-Pay Shift and Multi-Shift Work) Case 53-44

As requested at the April 6 meeting (see Item 1, Minutes, April 6 Mtg), the Staff has examined ASPR 12-102 to determine whether any revision thereof is necessary to conform to the proposed cost principle relating to the above subject.

It is concluded that a change should be made in ASPR 12-102(a) to indicate that in cost-reimbursement type contracts, prior approval is required for allowability of costs incurred in the payment of premium wages for direct labor, while such approval is not required in the case of similar payments for indirect labor.

It is proposed that ASPR 12-102(a) be revised to read substantially as set forth in Tab A (in which deletions are interlined and additions are enclosed within brackets).

It is also recommended that the following editorial changes be made in ASPR 12-202 at the same time:

a. Substitute the words "Department of Defense" for "each Department" in stating the policy.

b. Insert the word "-reimbursement" after "cost" wherever reference is made to "cost type contracts" or similar expressions.

c. Insert the word "firm" in front of the words "fixed-price contracts" wherever language is intended to apply only to firm fixed-price contracts.

d. Change initial capital letters of such words as "Contractor" and "Contracting Officers" to conform to current editing rules.

e. Include a cross-reference to ASPR 15-204.2(n).

W. K. Ghormley
Brigadier General, USA
Chairman, ASPR Committee

Attachment

COMPOSITE DRAFT OF ASPR 12-102
SHOWING RECOMMENDED CHANGES

12-102 Overtime, Extra-Pay Shifts and Multi-Shift Work. It shall be the policy of ~~each~~ [the] Department [of Defense] that contracts will be performed, so far as practicable, without the use of overtime, extra-pay shifts, or multi-shifts. Overtime, extra-pay shifts, and multi-shifts when required shall, to the extent practicable, be limited to and be the minimum required for, the accomplishment of the specific work.

(a) In the negotiation of contracts, the use of overtime, extra-pay shifts, and multi-shifts is to be considered a factor by the ~~Contracting Officer~~ [contracting officer] along with other factors listed in ASPR 3-101. Subsequent to the placing of a [firm] fixed-price contract, the responsibility for the use of overtime, extra-pay shifts, and multi-shifts will generally rest with the ~~Contractor~~ [contractor]. On cost [-reimbursement] type contracts, and to the extent required by the ~~Contracting Officer~~ [contracting officer] on redeterminable fixed price contracts, however, the authorization from the Government for the use of overtime, extra-pay shifts, and multi-shifts must be obtained to sustain the charge of any premium [direct] labor costs to the contract. Such authorizations shall generally be obtained prior to the use of overtime, extra-pay shifts, and multi-shifts. [The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work. Further requirements for allowability of such costs are set forth in ASPR 15-204.2(n).] Prior to the authorization of overtime, extra-pay shifts, and multi-shifts, whether in

pre-award negotiation or specific post-award instances consideration should be given to the practicability of using other sources for the furnishing of all or a portion of the supplies or services.

(b) Where two or more Departments have current contracts at a single facility, so scheduled that the authorization of overtime, extra-pay shifts, or multi-shifts by one Department will adversely affect the performance of a contract or contracts of another Department, the Department concerned will wherever practicable agree in advance as to the authorization of such work. Ordinarily, in the absence of evidence to the contrary, a Department in authorizing overtime, extra-pay shifts, or multi-shifts may rely upon a representation of the ~~Contractor~~ [contractor] that such authorization will not adversely affect the performance of other defense contracts. In any case where disagreement exists between the Departments concerned, either Department may refer the problem to the Assistant Secretary of Defense (Supply and Logistics) for decision.

(c) The policy stated above shall not be construed to limit the use of or payment for emergency overtime work as may be required. Nothing herein shall be construed to authorize payment for overtime, extra-pay shifts and multi-shifts where, under an existing contract, the ~~Contractor~~ [contractor] is already obligated without the right to additional compensation therefor to meet the desired delivery schedule, even though it is necessary for such a contractor to use overtime, extra-pay shifts or multi-shifts to meet such schedule.

OGC/GWM:lwt
26 April 1956

MEMORANDUM TO CHAIRMAN, ASPR COMMITTEE

Subj: ASPR Case 53-44 - Revision of Section XV Contract Cost Principles

1. The editing and reproduction of Part 2, Section XV, have been completed and a copy of the edited Part is attached hereto.

2. The edited part includes the Staff version of the previously reserved proposed ASPR 15-204.2(d), as revised at the ASPR Committee meeting of Tuesday, April 24, 1956, by the insertion of the words "under any such plan" in the last sentence of this paragraph after the word "allowable." It is understood that this paragraph is subject to the statement to be included in the notes and filing instructions in accordance with the action taken by the Material Secretaries on Action Paper No. 15 (Summary of Meeting No. 25 - Department of Defense Material Secretaries Council, 12 April 1956); and, also, that its inclusion in Part 2 is without prejudice to the respective Departmental positions with respect to the subject matter covered.

3. The following minor editing refinements have been made in the attached draft:

15-200 — Fifth line, the insertion of a comma after "subcontractors."

15-204.2(k) — First, second, and third lines of first sentence, commas replaced to clarify parenthetical aspect of the relative clause.

15-204.2(x) — First line, insertion of quotation marks around the term "special tooling" for purposes of consistent treatment based on action with respect to proposed ASPR 15-204.2(d) referred to above.

— Last complete line, comma deleted.

15-204.3(b) — Fourth line, the insertion of a comma in the parenthetical sentence after the word "programs."

15-204.3(k) — Third line, the word "or" corrected to "of."

George W. Markey, Jr.

GEORGE W. MARKEY, JR.
Navy Member
Chairman

OGC/GWM:lwt
20 April 1956

Part 2 - Supply, Service, and Research and Development Contracts, with Commercial Organizations

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.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (i) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

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

15-201.3 Credits. The applicable portion of income, rebates, allowances, and other credits received by or accruing to the contractor which is related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

15-202 Direct Costs.

15-202.1 General. Items of cost which are readily identifiable with (i) a contract, or (ii) other work of the contractor, should be charged directly to the contract or other work with which identified. This principle may be applied to items of cost, such as freight, travel, communications, and engineering services, as well as materials and productive labor, but when used must be applied consistently to all work of the contractor. When the accounting expense of direct costing of minor items would exceed the

resulting benefits, individual items, which otherwise would be treated as direct costs, may be treated as indirect costs. Each element of direct cost is subject to the limitations of this Part as to allowability.

15-202.2 Direct Material Costs. Direct material costs include the cost of raw materials, purchased items, and items supplied from stock, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically identifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable. Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable only to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

15-203 Indirect Costs.

15-203.1 General. (a) Items of cost which are incurred for common or joint objectives, and which are not readily subject to treatment as direct costs in accordance with ASPR 15-202, should be accumulated for accounting purposes by logical cost groupings and charged by a process of allocation. Each element of indirect cost is subject to the limitations of this Part as to allowability.

(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.

(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 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.

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 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. 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. 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.

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 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below. These applications govern whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

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.

All other advertising costs are unallowable.

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

(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.

(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.

(e) Depreciation.

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

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

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

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

(iii) by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954.

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

(3) Where a contractor has received a determination of "true depreciation" from an Emergency Facilities Depreciation Board relating to an emergency facility covered by a certificate of necessity, it may elect to use either normal or "true" depreciation. However, the method elected must be followed consistently throughout the life of the emergency facility. Where an election is made to use normal depreciation, the amount thereof shall be computed in accordance with (2) above. Where an election is made to use "true depreciation," the amount allowable as depreciation:

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

(ii) after the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life (but see (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.

(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. Use charges for assets not fully depreciated on the contractor's books are unallowable.

(f) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred, in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(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.

(h) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition

to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor which constitutes, in effect, an implied agreement on the contractor's part (but see (d) above, and (i)(3)(v), (p) and (w) below).

(i) Insurance and Indemnification.

(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes securing the contractor against liabilities to third persons not compensated by insurance or otherwise.

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

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

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

(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 unallowable except to the extent that the Government shall have approved or required such insurance or reserve;

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

(v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(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.

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

(k) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable (but see ASPR 15-204.3(e)). Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis.

(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.

(l) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

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

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

are allowable.

(m) Material Costs.

(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.

(5) Reasonable charges or credits arising from a difference 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 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 sales price to its most favored customer.

(n) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government and may be classified as either direct or indirect labor costs. When direct labor cost is the base for distribution of overhead, such premiums shall not be included in that base. When such premiums are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work.

(o) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. 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) and (v) below.)

(p) Pension Plans.

(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, either the 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 plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P. L. 591, 83rd Cong., 2d 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 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) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall 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) in determining the net 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 —

(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 adjustment 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.

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

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

(1) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(g)).

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

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

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

(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 agreement.

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

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

(u) Research and Development Costs.

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

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable 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.

(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 allowable as precontract costs (see ASPR 15-204.3(j)).

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

(w) Severance Pay.

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

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

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

(ii) abnormal or mass severance payments actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of the 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.

(x) Special Tooling Costs. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling acquired for performance of the contract are allowable and shall be charged directly thereto.

(y) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(g));

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

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

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

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

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

Reasonable costs of any such proceeding instituted by the contractor at the direction of the contracting officer are allowable. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are also allowable.

(3) Any refund of taxes, interest, or penalties, and any payment to the contractor of interest thereon, attributable to taxes, interest, or penalties which were allowed as contract costs, shall be credited or paid to the Government in the manner directed by the Government.

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

(1) Memberships. Costs of membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(aa) Training Costs. Reserved.

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

(cc) Travel Costs.

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

(2) Travel costs incurred in the normal course of overall administration of the business and applicable to the entire business are allowable. 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.

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

(dd) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

(i) ASPR 15-204.3(f);

(ii) ASPR 15-204.3(j); and

(iii) ASPR 15-204.3(l).

15-204.3 Unallowable Costs.

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

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs, see ASPR 15-204.2(i).)

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

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

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

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

(g) Interest and Other Financial Costs. Interest (however represented), bond discounts, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of the prospectus, costs of preparation and issuance of stock rights, and costs related thereto are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in ASPR 15-204.2(y) (but see ASPR 15-204.2(dd)(1)).

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

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

(j) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract.

(k) Profits and Losses on Dispostion of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments, shall be excluded in computing contract costs (but see ASPR 15-204.2(e)(2) as to basis for depreciation).

(l) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately

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 unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(m) General.

(1) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

(i) Advertising Costs, ASPR 15-204.2(a), last sentence;

(ii) Depreciation, ASPR 15-204.2(e)(4), and (5), last sentence;

(iii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(r)(3), first sentence;

(iv) Recruiting Costs, ASPR 15-204.2(s), last sentence;

(v) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(v), both provisos; and

(vi) Taxes, ASPR 15-204.2(y)(1)(i) through (iv).

(2) Certain other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

(i) Civil Defense Costs, ASPR 15-204.2(c), last sentence;

(ii) Compensation for Personal Services, ASPR 15-204.2(d) (5);

(iii) Depreciation, ASPR 15-204.2(e)(5), first sentence;

(iv) Food Service Costs and Credits, ASPR 15-204.2(g), last sentence;

(v) Insurance and Indemnification, ASPR 15-204.2(i)(3)(iii) and (iv), and (4);

(vi) Maintenance and Repair Costs, ASPR 15-204.2(k)(2);

(vii) Overtime, Extra-Pay Shift, and Multi-Shift Premiums, ASPR 15-204.2(n), second sentence;

(viii) Patent Costs, ASPR 15-204.2(o), second sentence;

(ix) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(r)(3), last sentence;

(x) Rental Costs (Including Sale and Leaseback of Facilities), ASPR 15-204.2(t)(3);

(xi) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(v);

(xii) Taxes, ASPR 15-204.2(y)(2); and

(xiii) Travel Costs, ASPR 15-204.2(cc)(4).

OGC/GWM:lwt
April 9, 1956

MEMORANDUM FOR THE ASPR COMMITTEE

Subj: ASPR Case 53-44 - Revision of Section XV Contract Cost Principles

1. Pursuant to the request of the ASPR Committee at the special meeting held on 6 April 1956, in connection with its consideration of the draft of Part 2, Section XV, dated 29 March 1956, the undersigned Special Editing Subcommittee has completed the editing of the material submitted. The attached TABS A, B, C, and D set forth composite drafts of this material as edited for retention in Part 2. The attached TAB H sets forth a proposed new Part 7 setting forth interim instructions for use in connection with facilities contracts and clauses in other type cost-reimbursement type contracts providing for the acquisition of industrial facilities.

2. In addition, this Subcommittee recommends that existing Parts 4, 5, and 6 be treated in the manner respectively set forth in the attached TABS E, F, and G, the proposed action in regard to these Parts to be effective simultaneously with the issuance of proposed Part 2. Similar action is recommended in TAB I with respect to existing Part 3.

CHARLES W. WILKINSON Lt. Colonel, SS JAG Army Member	GEORGE W. MARKEY, JR. Navy Member Chairman	WILLIAM MUNVES Air Force Member

Revised report - Rec'd 4/12/56.
Page 1 revised - Tab I added.
WFC

OGC/GWM:lwt
April 9, 1956

TAB A

Proposed Revision of Title of ASPR Section XV, Part 2 and ASPR 15-200 - Scope of Part

(For substitution on first page of draft of 29 March 1956)

Part 2-Supply, Service, and Research and Development Contracts, with /Commercial/ Organizations ~~Having Commercial Type Accounting Systems~~

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./ ~~having commercial type accounting systems. However, this Part does not apply to contracts for facilities, construction, or architect-engineer services related to construction. It also does not apply to clauses in supply or service contracts which provide for the furnishing of industrial facilities.~~

OGC/GWM:lwt
April 9, 1956

TAB B

Proposed Revision of ASPR 15-204.2(f) - Depreciation
(For substitution on page 7 of draft of 29 March 1956)

15-204.2(f) Depreciation.

* * *

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

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

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

~~(ii)~~ /(iii)/ ~~is computed~~ by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954 /~~, and~~

/provided further that, in no event, shall the amount allowed for depreciation exceed the amount which would be authorized for tax purposes pursuant to the Internal Revenue Code of 1954/.

Note: (1) The proviso contained in the last brackets is an edited version of a new substantive concept suggested by the Air Force and left as an issue at the special ASPR meeting of April 6, 1956. The Navy has opposed its inclusion. The Army has concurred with the Air Force.

(2) The two concluding sentences of the above subparagraph 2 should be added without change immediately following the proviso contained in the last brackets.

OGC/GWM:lwt
April 9, 1956

TAB C

Proposed Revision of ASPR 15-204.2(j) - Insurance and Indemnification

(For substitution on page 9 of draft of 29 March 1956)

15-204.2(j) Insurance and Indemnification.

(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes / securing the contractor against/ liabilities to third persons not compensated by insurance or otherwise.

OGC/GWM:lwt
April 9, 1956

TAB D

Proposed Revision of ASPR 15-204.2(n) - Material Costs

(For substitution on pages 11 and 12 of draft of 29 March 1956)

15-204.2(n) Material Costs.

(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)/ .

* * *

(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 the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is 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 ~~either~~ (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/ .

OGC/GWM:lwt
April 9, 1956

TAB E

Proposed Revision of Existing ASPR Section XV Part 4- Construction Contracts

Part 4 - Construction Contracts

* * * * *

15-403 Examples of Items of Allowable Costs. . . .

(q) Pension ~~and retirement~~ plans in accordance with the ~~interpretation~~ /principles and standards/ set forth in ~~paragraph 15-601~~ /ASPR 15-204.2(q)/ and group health, accident and life insurance plans (but see paragraph 15-404(b), (d), and (m)).

OGC/GWM:lwt
April 9, 1956

TAB F

Proposed Revision of Existing ASPR Section XV, Part 5 -
Subjects Affecting Cost Which May Require Special Consideration

Part 5 - Subjects Affecting Cost Which May Require Special Consideration

15-500 Scope of Part. This ~~part~~/Part/ enumerates certain subjects affecting cost which may require special consideration in connection with the negotiation or performance of cost-reimbursement type contracts and which are not specifically covered in ~~Part 3,~~ Part 3, or Part 4 of this section.

15-501 Consideration Required. It is important that Contracting Officers and their negotiators consider the subjects enumerated in paragraph 15-502, and any other subjects not precluded by the provisions of ~~Part 3,~~ Part 3, or Part 4 of this section (whichever part is applicable), for the purpose of (i) determining which subjects if any should be expressly provided for in a particular cost-reimbursement type contract, and (ii) incorporating appropriate clauses in the contract. Action taken with respect to any such subjects shall be reflected either in the contract or in the record of contract negotiations.

OGC/GWM:lwt
April 9, 1956

TAB G

Proposed Revision of Existing ASPR Section XV, Part 6 - Cost Interpretations

Part 6 - Cost Interpretations

Delete balance of this Part and substitute therefor the word "RESERVED".

Note: With respect to existing ASPR 15-601.2 the subject of pension plans is now covered in proposed ASPR 15-204.2(q) (pages 12 to 15 of draft of 29 March 1956).

In accordance with decision of the Procurement Secretaries, the subject of profit sharing is to be retained on the basis now appearing in existing ASPR 15-601.2(f). Presumably this subject will be covered under proposed ASPR 15-204.2(d) - Compensation for Personal Services which has been reserved in the draft of 29 March 1956.

With respect to existing ASPR 15-602 - Depreciation, this subject is now covered in proposed ASPR 15-204.2(f) in the draft of 29 March 1956. Existing ASPR 15-602 contains cross references only to existing ASPR 15-204(d), 15-205(b) and 15-205(o).

OGC/GWM:lwt
April 9, 1956

TAB H

Proposed New ASPR Section XV, Part 7 - Facilities Contracts

Part 7 - Facilities Contracts

15-700 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 the acquisition of industrial facilities to which the Government takes title under the contract. This Part also applies to clauses in any other cost-reimbursement type contracts or cost-reimbursement type subcontracts thereunder, which clauses provide for the acquisition of industrial facilities to which the Government takes title.

15-701 Applicability. Pending publication of the principles and standards to be incorporated in this Part, Parts 2, 3, or 4 shall be used to the extent appropriate in accordance with Departmental procedures.

OGC/GWM:lwt
April 9, 1956

TAB I

Proposed Revision of Existing ASPR Section XV,
Part 3 - Research Contracts with Nonprofit Institutions

Part 3 - Research Contracts with Nonprofit Institutions

* * * * *

15-304 Examples of Items of Allowable Costs. . . .

(g) Pension and ~~retirement~~ plans in accordance with the ~~interpretations~~ /principles and standards/ set forth in ~~paragraph 15-601~~ /ASPR 15-204.2(q)/ and group health, accident and life insurance plans (but see paragraph 15-305(k)).

(s) Professional Service Costs - Legal, Accounting, Engineering and Other. /15-204.29/

(t) Recruiting Costs. /15-204.32/

(u) Rental Costs (Including Sale and Leaseback of Facilities). /15-204.33/

(v) Research and Development Costs. /15-204.34/

(w) Royalties and Other Costs for Use of Patents. /15-204.35/

~~(x) Service and Installation Costs.~~ /15-204.36/ (deleted)

(x) Severance Pay. /15-204.37/

(y) Special Tooling Costs. /15-204.38/

(z) Taxes. /15-204.39/

(aa) Trade, Business, Technical, and Professional Activity Costs. /15-204.40/

(bb) Training Costs. /15-204.41/

(cc) Transportation Costs. /15-204.42/

(dd) Travel Costs. /15-204.43/

(ee) General. /15-204.23/

15-204.3 Unallowable Costs.

(a) Bad Debts. /15-204.2/

(b) Contingency Reserves. /15-204.7/

(c) Entertainment Costs. /15-204.11/

(d) Excess Facility Costs. /15-204.12/

TABLE OF TITLES AND PARAGRAPH NUMBERS OF PRINCIPLES AND STANDARDS FOR SELECTED ITEMS OF COST (ASPR 15-204.2 and 15-204.3)

15-204.2 Costs Allowable in Whole or in Part.

(a) Advertising Costs. /15-204.1/

(b) Bidding Costs. /15-204.3/

(c) Civil Defense Costs. /15-204.5/

(d) Compensation for Personal Services. /15-204.6/

(e) Contributions and Donations. /15-204.8/

(f) Depreciation. /15-204.9/

(g) Employee Morale, Health, and Welfare Costs and Credits. /15-204.10/

(h) Food Service Costs and Credits. /15-204.4/

(i) Fringe Benefits. /15-204.14/

(j) Insurance and Indemnification. /15-204.15/

(k) Labor Relations Costs. /15-204.17/

(l) Maintenance and Repair Costs. /15-204.19/

(m) Manufacturing and Production Engineering Costs. /15-204.20/

(n) Material Costs. /15-204.21/

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. /15-204.24/

(p) Patent Costs. /15-204.25/

(q) Pension Plans. /15-204.26/

(r) Plant Protection Costs. /15-204.27/

in the attached draft of Part 2 followed by brackets containing the corresponding paragraph reference in the draft submitted for editing.

Editing Subcommittee:

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* Will submit separate report.

VIII. Precontract Costs (ASPR 15-204.3(i), page 24). The parenthetical reference to ASPR 15-1xx was included by way of compromise of an issue within the Editing Subcommittee and, accordingly, this paragraph was not discussed in the sessions of the joint subcommittees. If Part 2 is approved with this reference included, the full reference to the appropriate paragraph in Part 1 should be inserted before Part 2 is released for printing.

D. Matters Not Necessarily Requiring Final Action by the ASPR Committee Prior to Adoption of Part 2, Section XV.

I. Pension Plans (ASPR 15-204.2(q)(3)(iv)(B), page 15). Attention is invited to the matter of "Implementation of 'Side' Agreements" which is discussed in paragraph 4.A. of the Editing Committee report of February 27, 1956. In the draft there discussed, the problem was related to proposed ASPR 15-204.2(q)(3)(iii)(B) /ASPR 15-204.26d in the draft for editing/.

II. Overtime, Extra-Pay Shift, and Multi-Shift Premiums, (ASPR 15-204.2(o), page 12). Attention is invited to the recommendation with respect to this matter in paragraph 5.A. of the Editing Committee report of February 27, 1956. Discussions of the joint subcommittees emphasize that the term "authorization" and "prior approval" are not uniformly understood.

6. It has not been possible in the time available for submission of this report, to set forth all of the differences between the draft submitted for editing and the attached draft. In this connection, it is recommended that, when this Part 2 is given detailed consideration by the ASPR Committee, the members of the Section XV Subcommittee be invited to participate for purposes of isolating and explaining such changes and the reasons therefor to the extent deemed appropriate by the ASPR Committee. In view of the substantially different numbering scheme which has been employed in the attached draft with respect to the Principles and Standards for Selected Items of Cost, covered under proposed ASPR 15-204, a table has been prepared (TAB A attached) showing the title and lettered paragraph designation of each item

been covered with respect to outright transfers of material and services (ASPR 15-204.2(n)(6)).

V. Research and Development Costs (ASPR 15-204.2(v)(3)). Unlike the question of disclosure of independent general research, the question of disclosure of independent related research was not covered at all in the draft for editing. In keeping with the recommendation as to disclosure of independent general research (see B. above), subparagraph (3) dealing with related research has been modified by the following addition in the third sentence:

> "and provided further that the contractor discloses to the Government the purposes and results of the research and development."

VI. Training Costs (ASPR 15-204.2(bb)). The attached draft provides that where training is conducted "by" an educational institution, the cost of "part-time" training which is of the "on-the-job type" is allowable without a specific contract provision. Discussions by the joint subcommittees, however, indicate that further clarification may be needed in regard to the meaning of "on-the-job type" training.

In regard to the costs of training "in" educational institutions, the proposed draft would make them unallowable "except to the extent specifically provided for in the contract in accordance with Departmental instructions." The words "in accordance with Departmental instructions" were included by the joint subcommittees in recognition of the fact that an area of increasing industry interest is involved and that it would be unwise not to develop a basis for consistent treatment. The added words appeared to afford the best means of achieving reasonable consistency within the limited time available for discussion of this item. The problem may well require additional study.

VII. General and Administrative Costs (ASPR 15-203.5, page 4). Under enumeration "(ii)" of factors to be considered in determining whether the method used for the allocation of general and administrative expenses provides for an equitable result, the proposed draft includes, "the results obtainable by using the input cost method" and also sets forth a definition of said method. This paragraph was otherwise subjected to substantial redrafting in view of the consensus of opinion within the Section XV Subcommittee that clarification was necessary.

B. Research and Development Costs - ASPR 15-204.2(v), page 18.

In the proposed ASPR 15-204.2(v), Research and Development Costs, the fourth and fifth sentences of subparagraph (2) (from "Generally, the contractor . . ." through the end of the subparagraph) appear to set forth instructions to the contracting officer rather than cost principles. It is recommended that the fourth sentence be revised to read:

> "The contractor shall disclose to the Government the purposes and results of any independent general research the costs of which are reimbursed in whole or in part by the Government."

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C. Certain Differences Between Draft for Editing and Attached Part 2.

I. Scope of Part (ASPR 15-200). The attached draft provides that the same treatment be given to clauses in supply or service contracts providing for the furnishing of industrial facilities and to facilities contracts, i.e., both are excluded from the coverage of Part 2. The draft for editing did not cover such facilities clauses. Filing instructions, however, should contain a notation that Part 2 may be used "to the extent appropriate" for these purposes pending publication of a separate Part covering facilities.

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such discussion permitted on the basis of a unilateral request by any member without concurrence of the Section XV Subcommittee. The Air Force and Army members of the Editing Subcommittee have questioned the authority of the joint subcommittees to undertake certain of these discussions and will file a separate report in regard thereto.

4. Except as indicated below and in the joint report of March 9, 1956, the attached draft of Part 2, Section XV, has the unanimous concurrence of all members of the Section XV Subcommittee from the standpoint of substance, and of the joint Editing and Section XV Subcommittees from the standpoint of editing. Owing to certain unavoidable circumstances, all members of the Section XV Subcommittee were unable to be present at the final joint session on March 28, 1956, and it has not been possible to clear the entire attached draft of Part 2 with each of them within the time required for submission to the ASPR Committee.

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Attention is also invited to the first paragraph on page 4 of the joint report of March 9, 1956 and the question is posed whether official acknowledgment should be made of the assistance furnished by the Internal Revenue Service.

OGC/GWM:lwt
April 2, 1956

MEMORANDUM FOR THE ASPR COMMITTEE

Subj: ASPR Case 53-44, Revision of Section XV, Contract Cost Principles

1. The joint report of the Editing Subcommittee and the Section XV Subcommittee, dated March 9, 1956, dealt with the three matters submitted by the Editing Subcommittee (report dated February 27, 1956), for resolution prior to completing the edited draft of Part 2, Section XV, and also submitted a proposed edited draft of the entire Part, prepared by the Editing Subcommittee. Except for the above three matters relating to Material and Supply Costs, Research and Development Costs, and Pension Plans, the Section XV Subcommittee had not participated in the edited draft. The ASPR Committee requested consideration of this edited draft (TAB B attached to the joint report of March 9, 1956), jointly, by the Editing and Section XV Subcommittees prior to further consideration by the ASPR Committee. Commencing March 16, 1956, the joint subcommittees met almost daily through March 28, 1956, preparing the attached draft of Part 2, Section XV, dated March 29, 1956.

2. The Section XV Subcommittee had fully recognized that its final draft as considered by the ASPR Committee (Minutes of November 22, 1955, Item 3) was in need of, and strongly recommended that it receive, substantial editing. After certain revisions by the ASPR Committee, that draft was submitted to the Editing Subcommittee for editing (Minutes of December 13, 1955, Item 4). In the course of consideration by the joint subcommittees of the draft of the Editing Subcommittee, it became apparent, with respect to various matters, that words originally included by the Section XV Subcommittee in its draft to express a particular principle or limitation or convey some other idea did not have the same meaning to accounting, procurement, and legal personnel. In other instances, it appeared that matters substantially agreed to in principle during the earlier deliberations of the Section XV Committee had either not been covered at all or were incompletely covered in the Section XV Subcommittee's draft.

3. In view of the above circumstances, when there was general agreement within the Section XV Subcommittee that a particular matter required discussion, the Chairman of the Editing Subcommittee, in presiding over the joint subcommittee sessions, permitted such discussion. In no case, was

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> "The contractor shall disclose to the Government the purposes and results of any independent general research the costs of which are reimbursed in whole or in part by the Government."

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IV. Rental Costs (Including Sale and Leaseback of Facilities). (ASPR 15-204.2(u)). Subparagraph (2) relating to charges in the nature of rent between organizations under common control was not included in the draft for editing although an analogous principle had

been covered with respect to outright transfers of material and services (ASPR 15-204.2(n)(6)).

V. Research and Development Costs (ASPR 15-204.2(v)(3)). Unlike the question of disclosure of independent general research, the question of disclosure of independent related research was not covered at all in the draft for editing. In keeping with the recommendation as to disclosure of independent general research (see B. above), subparagraph (3) dealing with related research has been modified by the following addition in the third sentence:

> "and provided further that the contractor discloses to the Government the purposes and results of the research and development."

VI. Training Costs (ASPR 15-204.2(bb)). The attached draft provides that where training is conducted "by" an educational institution, the cost of "part-time" training which is of the "on-the-job type" is allowable without a specific contract provision. Discussions by the joint subcommittees, however, indicate that further clarification may be needed in regard to the meaning of "on-the-job type" training.

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VIII. Precontract Costs (ASPR 15-204.3(i), page 24). The parenthetical reference to ASPR 15-lxx was included by way of compromise of an issue within the Editing Subcommittee and, accordingly, this paragraph was not discussed in the sessions of the joint subcommittees. If Part 2 is approved with this reference included, the full reference to the appropriate paragraph in Part 1 should be inserted before Part 2 is released for printing.

D. Matters Not Necessarily Requiring Final Action by the ASPR Committee Prior to Adoption of Part 2, Section XV.

I. Pension Plans (ASPR 15-204.2(q)(3)(iv)(B), page 15). Attention is invited to the matter of "Implementation of 'Side' Agreements" which is discussed in paragraph 4.A. of the Editing Committee report of February 27, 1956. In the draft there discussed, the problem was related to proposed ASPR 15-204.2(q)(3)(iii)(B) /ASPR 15-204.26d in the draft for editing/.

II. Overtime, Extra-Pay Shift, and Multi-Shift Premiums, (ASPR 15-204.2(o), page 12). Attention is invited to the recommendation with respect to this matter in paragraph 5.A. of the Editing Committee report of February 27, 1956. Discussions of the joint subcommittees emphasize that the term "authorization" and "prior approval" are not uniformly understood.

6. It has not been possible in the time available for submission of this report, to set forth all of the differences between the draft submitted for editing and the attached draft. In this connection, it is recommended that, when this Part 2 is given detailed consideration by the ASPR Committee, the members of the Section XV Subcommittee be invited to participate for purposes of isolating and explaining such changes and the reasons therefor to the extent deemed appropriate by the ASPR Committee. In view of the substantially different numbering scheme which has been employed in the attached draft with respect to the Principles and Standards for Selected Items of Cost, covered under proposed ASPR 15-204, a table has been prepared (TAB A attached) showing the title and lettered paragraph designation of each item

in the attached draft of Part 2 followed by brackets containing the corresponding paragraph reference in the draft submitted for editing.

Editing Subcommittee:

GEORGE W. MARKEY, JR.
Navy Member
Chairman

CHARLES W. WILKINSON*
Lt. Colonel, SS JAG
Army Member

JOHN W. PERRY*
Air Force Member

Section XV Subcommittee:

Army:

J. O. Hunnicutt, Jr., Maj., DCSLOG
T. P. Partyka, Hq. AAA
J. A. Mays, Hq. AAA

Navy:

Arthur C. Sawallisch, ONM
James Ruttenberg, OC-N
E. T. Cook, OC-N(alternate)
Mrs. Edith Niedling, OC-N (alternate)

DOD:

H. H. Gallup, OSD (S&L)
Chairman, Section XV Subcommittee

Air Force:

Paul M. Southwell, AFMPP
George A. Rudigier, AFAUD

* Will submit separate report.

TABLE OF TITLES AND PARAGRAPH NUMBERS OF PRINCIPLES AND STANDARDS FOR SELECTED ITEMS OF COST (ASPR 15-204.2 and 15-204.3)

15-204.2 Costs Allowable in Whole or in Part.

(a) Advertising Costs. /15-204.1/

(b) Bidding Costs. /15-204.3/

(c) Civil Defense Costs. /15-204.5/

(d) Compensation for Personal Services. /15-204.6/

(e) Contributions and Donations. /15-204.8/

(f) Depreciation. /15-204.9/

(g) Employee Morale, Health, and Welfare Costs and Credits. /15-204.10/

(h) Food Service Costs and Credits. /15-204.4/

(i) Fringe Benefits. /15-204.14/

(j) Insurance and Indemnification. /15-204.15/

(k) Labor Relations Costs. /15-204.17/

(l) Maintenance and Repair Costs. /15-204.19/

(m) Manufacturing and Production Engineering Costs. /15-204.20/

(n) Material Costs. /15-204.21/

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. /15-204.24/

(p) Patent Costs. /15-204.25/

(q) Pension Plans. /15-204.26/

(r) Plant Protection Costs. /15-204.27/

(s) Professional Service Costs - Legal, Accounting, Engineering and Other. /15-204.29/

(t) Recruiting Costs. /15-204.32/

(u) Rental Costs (Including Sale and Leaseback of Facilities). /15-204.33/

(v) Research and Development Costs. /15-204.34/

(w) Royalties and Other Costs for Use of Patents. /15-204.35/

~~(x) Service and Installation Costs.~~ /15-204.36/ (deleted)

(x) Severance Pay. /15-204.37/

(y) Special Tooling Costs. /15-204.38/

(z) Taxes. /15-204.39/

(aa) Trade, Business, Technical, and Professional Activity Costs. /15-204.40/

(bb) Training Costs. /15-204.41/

(cc) Transportation Costs. /15-204.42/

(dd) Travel Costs. /15-204.43/

(ee) General. /15-204.23/

15-204.3 Unallowable Costs.

(a) Bad Debts. /15-204.2/

(b) Contingency Reserves. /15-204.7/

(c) Entertainment Costs. /15-204.11/

(d) Excess Facility Costs. /15-204.12/

(e) Fines and Penalties. /15-204.13/

(f) Interest and Other Financial Costs. /15-204.16/

(g) Losses on Other Contracts. /15-204.18/

(h) Organization Costs. /15-204.22/

(i) Precontract Costs. /15-204.28/

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. /15-204.30/

(k) Reconversion Costs. /15-204.31/

APR 2 1956

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Section XV, Contract Cost Principles
Separate Report of the Army and Air Force members,
Editing Subcommittee

1. The Army and Air Force members of the Editing Subcommittee understood that the Editing Subcommittee's report of March 9, 1956 was returned to that Subcommittee solely to resolve, with the Section XV Subcommittee, any substantive differences between that report and the materials approved by the ASPR Committee in December 1955. On the contrary, a great part of the time of the two Subcommittees in the past two weeks has been devoted to consideration of entirely new substantive concepts put forth by various members of the Section XV Subcommittee. Since the Army and Air Force members of the Editing Subcommittee do not consider most of the changes made in the past two weeks necessary to conform the edited draft substantively to the draft approved by the ASPR Committee, and since they do not know which, if any, of the many new concepts have already been considered and rejected by the ASPR Committee or by the individual ASPR Committee members from the Departments in which the concepts originated, they are not able to recommend approval of the materials now being submitted to the ASPR Committee.

2. As examples, attention is directed to the paragraphs listed below.

a. 15-200 has been revised to exclude supply contracts with contractors not having commercial type accounting systems, and to exclude clauses in supply or service contracts providing for the acquisition of facilities.

b. 15-203 (c) has been revised by adding the first and third sentences. The first sentence defines "base period." The third sentence was added to preclude the idea that all indirect costs allocable to a contract which ran for several years had to be charged to one selected fiscal year.

c. 15-203.5 has been revised to include the "input cost method" as a yardstick for determining whether the contractor's method of distributing general and administrative costs is equitable and has deleted direct reference to inventory variations.

d. 15-204.2(f)(2) as approved by ASPR and as originally edited provided that depreciation should be "based upon original acquisition cost." As now changed the paragraph ignores acquisition cost and bases depreciation on whatever base is used for Federal income tax purposes. Read in conjunction with 15-204.3(j) this paragraph originally required that the contractor ignore, for Government contract cost purposes, both profits and losses on trade-ins. In addition, application of this paragraph (f)(2) as now revised to tax-exempt corporations which have commercial type accounting systems, will be difficult.

e. 15-204.2(f)(5) has been changed to prohibit use charges on assets acquired without cost to the contractor.

f. 15-204.2(n)(5) which did require that inventory discrepancies be included in arriving at "the cost of material" now requires that they be included in arriving at "the cost of performance."

g. 15-204.2(u)(2) is an entirely new paragraph limiting the rentals which may be charged between plants, divisions, or organizations under common control.

h. 15-204. r)(3) has been changed to requi disclosure to the Government of the purposes and results of related research and development for which the contractor is reimbursed in whole or in part by the Government.

i. 15-204.2(aa)(1) has been limited to the costs of the contractor's membership in organizations, as distinguished from the costs of membership of contractor employees.

j. 15-204.2(bb) has been changed to limit on-the-job training conducted by educational institutions to part-time training, and to require Departmental implementation before training in educational institutions can be provided for in a contract.

k. 15-204.3(d) has been changed to:

(1) disallow costs of repairing idle and excess facilities;

(2) limit the provision to contractor-owned facilities; and

(3) clarify the assumed meaning of "standby purposes."

l. 15-204.3(j) has been changed by adding a cross reference which is in fact an exception.

3. If a generalization may be hazarded, the changes made in the past two weeks tend to negate the idea of looking to the "reasonableness" of costs incurred, and substituting therefor various rigid rules of allowability of costs. This trend in turn is attributable, at least in part, to the idea expressed by certain members of the Section XV Subcommittee that the doctrine of "reasonableness" expressed in 15-201.2 permits only questioning the reasonableness of the price paid as compared to what the contractor got but does not permit questioning the reasonableness of the contractor's incurring the cost in the first place. Possibly this limited interpretation of "reasonableness" is due to the school of thought which considers Part 2 of Section XV to be an audit manual.

4. The Army and Air Force members of the Editing Subcommittee recommend that the ASPR Committee review the materials now being submitted on the subject case as if they were an entirely new substantive submission from the subject Subcommittee, subject only to recognition that the submission has been edited.

Lt. Col. Charles W. Wilkinson
Army Member
Editing Subcommittee

John W. Perry
Air Force Member
Editing Subcommittee

OGC/GWM:lwt
April 2, 1956

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III. Depreciation (ASPR 15-204.2(f)(2)). The draft for editing (ASPR 15-204.9(b)) includes the principles recognized under Section 167 of the Internal Revenue Code among any generally accepted accounting principles which may be used in the computation of depreciation. The attached draft requires the contractor to follow the same cost basis in regard to depreciation for contract costing as it followed for Federal income tax purposes.

IV. Rental Costs (Including Sale and Leaseback of Facilities). (ASPR 15-204.2(u)). Subparagraph (2) relating to charges in the nature of rent between organizations under common control was not included in the draft for editing although an analogous principle had

been covered with respect to outright transfers of material and services (ASPR 15-204.2(n)(6)).

V. Research and Development Costs (ASPR 15-204.2(v)(3)). Unlike the question of disclosure of independent general research, the question of disclosure of independent related research was not covered at all in the draft for editing. In keeping with the recommendation as to disclosure of independent general research (see B. above), subparagraph (3) dealing with related research has been modified by the following addition in the third sentence:

> "and provided further that the contractor discloses to the Government the purposes and results of the research and development."

VI. Training Costs (ASPR 15-204.2(bb)). The attached draft provides that where training is conducted "by" an educational institution, the cost of "part-time" training which is of the "on-the-job type" is allowable without a specific contract provision. Discussions by the joint subcommittees, however, indicate that further clarification may be needed in regard to the meaning of "on-the-job type" training.

In regard to the costs of training "in" educational institutions, the proposed draft would make them unallowable "except to the extent specifically provided for in the contract in accordance with Departmental instructions." The words "in accordance with Departmental instructions" were included by the joint subcommittees in recognition of the fact that an area of increasing industry interest is involved and that it would be unwise not to develop a basis for consistent treatment. The added words appeared to afford the best means of achieving reasonable consistency within the limited time available for discussion of this item. The problem may well require additional study.

VII. General and Administrative Costs (ASPR 15-203.5, page 4). Under enumeration "(ii)" of factors to be considered in determining whether the method used for the allocation of general and administrative expenses provides for an equitable result, the proposed draft includes, "the results obtainable by using the input cost method" and also sets forth a definition of said method. This paragraph was otherwise subjected to substantial redrafting in view of the consensus of opinion within the Section XV Subcommittee that clarification was necessary.

VIII. Precontract Costs (ASPR 15-204.3(i), page 24). The parenthetical reference to ASPR 15-lxx was included by way of compromise of an issue within the Editing Subcommittee and, accordingly, this paragraph was not discussed in the sessions of the joint subcommittees. If Part 2 is approved with this reference included, the full reference to the appropriate paragraph in Part 1 should be inserted before Part 2 is released for printing.

D. Matters Not Necessarily Requiring Final Action by the ASPR Committee Prior to Adoption of Part 2, Section XV.

I. Pension Plans (ASPR 15-204.2(q)(3)(iv)(B), page 15). Attention is invited to the matter of "Implementation of 'Side' Agreements" which is discussed in paragraph 4.A. of the Editing Committee report of February 27, 1956. In the draft there discussed, the problem was related to proposed ASPR 15-204.2(q)(3)(iii)(B) /ASPR 15-204.26d in the draft for editing/.

II. Overtime, Extra-Pay Shift, and Multi-Shift Premiums, (ASPR 15-204.2(o), page 12). Attention is invited to the recommendation with respect to this matter in paragraph 5.A. of the Editing Committee report of February 27, 1956. Discussions of the joint subcommittees emphasize that the term "authorization" and "prior approval" are not uniformly understood.

6. It has not been possible in the time available for submission of this report, to set forth all of the differences between the draft submitted for editing and the attached draft. In this connection, it is recommended that, when this Part 2 is given detailed consideration by the ASPR Committee, the members of the Section XV Subcommittee be invited to participate for purposes of isolating and explaining such changes and the reasons therefor to the extent deemed appropriate by the ASPR Committee. In view of the substantially different numbering scheme which has been employed in the attached draft with respect to the Principles and Standards for Selected Items of Cost, covered under proposed ASPR 15-204, a table has been prepared (TAB A attached) showing the title and lettered paragraph designation of each item

in the attached draft of Part 2 followed by brackets containing the corresponding paragraph reference in the draft submitted for editing.

Editing Subcommittee:

GEORGE W. MARKEY, JR.
Navy Member
Chairman

CHARLES W. WILKINSON*
Lt. Colonel, SS JAG
Army Member

JOHN W. PERRY*
Air Force Member

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Army:

J. O. Hunnicutt, Jr., Maj., DCSLOG
T. P. Partyka, Hq. AAA
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Arthur C. Sawallisch, ONM
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DOD:

H. H. Gallup, OSD (S&L)
Chairman, Section XV Subcommittee

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Paul M. Southwell, AFMPP
George A. Rudigier, AFAUD

* Will submit separate report.

TABLE OF TITLES AND PARAGRAPH NUMBERS OF PRINCIPLES AND STANDARDS FOR SELECTED ITEMS OF COST (ASPR 15-204.2 and 15-204.3)

15-204.2 Costs Allowable in Whole or in Part.

(a) Advertising Costs. /15-204.1/

(b) Bidding Costs. /15-204.3/

(c) Civil Defense Costs. /15-204.5/

(d) Compensation for Personal Services. /15-204.6/

(e) Contributions and Donations. /15-204.8/

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(g) Employee Morale, Health, and Welfare Costs and Credits. /15-204.10/

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(t) Recruiting Costs. /15-204.32/

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(v) Research and Development Costs. /15-204.34/

(w) Royalties and Other Costs for Use of Patents. /15-204.35/

~~(x) Service and Installation Costs.~~ /15-204.36/ (deleted)

(x) Severance Pay. /15-204.37/

(y) Special Tooling Costs. /15-204.38/

(z) Taxes. /15-204.39/

(aa) Trade, Business, Technical, and Professional Activity Costs. /15-204.40/

(bb) Training Costs. /15-204.41/

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(dd) Travel Costs. /15-204.43/

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(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. /15-204.30/

(k) Reconversion Costs. /15-204.31/

APR 2 1956

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Section XV, Contract Cost Principles
Separate Report of the Army and Air Force members,
Editing Subcommittee

1. The Army and Air Force members of the Editing Subcommittee understood that the Editing Subcommittee's report of March 9, 1956 was returned to that Subcommittee solely to resolve, with the Section XV Subcommittee, any substantive differences between that report and the materials approved by the ASPR Committee in December 1955. On the contrary, a great part of the time of the two Subcommittees in the past two weeks has been devoted to consideration of entirely new substantive concepts put forth by various members of the Section XV Subcommittee. Since the Army and Air Force members of the Editing Subcommittee do not consider most of the changes made in the past two weeks necessary to conform the edited draft substantively to the draft approved by the ASPR Committee, and since they do not know which, if any, of the many new concepts have already been considered and rejected by the ASPR Committee or by the individual ASPR Committee members from the Departments in which the concepts originated, they are not able to recommend approval of the materials now being submitted to the ASPR Committee.

2. As examples, attention is directed to the paragraphs listed below.

a. 15-200 has been revised to exclude supply contracts with contractors not having commercial type accounting systems, and to exclude clauses in supply or service contracts providing for the acquisition of facilities.

b. 15-203 (c) has been revised by adding the first and third sentences. The first sentence defines "base period." The third sentence was added to preclude the idea that all indirect costs allocable to a contract which ran for several years had to be charged to one selected fiscal year.

c. 15-203.5 has been revised to include the "input cost method" as a yardstick for determining whether the contractor's method of distributing general and administrative costs is equitable and has deleted direct reference to inventory variations.

d. 15-204.2(f)(2) as approved by ASPR and as originally edited provided that depreciation should be "based upon original acquisition cost." As now changed the paragraph ignores acquisition cost and bases depreciation on whatever base is used for Federal income tax purposes. Read in conjunction with 15-204.3(j) this paragraph originally required that the contractor ignore, for Government contract cost purposes, both profits and losses on trade-ins. In addition, application of this paragraph (f)(2) as now revised to tax-exempt corporations which have commercial type accounting systems, will be difficult.

e. 15-204.2(f)(5) has been changed to prohibit use charges on assets acquired without cost to the contractor.

f. 15-204.2(n)(5) which did require that inventory discrepancies be included in arriving at "the cost of material" now requires that they be included in arriving at "the cost of performance."

g. 15-204.2(u)(2) is an entirely new paragraph limiting the rentals which may be charged between plants, divisions, or organizations under common control.

h. 15-204. r)(3) has been changed to requi disclosure to the Government of the purposes and results of related research and development for which the contractor is reimbursed in whole or in part by the Government.

i. 15-204.2(aa)(1) has been limited to the costs of the contractor's membership in organizations, as distinguished from the costs of membership of contractor employees.

j. 15-204.2(bb) has been changed to limit on-the-job training conducted by educational institutions to part-time training, and to require Departmental implementation before training in educational institutions can be provided for in a contract.

k. 15-204.3(d) has been changed to:

(1) disallow costs of repairing idle and excess facilities;

(2) limit the provision to contractor-owned facilities; and

(3) clarify the assumed meaning of "standby purposes."

l. 15-204.3(j) has been changed by adding a cross reference which is in fact an exception.

3. If a generalization may be hazarded, the changes made in the past two weeks tend to negate the idea of looking to the "reasonableness" of costs incurred, and substituting therefor various rigid rules of allowability of costs. This trend in turn is attributable, at least in part, to the idea expressed by certain members of the Section XV Subcommittee that the doctrine of "reasonableness" expressed in 15-201.2 permits only questioning the reasonableness of the price paid as compared to what the contractor got but does not permit questioning the reasonableness of the contractor's incurring the cost in the first place. Possibly this limited interpretation of "reasonableness" is due to the school of thought which considers Part 2 of Section XV to be an audit manual.

4. The Army and Air Force members of the Editing Subcommittee recommend that the ASPR Committee review the materials now being submitted on the subject case as if they were an entirely new substantive submission from the subject Subcommittee, subject only to recognition that the submission has been edited.

Lt. Col. Charles W. Wilkinson
Army Member
Editing Subcommittee

John W. Perry
Air Force Member
Editing Subcommittee

(e) Fines and Penalties. /15-204.13/

(f) Interest and Other Financial Costs. /15-204.16/

(g) Losses on Other Contracts. /15-204.18/

(h) Organization Costs. /15-204.22/

(i) Precontract Costs. /15-204.28/

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. /15-204.30/

(k) Reconversion Costs. /15-204.31/

OGC/GWM:lwt
April 2, 1956

MEMORANDUM FOR THE ASPR COMMITTEE

Subj: ASPR Case 53-44, Revision of Section XV, Contract Cost Principles

1. The joint report of the Editing Subcommittee and the Section XV Subcommittee, dated March 9, 1956, dealt with the three matters submitted by the Editing Subcommittee (report dated February 27, 1956), for resolution prior to completing the edited draft of Part 2, Section XV, and also submitted a proposed edited draft of the entire Part, prepared by the Editing Subcommittee. Except for the above three matters relating to Material and Supply Costs, Research and Development Costs, and Pension Plans, the Section XV Subcommittee had not participated in the edited draft. The ASPR Committee requested consideration of this edited draft (TAB B attached to the joint report of March 9, 1956), jointly, by the Editing and Section XV Subcommittees prior to further consideration by the ASPR Committee. Commencing March 16, 1956, the joint subcommittees met almost daily through March 28, 1956, preparing the attached draft of Part 2, Section XV, dated March 29, 1956.

2. The Section XV Subcommittee had fully recognized that its final draft as considered by the ASPR Committee (Minutes of November 22, 1955, Item 3) was in need of, and strongly recommended that it receive, substantial editing. After certain revisions by the ASPR Committee, that draft was submitted to the Editing Subcommittee for editing (Minutes of December 13, 1955, Item 4). In the course of consideration by the joint subcommittees of the draft of the Editing Subcommittee, it became apparent, with respect to various matters, that words originally included by the Section XV Subcommittee in its draft to express a particular principle or limitation or convey some other idea did not have the same meaning to accounting, procurement, and legal personnel. In other instances, it appeared that matters substantially agreed to in principle during the earlier deliberations of the Section XV Committee had either not been covered at all or were incompletely covered in the Section XV Subcommittee's draft.

3. In view of the above circumstances, when there was general agreement within the Section XV Subcommittee that a particular matter required discussion, the Chairman of the Editing Subcommittee, in presiding over the joint subcommittee sessions, permitted such discussion. In no case, was

such discussion permitted on the basis of a unilateral request by any member without concurrence of the Section XV Subcommittee. The Air Force and Army members of the Editing Subcommittee have questioned the authority of the joint subcommittees to undertake certain of these discussions and will file a separate report in regard thereto.

4. Except as indicated below and in the joint report of March 9, 1956, the attached draft of Part 2, Section XV, has the unanimous concurrence of all members of the Section XV Subcommittee from the standpoint of substance, and of the joint Editing and Section XV Subcommittees from the standpoint of editing. Owing to certain unavoidable circumstances, all members of the Section XV Subcommittee were unable to be present at the final joint session on March 28, 1956, and it has not been possible to clear the entire attached draft of Part 2 with each of them within the time required for submission to the ASPR Committee.

5. It is desired that the attention of the ASPR Committee be invited to the following specific matters. Unless otherwise indicated, reference to ASPR paragraphs and related page numbers are to such paragraphs and pages in the attached draft of Part 2, Section XV, dated March 29, 1956.

A. Joint Report of March 9, 1956.

I. Material and Supply Costs. In the first two quoted excerpts under 2.A., of the joint report of March 9, 1956, on page 1, change "transferor" to "transferee." The title of the paragraph in which this problem appears has been changed to Material Costs (see ASPR 15-204.2(n)(6), at bottom of page 11).

II. Research and Development Costs. Joint Recommendation I under paragraph 2.B. of the joint report of March 9, 1956 suggests that further study be given to use of the term "product line" (see ASPR 15-204.2(v)(3), on page 18).

III. Pension Plans. The issues within the Editing Committee with respect to this matter have been resolved, as discussed in paragraph 2.C. of the joint report of March 9, 1956. (See ASPR 15-204.2(q), pages 12-15 of attached draft which contains some additional minor editing refinements.)

Attention is also invited to the first paragraph on page 4 of the joint report of March 9, 1956 and the question is posed whether official acknowledgment should be made of the assistance furnished by the Internal Revenue Service.

B. Research and Development Costs - ASPR 15-204.2(v), page 18.

In the proposed ASPR 15-204.2(v), Research and Development Costs, the fourth and fifth sentences of subparagraph (2) (from "Generally, the contractor . . ." through the end of the subparagraph) appear to set forth instructions to the contracting officer rather than cost principles. It is recommended that the fourth sentence be revised to read:

> "The contractor shall disclose to the Government the purposes and results of any independent general research the costs of which are reimbursed in whole or in part by the Government."

Alternatively, it is suggested that the fourth sentence be deleted from Part 2 of Section XV and inserted elsewhere in ASPR as an instruction to the contracting officer. In any event, it is recommended that the fifth sentence, enumerating factors to be considered in providing for costs of independent general research, be deleted from Part 2 of Section XV and inserted elsewhere in ASPR, possibly either in Section III or in Part 1 of Section XV. See, also, C.V. below.

C. Certain Differences Between Draft for Editing and Attached Part 2.

I. Scope of Part (ASPR 15-200). The attached draft provides that the same treatment be given to clauses in supply or service contracts providing for the furnishing of industrial facilities and to facilities contracts, i.e., both are excluded from the coverage of Part 2. The draft for editing did not cover such facilities clauses. Filing instructions, however, should contain a notation that Part 2 may be used "to the extent appropriate" for these purposes pending publication of a separate Part covering facilities.

II. Base Period (ASPR 15-203.1(c)). The draft for editing (ASPR 15-203.5) did not contain the first sentence which has been proposed as a definition, or the third sentence.

III. Depreciation (ASPR 15-204.2(f)(2)). The draft for editing (ASPR 15-204.9(b)) includes the principles recognized under Section 167 of the Internal Revenue Code among any generally accepted accounting principles which may be used in the computation of depreciation. The attached draft requires the contractor to follow the same cost basis in regard to depreciation for contract costing as it followed for Federal income tax purposes.

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been covered with respect to outright transfers of material and services (ASPR 15-204.2(n)(6)).

V. Research and Development Costs (ASPR 15-204.2(v)(3)). Unlike the question of disclosure of independent general research, the question of disclosure of independent related research was not covered at all in the draft for editing. In keeping with the recommendation as to disclosure of independent general research (see B. above), subparagraph (3) dealing with related research has been modified by the following addition in the third sentence:

> "and provided further that the contractor discloses to the Government the purposes and results of the research and development."

VI. Training Costs (ASPR 15-204.2(bb)). The attached draft provides that where training is conducted "by" an educational institution, the cost of "part-time" training which is of the "on-the-job type" is allowable without a specific contract provision. Discussions by the joint subcommittees, however, indicate that further clarification may be needed in regard to the meaning of "on-the-job type" training.

In regard to the costs of training "in" educational institutions, the proposed draft would make them unallowable "except to the extent specifically provided for in the contract in accordance with Departmental instructions." The words "in accordance with Departmental instructions" were included by the joint subcommittees in recognition of the fact that an area of increasing industry interest is involved and that it would be unwise not to develop a basis for consistent treatment. The added words appeared to afford the best means of achieving reasonable consistency within the limited time available for discussion of this item. The problem may well require additional study.

VII. General and Administrative Costs (ASPR 15-203.5, page 4). Under enumeration "(ii)" of factors to be considered in determining whether the method used for the allocation of general and administrative expenses provides for an equitable result, the proposed draft includes, "the results obtainable by using the input cost method" and also sets forth a definition of said method. This paragraph was otherwise subjected to substantial redrafting in view of the consensus of opinion within the Section XV Subcommittee that clarification was necessary.

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D. Matters Not Necessarily Requiring Final Action by the ASPR Committee Prior to Adoption of Part 2, Section XV.

I. Pension Plans (ASPR 15-204.2(q)(3)(iv)(B), page 15). Attention is invited to the matter of "Implementation of 'Side' Agreements" which is discussed in paragraph 4.A. of the Editing Committee report of February 27, 1956. In the draft there discussed, the problem was related to proposed ASPR 15-204.2(q)(3)(iii)(B) /ASPR 15-204.26d in the draft for editing/.

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6. It has not been possible in the time available for submission of this report, to set forth all of the differences between the draft submitted for editing and the attached draft. In this connection, it is recommended that, when this Part 2 is given detailed consideration by the ASPR Committee, the members of the Section XV Subcommittee be invited to participate for purposes of isolating and explaining such changes and the reasons therefor to the extent deemed appropriate by the ASPR Committee. In view of the substantially different numbering scheme which has been employed in the attached draft with respect to the Principles and Standards for Selected Items of Cost, covered under proposed ASPR 15-204, a table has been prepared (TAB A attached) showing the title and lettered paragraph designation of each item

in the attached draft of Part 2 followed by brackets containing the corresponding paragraph reference in the draft submitted for editing.

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APR 2 1956

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Section XV, Contract Cost Principles
Separate Report of the Army and Air Force members,
Editing Subcommittee

1. The Army and Air Force members of the Editing Subcommittee understood that the Editing Subcommittee's report of March 9, 1956 was returned to that Subcommittee solely to resolve, with the Section XV Subcommittee, any substantive differences between that report and the materials approved by the ASPR Committee in December 1955. On the contrary, a great part of the time of the two Subcommittees in the past two weeks has been devoted to consideration of entirely new substantive concepts put forth by various members of the Section XV Subcommittee. Since the Army and Air Force members of the Editing Subcommittee do not consider most of the changes made in the past two weeks necessary to conform the edited draft substantively to the draft approved by the ASPR Committee, and since they do not know which, if any, of the many new concepts have already been considered and rejected by the ASPR Committee or by the individual ASPR Committee members from the Departments in which the concepts originated, they are not able to recommend approval of the materials now being submitted to the ASPR Committee.

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i. 15-204.2(aa)(1) has been limited to the costs of the contractor's membership in organizations, as distinguished from the costs of membership of contractor employees.

j. 15-204.2(bb) has been changed to limit on-the-job training conducted by educational institutions to part-time training, and to require Departmental implementation before training in educational institutions can be provided for in a contract.

k. 15-204.3(d) has been changed to:

(1) disallow costs of repairing idle and excess facilities;

(2) limit the provision to contractor-owned facilities; and

(3) clarify the assumed meaning of "standby purposes."

l. 15-204.3(j) has been changed by adding a cross reference which is in fact an exception.

3. If a generalization may be hazarded, the changes made in the past two weeks tend to negate the idea of looking to the "reasonableness" of costs incurred, and substituting therefor various rigid rules of allowability of costs. This trend in turn is attributable, at least in part, to the idea expressed by certain members of the Section XV Subcommittee that the doctrine of "reasonableness" expressed in 15-201.2 permits only questioning the reasonableness of the price paid as compared to what the contractor got but does not permit questioning the reasonableness of the contractor's incurring the cost in the first place. Possibly this limited interpretation of "reasonableness" is due to the school of thought which considers Part 2 of Section XV to be an audit manual.

4. The Army and Air Force members of the Editing Subcommittee recommend that the ASPR Committee review the materials now being submitted on the subject case as if they were an entirely new substantive submission from the subject Subcommittee, subject only to recognition that the submission has been edited.

Lt. Col. Charles W. Wilkinson
Army Member
Editing Subcommittee

John W. Perry
Air Force Member
Editing Subcommittee

(e) Fines and Penalties. /15-204.13/

(f) Interest and Other Financial Costs. /15-204.16/

(g) Losses on Other Contracts. /15-204.18/

(h) Organization Costs. /15-204.22/

(i) Precontract Costs. /15-204.28/

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. /15-204.30/

(k) Reconversion Costs. /15-204.31/

February 27, 1956

MEMORANDUM FOR THE ASPR COMMITTEE

Subj: ASPR Case 53-44, Revision of Section XV, Contract Cost Principles

1. The Editing Committee has substantially completed its task with respect to the draft of Part 2, Section XV, submitted for editing in accordance with Item 4 of the Minutes of the ASPR Committee Meeting of 13 December 1955. In accordance with instructions of the Staff the edited Part is not submitted herewith; however, it can be submitted in final edited form immediately after resolution of the following three matters.

A. Consideration by the ASPR Committee of certain new substantive matter introduced by the Editing Subcommittee in connection with Material and Supply Costs (proposed ASPR 15-204.2(n)(6)). This is discussed in paragraph 3.A. below.

B. Consideration by the ASPR Committee, in connection with Research and Development Costs (proposed ASPR 15-204.2 (v)(3), of the need for clarification of the term "product line" and, also, of the possibility of an inequity in regard to the allocation of costs allowable under the subject subparagraph. This is discussed in paragraph 3.B. below.

C. An issue within the Editing Subcommittee with respect to the costs of Pension Plans (proposed ASPR 15-204.2(q)). This is discussed in paragraph 3.C. below.

2. In addition to the foregoing there are certain other matters which the members of the Subcommittee wish to bring to the attention of the ASPR Committee. These matters are discussed in paragraphs 4 and 5 below. They do not necessarily require resolution by the ASPR Committee prior to reproducing the edited Part.

3. The matters requiring consideration by the ASPR Committee prior to reproducing the edited Part are discussed under A, B, and C of this paragraph. It should be noted that the numbering of the edited Part is entirely different from that in the draft for editing. For convenience of reference, the heading for each comment in this paragraph, as well as elsewhere in this report, sets forth the number of the applicable paragraph and subparagraph in the edited Part followed by brackets containing the corresponding number in the draft for editing.

A. Material and Supply Costs - ASPR 15-204.2(n)(6) /15-204.21f/

The subject subparagraph as edited provides:

"(6) Costs of material, services, or supplies, sold or transferred between plants, divisions, or organizations, under common control, are allowable only to the extent of the cost to the transferor /, or the cost to the transferee, or the prices of other suppliers for the same or substantially similar items, whichever is lowest;/ 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 either (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."

In editing this subparagraph, the Subcommittee has added the words in brackets at the end of the first sentence in the draft for editing, immediately following the word "transferor." The inclusion of these words presents an addition of substance which is for consideration by the ASPR Committee.

B. Research and Development Costs - ASPR 15-204.2(v)(3) / 15-204.34b(ii)/

The subject subparagraph as edited provides:

"(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 ASPR 15-204.2 (m)). 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 type production contract if allocated to all production work of the contractor; provided the research is related to the contract product or product line. Such research costs are unallowable under cost type research and development contracts."

From the above, it will be noted that independent related research and development costs are allowable only if related to the contract product or "product line", but that such costs must be allocated "to all production work of the contractor." The Editing Committee is of the view that the term "product line" is susceptible of different interpretations and, in the interests of clarity, suggests that the ASPR Committee give consideration to the use of more meaningful terminology or to the development of a precise definition. Also, it appears that the requirement for allocating related research and development costs to "all production work of the contractor" may create an inequity. Under the circumstances, it may be desirable to consider whether the current requirement for allocation to "all production work of the contractor" should be revised to require allocation to all production work in connection with the "product line" as that term may subsequently be defined or otherwise clarified.

C. Pension Plans - ASPR 15-204.2(q) /ASPR 15-204.26/

The Chairman and the Army and Air Force members are not in agreement with respect to the subject paragraph as to the matters set forth below.

I. Substantive Change. The major difference of opinion arises over the question whether the edited version of proposed ASPR 15-204.2(q)(iii) acceptable to the Army and Air Force members varies substantively from the corresponding paragraph /15-204.26d/ of the draft for editing. The latter paragraph provides:

"d. In determining the net costs allocable to military contracts, consideration will be given to the possibility of future abnormal termination credits or gains and the effect such credits or gains would have upon current costs. These termination credits or gains will arise with respect to individuals for whom current costs are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits purchased or funded by current costs. When such credits or gains are foreseeable and their worth can be evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to the anticipated future credits or gains will be made. Such equitable adjustment can be accomplished either by discounting 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 discount for the abnormal termination credits or gains which are anticipated. However, most often such abnormal credits or gains, if foreseeable at all, are not susceptible of being evaluated at the time of contracting because neither the timing nor the severity of the termination actions will be known. Under these circumstances, the Government's interest in such abnormal credits or gains will be preserved for retrospective evaluation and accounting. If a contractor has but one or relatively few Government contracts, an appropriate contractual provision may be used to preserve the Government's interest by providing retrospective accounting and any necessary adjustment to pension plan cost incurred under the contract. In other cases, where a contractor is not limited to one or few Government contracts or there is reasonable probability he will receive follow-on contracts, a separate contractual "side" agreement will be negotiated having application to all pension costs allowed under contracts with the particular contractor and provide for an accounting of abnormal credits or gains, as that term is defined in the agreement, arising by reason of a cutback or cessation of Government contract work."

There is set forth below, as proposed ASPR 15-204.2(q)(3)(iii), a consolidated edited version of the preceding paragraph. The Army and Air Force members are in agreement with all except the words in brackets which the Chairman considers necessary to avoid a substantive change in the draft for editing. If the Chairman's version is adopted, the underlined word "and" preceding the "or" in each of the first two sets of brackets should be deleted.

> "(iii) in determining the net costs allocable to military contracts, consideration shall be given, in accordance with (A) and /or/ (B) below, to the effect upon current costs of possible future abnormal termination credits or gains which may arise with respect to individuals for whom current costs are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits purchased or funded by current costs —

"(A) when such credits or gains can be currently evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to the 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 /or/

"(B) /when such credits or gains cannot be currently evaluated with reasonable accuracy,/ such pension plan costs incurred under the contract shall be subject to retrospective accounting and any necessary adjustment for subsequent termination credits unless the Government and the contractor agree in writing upon any necessary adjustment, or the method of determining such adjustment."

II. Consistency with Interpretation in Part 6, Section XV. A lesser difference also exists within the Editing Subcommittee with regard to proposed ASPR 15-204.2(q)(2). Here, the disagreement does not involve the question whether the edited version acceptable to the Army and Air Force members is substantively different from the corresponding subparagraph /15-204.26c/ in the draft for editing but the question whether it was intended that the latter draft should be significantly different from the interpretation set forth in Part 6, Section XV. The Chairman is of the view that an apparently unexplained significant difference does exist with respect to the coverage of pension plans for nonprofit and other tax exempt organizations.

Subparagraph 15-204.26c of the draft for editing provides:

"c. The costs of a pension plan approved by the Military Department concerned, to the extent such costs are claimed and deductible for income tax purposes (or are determined to be reasonable in the case of nonprofit or tax exempt organizations), are allowable except

as otherwise determined unallowable under this paragraph. Such costs may include excess contributions to the extent such contributions are claimed and allowed for Federal income tax purposes in the current taxable period. In cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract cost will be made for contributions disallowed for tax purposes which previously had been allocated to and allowed as contract costs."

It is the Chairman's understanding that no particular reason existed within the Section XV Subcommittee for significant departure from the current treatment of the pension plans of nonprofit or tax exempt organizations, set forth in part in ASPR 15-601.2(b), as follows:

"(b) Pension or retirement plans of a contractor which are subject to approval of the Bureau of Internal Revenue must have been so approved before costs under the plans may be accepted as charges to Government contracts. Many plans of nonprofit or other tax exempt organizations are also reviewed and approved by the Bureau of Internal Revenue -- when not so reviewed and approved, each such plan will be reviewed, and approved or disapproved, by the Department to which audit cognizance is assigned, using, insofar as applicable, the criteria and standards of the Internal Revenue Code and the regulations of the Bureau of Internal Revenue. In any case where the Bureau of Internal Revenue withdraws approval of a plan, approval of amounts allocated to contract costs will be withdrawn accordingly."

Since Part 6, Section XV, received extended consideration by a Subcommittee addressing itself to that specific problem, the Chairman is of the view that significant departures therefrom should be avoided unless clearly intended and adequately justified.

There is set forth below, as proposed ASPR 15-204.2(q)(2) and (3)(i) and (ii), a consolidated edited version of the above subparagraph 15-204.26c, with the controversial portions favored by the Army and Air Force members underlined and those favored by the Chairman in brackets.

"(2) Consideration, and approval or disapproval, of all pension plans and the method of determination of the costs thereof / of approved plans/ 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. Plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the cognizant Department; 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. Pension plans of nonprofit or other tax exempt organizations are not required to be reviewed and approved by the Internal Revenue Service. / Many pension plans of nonprofit or other tax exempt organizations are reviewed and approved by the Internal Revenue Service although such review and approval is not required. When the plans of such organizations are not reviewed and approved by the Internal Revenue Service, the cognizant Department shall review, and approve or disapprove, such plans, using, insofar as applicable, the criteria and standards of the Internal Revenue Code and the Regulations of the Internal Revenue Service./

"(3) Reasonable costs of pension plans approved by the cognizant Military Department are allowable subject to the following conditions:

"(i) except in the case of nonprofit or tax exempt organizations, such costs, including excess contributions, are allowable only to the extent claimed and allowed for Federal income tax purposes in the current taxable period;

"(ii) in cases where the Internal Revenue Service withdraws approval of a plan, /whether or not review of the plan by Internal Revenue Service was mandatory,/ an appropriate adjustment of contract costs shall be made for /which, except in the case of nonprofit and tax exempt organizations, shall take into account/ contributions disallowed for tax purposes which previously had been allocated to and allowed as contract costs;"

The Chairman is of the view that the underlined third sentence of subparagraph (2) treats the problem of pension plans of non-profit and other tax exempt organizations in a manner which is too cryptic. If it is desired that the treatment of the problem be substantially parallel to that in existing ASPR 15-601.2(f), the Chairman recommends the deletion of the underlined sentence and substitution of the material in brackets which follows in both subparagraphs (2) and (3).

Attached as TAB A is a consolidated edited treatment of Pensions Plans -- ASPR 15-204.2(q) /15-204.26/ in which the controversial portions favored by the Army and Air Force members are underlined and those favored by the Chairman are in brackets.

4. The Chairman further invites the attention of the ASPR Committee to the following which is one of the matters referred to in paragraph 2 above as not necessarily requiring final action by the ASPR Committee prior to reproduction of the edited Part.

Pension Plans - ASPR 15-204.2(q)(3)(iii)(B) /15-204.26d/

A. Implementation by "Side" Agreements. In connection with subject subparagraph (see TAB A attached), it is noted that the ASPR Committee recently considered the development of an agreement for Government-wide or DOD-wide use to provide for the recovery of reversionary credits of costs of pension plans (see ASPR Case 55-111, Item 11 of the Minutes of December 13, 1955). This case was withdrawn by the Army ASPR Committee Member on the basis of the prior consideration given to the general problem of reversionary credits by the ASPR Conference in Case 51-34 (see Item 8 of the Minutes of April 8, 1952). In that case, the ASPR Conference approved the report of the Contract Cost Subcommittee of 13 March 1952, which recommended as follows:

> "The Committee feels that what is needed here is appropriate implementation by the military departments to their auditors and contract negotiators so that pension costs will be questioned and proper action taken thereon where appropriate. It does not believe that any action by the ASPR Conference beyond concurrence with this viewpoint is necessary or desirable at this time." (Emphasis added.)

It is understood that each of the Departments has been experimenting with the development of agreements to provide for the recovery of reversionary credits, of the same general type as referred to in Case 55-111, and that, in the interests of achieving uniformity, there has been informal coordination among representatives of the Departments. Paragraph 15-204.26d of the draft for editing (set forth in paragraph 3.C. above) refers to similar agreements as "side" agreements. Under the circumstances, the ASPR Committee may wish to consider whether further action on the matter of DOD-wide agreements providing for the recovery of reversionary credits is appropriate at the present time.

B. Further Implementation. It is suggested that it may be desirable to consider whether further implementation of the subject subparagraph is appropriate. Attention is invited to ASPR Case 55-47 - Cost Reimbursement Type Contracts - Development of Standard Basic Forms for Release and Assignment of Credits, Refunds, and Rebates, for possible consideration in this regard.

5. The Editing Subcommittee invites the attention of the ASPR Committee to the following as one of the matters referred to in paragraph 2, which do not necessarily require final action by the ASPR Committee prior to reproduction of the edited Part.

Overtime, Extra-Pay Shift, and Multi-Shift Premiums- ASPR 15-204.2(o) / 15-204.24/

The subject paragraph provides as follows:

"(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees may be classified as either direct or indirect labor costs, but the amount of such premiums shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government (see ASPR 12-102 for further information concerning the policy regarding such authorization). When direct labor cost is the base for distribution of overhead, the premium portion of overtime payments shall not be included in that base. The premium portion of overtime,

extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work. When such premium costs are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs."

It is considered that an appropriate subcommittee familiar with the policy set forth in ASPR 12-102 should be asked to reconsider that ASPR provision in the light of proposed ASPR 15-204.2(o). It is considered that particular attention should be addressed to the terms "authorization" and "prior approval", and to the matter of premium pay to indirect labor employees which is not now specifically treated in ASPR 12-102.

6. It is requested that the Editing Subcommittee be furnished instructions with respect to the matters set forth in paragraph 3 and that the ASPR Committee take such action as may be appropriate with respect to the matters set forth in paragraphs 4 and 5.

GEORGE W. MARKEY, JR.
Navy Member
Chairman

CHARLES W. WILKINSON
Lt. Colonel, SS JAG
Army Member

JOHN W. PERRY
Air Force Member

February 27, 1956

PROPOSED ASPR 15-204.2

* * *

(q) Pension Plans.

(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, either the 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 (q).)

(2) Consideration, and approval or disapproval, of all pension plans and the method of determination of the costs thereof / of approved plans/ 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. Plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the cognizant Department; 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. Pension plans of nonprofit or other tax exempt organizations are not required to be reviewed and approved by the Internal Revenue Service. / Many pension plans of nonprofit or other tax exempt organizations are reviewed and approved by the

Internal Revenue Service although such review and approval is not required. When the plans of such organizations are not reviewed and approved by the Internal Revenue Service, the cognizant Department shall review, and approve or disapprove, such plans, using, insofar as applicable, the criteria and standards of the Internal Revenue Code and the Regulations of the Internal Revenue Service. /

(3) Reasonable costs of pension plans approved by the cognizant Military Department are allowable subject to the following conditions:

(i) except in the case of nonprofit or tax exempt organizations, such costs, including excess contributions, are allowable only to the extent claimed and allowed for Federal income tax purposes in the current taxable period;

(ii) in cases where the Internal Revenue Service withdraws approval of a plan, /whether or not review of the plan by Internal Revenue Service was mandatory,/ an appropriate adjustment of contract costs shall be made for /which, except in the case of nonprofit and tax exempt organizations, shall take into account/ contributions disallowed for tax purposes which previously had been allocated to and allowed as contract costs;

(iii) in determining the net costs allocable to military contracts, consideration shall be given, in accordance with (A) and /or/ (B) below, to the effect upon current costs of possible future abnormal termination credits or gains which may arise with respect to individuals for whom current costs are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits purchased or funded by current costs —

(A) when such credits or gains can be currently evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to the 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 /or/

(B) /when such credits or gains cannot be currently evaluated with reasonable accuracy,/ such pension plan costs incurred under the contract shall be subject to retrospective accounting and any necessary adjustment for subsequent termination credits unless the Government and the contractor agree in writing upon any necessary adjustment, or the method of determining such adjustment.

(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.

NOTE — The above proposed ASPR 15-204.2(q) is a consolidated edited version of paragraph 15-204.26 of the draft for editing. The controversial material favored by the Army and Air Force members is underlined and that favored by the Chairman is in brackets.

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

November 1, 1955

MEMORANDUM FOR THE ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Part 2, Section XV

Your Subcommittee has reviewed the comments of the following with respect to subject: NSIA, MAPI, RETMA, NAM, AMA, C. of C., AIA, American Institute of Accountants, Council of Profit Sharing Industries, and Comptrollers Institute of America. These comments resulted in numerous revisions of our 3/23/55 draft.

At the outset, the subcommittee wishes to draw attention to certain major issues with industry which are historic and have not been resolved in this draft to the complete satisfaction of industry. While these issues have been taken up separately in this report, they are mentioned here because of their importance and long standing differences. They are (1) 15-203.3, Selling and Distribution Expenses, (2) 15-204.1, Advertising, (3) 15-204.11, Entertainment, (4) 15-204.16, Interest and (5) 15-204.18, Losses on Other Contracts.

Industry made the following general observations which the subcommittee believes worthy of mentioning. First, they object to the requirement, in many cases, that some costs to be allowable must be upon authorization by special contract provision or by written authorization of the contracting officer, rather than just the approval of the contracting officer.

Second, throughout the proposed draft there is interjected a requirement that the auditor evaluate the equities of the situation, in addition to his usual function of measuring the reasonableness of the amount and the proper allocability of the item. Section XV should be limited to indicate types and amounts of cost which are or are not allowable in cost-type contracts and it should not be made an audit manual for the various services.

The third observation is that detailed implementing instructions of the departments should be prepared prior to the publishing of this section.

The following paragraphs contain what the Subcommittee considered to be major unresolved issues with industry, certain differences which developed within the Subcommittee, and other comments on particular paragraphs of the draft.

15-200 Scope of Part.

INDUSTRY POSITION

A statement should be included to the effect that Section XV is not applicable to fixed price contracts, including those with price redetermination provisions.

SUBCOMMITTEE POSITION

The proposal is not acceptable since audit agencies have no alternative at present other than to use Section XV as a guide in auditing these contracts.

15-201(b) Factors Affecting Allowability of Costs.

INDUSTRY POSITION

Costs should not be measured by the new criterion "significant deviation in the established practices of the contractor which substantially increase the contract costs."

SUBCOMMITTEE POSITION

This new criterion is only one of the factors affecting allowability of costs. This does not take anything away from the contractor. If the reason for the deviation is justified, costs may still be allowed.

15-203.2 Indirect Engineering Expenses.

AIR FORCE MINORITY POSITION

The Air Force Procurement member does not agree with the subcommittee's change of inserting the parenthetical phrase "(including independent research projects)" in paragraph 15-203.2.

The Subcommittee's purpose in inserting this phrase was to cover those few situations where contractors do not have a separate research department but perform their research in their engineering departments. To meet these situations, the subcommittee wanted a statement in Section XV to provide that where independent research is performed in an engineering department, allocation of indirect engineering expenses will be made to such research work.

The objection of the Air Force procurement member stems from the belief that such statement is unnecessary since the purpose of inserting the parenthetical statement is already accomplisned by the present wording of recognizing independent research expenses in paragraph 15-204.34c:

> "Independent research projects will absorb their appropriate share of indirect expenses of the department where research work is performed."

Furthermore, the insertion of the parenthetical statement makes paragraph 15-203.2 subject to misinterpretation since a literal reading of the paragraph with the insertion is likely to be to the effect that indirect engineering expenses of the engineering department should be allocated to research projects even though such work is performed in a research department independent and apart from the location of the engineering department. This, of course, was not what was intended. The Air Force procurement member, therefore, recommends the deletion of the parenthetical statement.

15-203.3 Selling and Distribution Expense.

INDUSTRY POSITION

Selling and distribution expenses are generally a cost which should be acceptable as allocable to Government contracts by associating such expenditures with an indirect benefit to Government work. It contends that the Government stands to benefit by being able to place orders for standard commercial products or specially designed products with companies which, through expenditures for advertising, sales promotion and selling activities, have capacities to produce efficiently and quickly the requirements of the Government that otherwise could not be possible without delays and expenditures. Industry would like the allowable costs more clearly defined. However, it is noted that the American Institute of Accountants says: "This treatment of selling expenses seems entirely satisfactory to me, and is in agreement with good industrial and contract practice."

SUBCOMMITTEE POSITION

Pure selling expense of the contractor as such is unallowable for the reason that it is not necessary and does not contribute anything to the performance of the contract. Generally, any type of marketing expense in the ordinary sense is not considered to be necessary in contract performance and is not required in doing business with the Government. However, the Subcommittee does feel that a reasonable demonstration that his technical, consulting and related beneficial services which are for purposes of application and adaptation of the contractors products may justify allocation of Government contracts. Any further liberalization would be unjustified.

15-203.4 General and Administrative Expenses.

INDUSTRY POSITION

It is not necessary to enumerate factors to be considered in determining whether a method of distributing general and administrative expenses will produce equitable results. The inclusion of such a listing will lead only to further confusion and may cause overemphasis on the use of the factors enumerated.

SUBCOMMITTEE POSITION

It is recognized that this paragraph involves a controversial matter and one which requires the consideration of many different points. However, it is felt that inclusion in this paragraph of several illustrative factors to be given consideration will not only insure that the listed factors are considered but will tend to indicate that there are many facets to the problem.

15-203.5 Base Period for Allocation of Indirect Expenses.

INDUSTRY POSITION

This paragraph is inconsistent with 15-203(b) and permits Government personnel to select the periods which must be used.

SUBCOMMITTEE POSITION

The Subcommittee fails to see any inconsistency between this paragraph and 15-203(b). One deals with the method of allocation and the other with the base period for allocation.

15-204.1 Advertising.

INDUSTRY POSITION

The present limitations on advertising are too restrictive, and overlook the fact that any advertising is a normal cost of doing business from which the Government has derived benefit and as such should bear a portion of the expenses.

SUBCOMMITTEE POSITION

Advertising, generally, is not necessary in order for industry to conduct business with the Government. On the other hand, in the modified version, Government recognition has been accorded that portion of industry advertising which encourages dissemination of technical information within industry itself through certain media, the results of which benefit both industry and the Government, and the Government will share in its portion of same. One slight concession made by the Subcommittee is the deletion in the third line of paragraph a. (1) after the word "placed" of the phrase, "for the purpose of offering financial support to", and substituting the word "in". The change was made because of the difficulty of determining a contractor's intent and the words were not helpful in determining cost allowances. The Subcommittee set forth its views on this subject in greater detail in previous reports.

15-204.6 Compensation for Personal Services.

The DOD position on profit sharing has not been determined by higher authority. Accordingly, the Subcommittee found it impracticable, because of cross references, to write this entire paragraph in final form until policy guidance is forthcoming.

15-204.8 Contributions and Donations.

INDUSTRY POSITION

Industry has two objections to the proposed recognition of contributions and donations. First, industry objects to the exclusion of religious contributions and donations as a reimbursable cost. Next, industry feels that aside from the reasonableness of the amount of donations and the contractor's consistent practice of making such donations that the only additional limitation for the recognition of these donations is that the amount be deductible for federal income tax purposes. Accordingly, industry objects to the phrase "but the deductibility of the contribution for income tax purposes does not in itself justify its allowability as a contract cost."

SUBCOMMITTEE POSITION

(1) Religious donations should not be a reimbursable contract cost because (a) it cannot be said that religious donations are an ordinary and necessary business expense and (b) it is believed that the reimbursement to contractors of their religious donations from Public and Defense Funds would violate public policy.

(2) The deductibility of an item for federal income tax purposes should not be the only consideration for its recognition as a contract cost. For example, propriety and reasonableness are other standards. Hence, the phrase quoted above and objected to by industry is necessary in regarding the recognition of contributions and donations.

15-204.9e Depreciation.

Protracted discussions in the Subcommittee failed to resolve the question of whether the term "emergency facility" or "emergency facilities" should be used in this paragraph.

MAJORITY POSITION

The issue arises because of the Army and Air Force policy of allowing contractors to select categories of facilities, for which separate findings are made on a determination, for true depreciation and those for normal depreciation.

NAVY MINORITY POSITION

Navy policy is that once a true depreciation determination is made, a contractor must elect to take true or normal depreciation for all the facilities covered by the determination. Hence, Navy insistence on the words "emergency facilities"

15-204.11 Entertainment Expense.

INDUSTRY POSITION

Industry objects to the words "social activities" as it may create conflict with the provisions of 15-204.10 and 15-204.40. It further contends that unless there is an overriding public policy to the contrary, entertainment expenses reasonably allocable to Government contracts should be recognized, to the extent that it can be demonstrated that such expenses are ordinary and necessary to the business of a contractor.

SUBCOMMITTEE POSITION

There is no conflict with this paragraph and paragraphs 15-204.10 and 15-204.40. Furthermore, this type of expense is solely for the benefit of the contractor, serves no purpose to Government work and has been traditionally disallowed. The contractor may be placed in a favored class should he be allowed to recoup entertainment expense through Government contracts and is considered to be against public policy.

15-204.15(f) Insurance and Indemnification.

AIR FORCE MINORITY POSITION

The Air Force procurement member disagrees with the Subcommittee's wording of subparagraph (f) and believes that the following proposed wording would permit a more practicable application of accepting uninsured losses as a contract cost. The proposed change would remove uncertainty as to the Government commitments and liability in this area. It also makes the Government's commitment known at the time of contracting. Furthermore, it eliminates the Departmental approval of such cost (as the present language provides) and places it at the level of the procuring activity. It is proposed that (f) read:

> "f. losses resulting from failure to insure (through self insurance or otherwise) are not allowable unless authorized by special contract provision."

OSD MINORITY POSITION

It is recommended that the words, "unless approved by the Department concerned" be deleted in paragraph (f) since only one known Navy case was cited in substantiation of the phrase.

15-204.16 Interest and Other Financial Expenses.

INDUSTRY POSITION

Industry contends that interest should be allowable.

SUBCOMMITTEE POSITION

Interest has always been considered as unallowable because it represents a distribution of profits to persons who have advanced capital on a loan basis. The Subcommittee sees no reason why this position should be changed. More detailed reasons for disallowance are set forth in previous reports. In this connection, it should be noted that DOD Directive requires interest to be charged on advance payments.

15-204.18 Losses on Other Contracts.

INDUSTRY POSITION

Industry, in effect, requests that the portion of cost-participation contracts not reimbursed by the Government under that contract be allowed as a cost on other contracts.

SUBCOMMITTEE POSITION

This proposal is rejected since a contractor in accepting a cost-participating R&D contract expects that later production contracts will be obtained resulting in profit to compensate for earlier costs of participation.

15-204.19(b) Maintenance and Repairs.

INDUSTRY POSITION

Industry objects to the restriction of recognizing deferred maintenance expenses only by specific contract provision.

SUBCOMMITTEE POSITION

The requirement of a specific contract provision for recognition of this expense is necessary in order that the Government may exercise some control over the amount of deferred maintenance expense which may be charged against cost-type contracts. The contract provision requirement in no way lessens the recognition of this expense. Since such expenses could be substantial and the possibility of a dispute would always be present as to the amount which should be accepted as a contract cost, it seems best that this be covered by a contract provision.

15-204.21b. Materials and Supplies (Cash Discounts)

INDUSTRY POSITION

Industry questions the requirement of the Government that cash discount be taken as a credit against the cost of materials, their theory being that cash discount is actually financial income comparable to interest as a financial expense, and since interest is not considered an allowable cost, cash discount credits should be omitted from consideration.

SUBCOMMITTEE POSITION

The subject of cash discount credit is in an area completely separate from that of financial expense or financial income. Classifying cash discount as financial income is fallacious since realized income cannot arise through the operation of buying. Net prices are substantially on a cash basis and therefore represent the most effective costs. It is the net price which a seller expects to receive, and a buyer expects to pay. The cost of materials therefore is represented by the total outlay of cash or its equivalent for the purchase of the materials; if the cash paid out includes a reduction for allowances or credits taken by the contractor, the net amount paid represents the true cost of the material.

AIR FORCE MINORITY POSITION

The Air Force Procurement member believes the third sentence of this subparagraph is subject to misinterpretation since it gives the impression that a contractor has the election to credit discounts, rebates, etc. to material costs or to indirect costs. The Air Force Procurement member would clarify the 3rd sentence by adding the following: "which ever method has been consistently followed by the contractor." These added words are considered necessary since it is believed that the requirement for a consistent application of these credits is not necessarily found by reading the questioned sentence in light of the Basic Principles and Standards (15-201).

15-204.21e. Materials and Supplies (Write-down of Inventory Values).

INDUSTRY POSITION

Write-down of inventory value should be allowed as a contract cost.

SUBCOMMITTEE POSITION

Although this item is not a major objection by industry, the Subcommittee's position is that there is little, if any, merit to industry's contention in cost-type contracts. Write-down of material costs would, of necessity, have to apply to material costs unrelated to a Government cost-type contract and, therefore, should be absorbed by the business to which the (write-down of value) applies.

15-204.24 Overtime, Extra Pay Shift and Multi-Shift Premiums.

INDUSTRY POSITION

Industry wants restriction lifted with respect to cost of overtime and shift premium on indirect labor. The suggested change in the draft may remove some of the objection. As to such cost on direct labor industry wants no restriction except as provided by contract terms in accordance with the contractor's practices and procedures, this being a standard operating procedure for most companies and such provision is often made for such procedures in union contracts. This argument does not in any way appear to bind the Government.

SUBCOMMITTEE POSITION

For the contractor to be required to identify separately shift premium and overtime on his books is a sound practice and one which requires but little or no overhead cost to segregate. This has been traditional with the Government to restrict and control overtime and extra pay shift cost. Not to do so would invite the contractor to work normal hours on commercial work and run up lage amounts of extra pay and overtime cost. Extra pay cost and overtime premium on indirect labor is allowable on a pro rata basis to commercial and Government provided it is otherwise reasonable.

15-204.25 Patent Expenses.

INDUSTRY POSITION NO. 1

Costs of filing patent applications by a contractor should be allowed even though the Government may not obtain any rights under the patents because, by obtaining a patent, a contractor avoids the necessity of eventually being required to pay a royalty to some other person who may obtain a patent on the same invention.

SUBCOMMITTEE POSITION NO. 1

This comment was rejected on the basis that the contractor gets title to the patents and the primary benefits therefrom. This would amount to a windfall to the contractor if the Government paid.

INDUSTRY POSITION NO. 2

Add to allowable costs "the defense of patent infringement litigation".

SUBCOMMITTEE POSITION NO. 2

Under the Act of June 25, 1910, as amended, (28 USC 1498), only the Government can be sued for patent infringement on contractor's production for the Government. If a contractor is sued for patent infringement, it must be for its own commercial production. Therefore, there can be no costs to industry for defense of patent infringement litigation, except such as are passed on to industry by the Government through the Patent Indemnity clause. To allow such costs would conflict with the purpose of the Patent Indemnity Clause.

15-204.29c. Legal Fees.

INDUSTRY POSITION

The cost of successful anti-trust suits brought by the Government and the cost of successful prosecution of claims against the Government should be allowable on the premise that these are ordinary, necessary and proper expenses of doing business and therefore should be considered allowable.

SUBCOMMITTEE POSITION

Costs incurred in these connections, whether the results of the actions are successful or not, are unallowable. Reimbursement of litigation costs where the Government is a party to the suit is obviously untenable. The Government can not financially support the party with which it is engaged in legal dispute.

15-204.30 Profits and Losses on Disposition of Plant, Equipment or Other Capital Assets.

INDUSTRY POSITION

Such profits and losses should be allowable to the extent that they represent adjustments to depreciation on assets acquired for Government business.

SUBCOMMITTEE POSITION

The subcommittee agrees with this contention but feels that it would be impractical, if not impossible, to distinguish between that portion of a profit or loss which represents an adjustment of depreciation and that which was caused by fluctuations in the general price level.

15-204.31 Reconversion Expenses.

INDUSTRY POSITION

Industry comments ran the complete gamut from general agreement with the item as drafted to an extreme statement by Auto Manufacturers Association that "we can see no reason for disallowing any conversion expenses".

SUBCOMMITTEE POSITION

It is apparent that industry should seek a birth-to-burial treatment of reconversion expenses; however, the comments furnished no valid reasons for changing the principle. Specific provision in the contract of those reconversion expenses which are allowable appears the best method of assuring fair treatment of the Government's and contractors' interests. All items not specifically provided for in the initial contract or by modification are not allowable.

15-204.33 Rentals of Plant and Equipment.

INDUSTRY POSITION

The restriction on amounts of allowable rent for facilities covered by sale and lease-back agreements is not equitable. As long as the rents are reasonable in the light of the type, condition and value of the facilities leased, options available and other provisions of the rental agreement the Government's interests are adequately protected. In addition, the Government would be penalizing companies who have sale and lease-back agreements as contrasted with companies holding conventional leases.

SUBCOMMITTEE POSITION

Sale and lease-back agreements are primarily entered into to provide additional working capital, without borrowing funds, or issuing additional capital stock. Another reason could be to obtain tax benefits. To accept the risk, financing and profit factors included in the rental of sale and lease-back facilities would be contrary to our position regarding interest as a nonallowable cost. Furthermore, the accelerated amortization usually included in the rental may represent an unreasonable contract cost.

15-204.34b(i) Research and Development (General Research)

The subcommittee concurs with the violent objection of industry to placing a ceiling of 25% on general research costs. The draft takes a new approach of allowing "the allocable portion of 75% of the allowable costs of a contractor's independent general research". Under this arbitrary formula, there is no penalty for being predominantly a defense contractor but some restriction is placed on such a contractor from going whole hog on general research by forcing him to place some of his own funds into such projects. Some Subcommittee members are not adamant in the position on the percentage figure and are willing that the figure be as high as 90%. Other Subcommittee members feel that 75% is a reasonable figure but should be followed by the parenthetical insertion "(or such other percentage as may be agreed upon and set forth in the contract Schedule)" since flexibility is desirable in this area.

15-204.35 Royalty Payments.

INDUSTRY POSITION

Industry takes objection to the limitation on the allowability of royalties where royalties paid or payable for the right to use patents necessary

for the proper performance of a contract and where the Government does not already have a royalty-free license to use such patents, the royalties are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the Contracting Officer. Industry contends that it should be permitted to manufacture products under license agreements which they would otherwise have to purchase and that payment for same should not be subject to such limitations.

SUBCOMMITTEE POSITION

In the Subcommittee's opinion, the payment of royalties to contractors under the circumstances described should be circumscribed by contract provisions or effected under the Contracting Officer's cognizance. Because fees for use of patents, where the Government does not have a royalty-free license to use same, may often be predicated on the highest rates the market will bear, and since payment limitations are difficult to establish where effective competition does not exist, the Government has established procedures leading to the reduction of royalties where royalty payments in connection with contract performance are deemed excessive. The inclusion of the limitations in the revision permits review of the circumstances surrounding the incurrence of royalty payment costs and assures control by the Contracting Officer. In addition to the cost feature, review by the Government can be effected to assure that the Government does not already have a royalty-free license to use the patent concerned. In summary, Contracting Officers can determine if the royalty costs are bona fide and reasonable.

15-204.36 Service and Installation Expenses.

BACKGROUND

The 3/23/55 draft contained a provision (now deleted) concerning correcting product defects and replacing defective parts.

ASPR POSITION

ASPR 7-203.5 - Inspection of Supplies and Correction of Defects - provides that the Government will pay these costs unless caused by high officials of the contractor.

SUBCOMMITTEE POSITION

When such costs are incurred due to failure to comply with contract terms or specifications, or from causes considered to be beyond the area or reasonableness, such costs including any applicable overhead should be unallowable. The Subcommittee will present an actual case in substantiation of its recommendation that the ASPR Committee give serious consideration to amending ASPR 7-203.5 along the above lines.

15-204.37 Severance Pay.

INDUSTRY POSITION

The portion of the revised provision relating to contract costing of mass or

abnormal severance pay is impractical and would be difficult and cumbersome to apply, and the cost of severance pay, generally, should be handled on a basis conforming with accepted accounting principles and practices and the established policy of a contractor, rather than policy which constitutes an implicit agreement on the contractor's part. Industry also feel that perhaps allowability should be provided for on either an actual or an accrual basis.

SUBCOMMITTEE POSITION

The treatment as proposed for mass severance pay is the most practical and realistic approach to a problem which concerns an unpredictable contingency. It is felt that a contingency reserve for mass severance pay is too conjectural to be considered a cost. The Government should not obligate itself for more than its pro rata share of severance wage payments actually made, in accordance with a policy reflecting implicit agreement by a contractor, on the basis of its ratio of participation in the contractor's total business during the period of employment of the individual involved.

15-204.39a(3) Taxes

INDUSTRY POSITION

This clause should be eliminated as in many cases the cost of securing the exemption exceeds the amount to be saved.

AIR FORCE MINORITY POSITION

The Air Force members believe there is merit in industry's comment and propose the clause be revised to read as follows:

> "Taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the Government."

15-204.39b. Taxes.

INDUSTRY POSITION

Industry generally contends that this paragraph should be revised to allow cost of taxes, interest, penalties and expenses of contractor's acts in resisting assessments or attempting to secure refunds, without the imposition of the restrictions presently included in this paragraph as in certain situations contractors cannot possibly or reasonably comply with these requirements.

SUBCOMMITTEE POSITION

The restrictions imposed by this paragraph are reasonable in that they merely require the contractor to obtain and follow instructions from the contracting officer in cases where there is a doubt as to the legality or correctness of a tax assessment.

15-204.40 Trade, Business and Professional Activities (Exhibitions).

INDUSTRY POSITION

The expenses of holding exhibitions is a required cost of doing business, as normal and essential as expenses incident to meetings and conferences, and as such should be allowable. Further, the revision is unduly restrictive in that it relates only to expenses incurred at meetings and conferences when the primary purpose of the incurrence is the dissemination of technical information or information aimed at the stimulation of production, and does not include expenses of exhibitions incurred for dissemination of information to the trade, the public, prospective employees, etc., about the particular business.

SUBCOMMITTEE POSITION

This matter is quite similar to the problem of allowability of advertising. Doing business with the Government does not presume that dissemination of information about the business to the trade or public through exhibitions is necessary. The Government is agreeable, however, to accepting its pro rata share of expenses incurred for the dissemination of technical information or information aimed at stimulation of production through meetings or conferences. The exhibitions referred to by industry are those held for purposes other than these; therefore, the costs thereof are considered unallowable.

GENERAL COMMENTS

1. Some existing subcommittee members do not necessarily concur with every view expressed by their predecessors but concurred in the Report to expedite consideration.

2. The need for editing is recognized.

3. GAO concurrence has not been obtained.

4. Prior to publication, Part 1 must also be revised (the Subcommittee has made considerable progress on revised Part 1) and certain cross-referencing accomplished on existing Parts 3 and 4.

SECTION XV SUBCOMMITTEE

MEMBERS:

H. H. Gallup (Chairman)
Maj. J. O. Hunnicutt
Mr. E. M. Wiseman
Mr. James Ruttenberg
Mr. A. C. Sawallisch
Mr. P. M. Southwell
Mr, George Rudigier

27 April 1955

MEMORANDUM FOR: CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44 - Depreciation Cost Interpretation for Inclusion in Part 6, Section XV, ASPR

1. Reference is made to the memorandum for the Chairman, ASPR Committee, dated 24 March 1955, subject as above, in which the Editing Committee presented an edited proposed ASPR 15-602. This was discussed at the ASPR Committee meeting on 5 April 1955, and returned to the Editing Committee for further revision, as indicated in the minutes of that meeting.

2. The Editing Committee has reviewed proposed ASPR 15-602 in the light of the mentioned minutes, and recommends only that ASPR 15-602.1 be revised to read as follows:

15-602.1 - Applicability and Effective Date. This cost interpretation pertains to ASPR 15-204(d), 15-205(b), and 15-205(c), with regard to contracts executed on or after the date of its issuance. It shall also apply to existing contracts in those cases where such interpretation was (i) specially provided for in the contract or in the record of contract negotiations, or (ii) in the absence of specific agreement, where the parties have reserved final resolution of the question of cost allowance in regard to depreciation pending the issuance of an interpretation by the Departments with respect to the applicability of Section 167 of the Internal Revenue Code of 1954.

3. The Editing Committee has considered other suggestions contained in the minutes, but does not feel that the proposed ASPR 15-602 should be further revised to quote or paraphrase the statute, or to make reference to "assets" involved.

MEMO FOR: ASPR COMMITTEE 27 Apr 55
SUBJECT: Case 53-44...

4. The Navy Member presented to the Editing Committee, for consideration, a memorandum to him, (Tab 1), recommending further change to ASPR 15-602.2, as set forth in Inclosure 1 to mentioned memorandum from the Editing Committee, dated 24 March 1955. The Editing Committee feels that this proposal should be considered by the ASPR Committee, and, therefore has taken no affirmative action on the recommendation.

1 Incl
(Tab 1)

MAURICE LEVIN
Lt. Colonel, JAGC
Army Member
Chairman

GEORGE W. MARKEY, JR.
Navy Member

WILLIAM MUNVES
Air Force Member

OGC/GWM:lwt
April 2, 1956

MEMORANDUM FOR THE ASPR COMMITTEE

Subj: ASPR Case 53-44, Revision of Section XV, Contract Cost Principles

1. The joint report of the Editing Subcommittee and the Section XV Subcommittee, dated March 9, 1956, dealt with the three matters submitted by the Editing Subcommittee (report dated February 27, 1956), for resolution prior to completing the edited draft of Part 2, Section XV, and also submitted a proposed edited draft of the entire Part, prepared by the Editing Subcommittee. Except for the above three matters relating to Material and Supply Costs, Research and Development Costs, and Pension Plans, the Section XV Subcommittee had not participated in the edited draft. The ASPR Committee requested consideration of this edited draft (TAB B attached to the joint report of March 9, 1956), jointly, by the Editing and Section XV Subcommittees prior to further consideration by the ASPR Committee. Commencing March 16, 1956, the joint subcommittees met almost daily through March 28, 1956, preparing the attached draft of Part 2, Section XV, dated March 29, 1956.

2. The Section XV Subcommittee had fully recognized that its final draft as considered by the ASPR Committee (Minutes of November 22, 1955, Item 3) was in need of, and strongly recommended that it receive, substantial editing. After certain revisions by the ASPR Committee, that draft was submitted to the Editing Subcommittee for editing (Minutes of December 13, 1955, Item 4). In the course of consideration by the joint subcommittees of the draft of the Editing Subcommittee, it became apparent, with respect to various matters, that words originally included by the Section XV Subcommittee in its draft to express a particular principle or limitation or convey some other idea did not have the same meaning to accounting, procurement, and legal personnel. In other instances, it appeared that matters substantially agreed to in principle during the earlier deliberations of the Section XV Committee had either not been covered at all or were incompletely covered in the Section XV Subcommittee's draft.

3. In view of the above circumstances, when there was general agreement within the Section XV Subcommittee that a particular matter required discussion, the Chairman of the Editing Subcommittee, in presiding over the joint subcommittee sessions, permitted such discussion. In no case, was

such discussion permitted on the basis of a unilateral request by any member without concurrence of the Section XV Subcommittee. The Air Force and Army members of the Editing Subcommittee have questioned the authority of the joint subcommittees to undertake certain of these discussions and will file a separate report in regard thereto.

4. Except as indicated below and in the joint report of March 9, 1956, the attached draft of Part 2, Section XV, has the unanimous concurrence of all members of the Section XV Subcommittee from the standpoint of substance, and of the joint Editing and Section XV Subcommittees from the standpoint of editing. Owing to certain unavoidable circumstances, all members of the Section XV Subcommittee were unable to be present at the final joint session on March 28, 1956, and it has not been possible to clear the entire attached draft of Part 2 with each of them within the time required for submission to the ASPR Committee.

5. It is desired that the attention of the ASPR Committee be invited to the following specific matters. Unless otherwise indicated, reference to ASPR paragraphs and related page numbers are to such paragraphs and pages in the attached draft of Part 2, Section XV, dated March 29, 1956.

A. Joint Report of March 9, 1956.

I. Material and Supply Costs. In the first two quoted excerpts under 2.A., of the joint report of March 9, 1956, on page 1, change "transferor" to "transferee." The title of the paragraph in which this problem appears has been changed to Material Costs (see ASPR 15-204.2(n)(6), at bottom of page 11).

II. Research and Development Costs. Joint Recommendation I under paragraph 2.B. of the joint report of March 9, 1956 suggests that further study be given to use of the term "product line" (see ASPR 15-204.2(v)(3), on page 18).

III. Pension Plans. The issues within the Editing Committee with respect to this matter have been resolved, as discussed in paragraph 2.C. of the joint report of March 9, 1956. (See ASPR 15-204.2(q), pages 12-15 of attached draft which contains some additional minor editing refinements.)

Attention is also invited to the first paragraph on page 4 of the joint report of March 9, 1956 and the question is posed whether official acknowledgment should be made of the assistance furnished by the Internal Revenue Service.

B. Research and Development Costs - ASPR 15-204.2(v), page 18.

In the proposed ASPR 15-204.2(v), Research and Development Costs, the fourth and fifth sentences of subparagraph (2) (from "Generally, the contractor . . ." through the end of the subparagraph) appear to set forth instructions to the contracting officer rather than cost principles. It is recommended that the fourth sentence be revised to read:

> "The contractor shall disclose to the Government the purposes and results of any independent general research the costs of which are reimbursed in whole or in part by the Government."

Alternatively, it is suggested that the fourth sentence be deleted from Part 2 of Section XV and inserted elsewhere in ASPR as an instruction to the contracting officer. In any event, it is recommended that the fifth sentence, enumerating factors to be considered in providing for costs of independent general research, be deleted from Part 2 of Section XV and inserted elsewhere in ASPR, possibly either in Section III or in Part 1 of Section XV. See, also, C.V. below.

C. Certain Differences Between Draft for Editing and Attached Part 2.

I. Scope of Part (ASPR 15-200). The attached draft provides that the same treatment be given to clauses in supply or service contracts providing for the furnishing of industrial facilities and to facilities contracts, i.e., both are excluded from the coverage of Part 2. The draft for editing did not cover such facilities clauses. Filing instructions, however, should contain a notation that Part 2 may be used "to the extent appropriate" for these purposes pending publication of a separate Part covering facilities.

II. Base Period (ASPR 15-203.1(c)). The draft for editing (ASPR 15-203.5) did not contain the first sentence which has been proposed as a definition, or the third sentence.

III. Depreciation (ASPR 15-204.2(f)(2)). The draft for editing (ASPR 15-204.9(b)) includes the principles recognized under Section 167 of the Internal Revenue Code among any generally accepted accounting principles which may be used in the computation of depreciation. The attached draft requires the contractor to follow the same cost basis in regard to depreciation for contract costing as it followed for Federal income tax purposes.

IV. Rental Costs (Including Sale and Leaseback of Facilities). (ASPR 15-204.2(u)). Subparagraph (2) relating to charges in the nature of rent between organizations under common control was not included in the draft for editing although an analogous principle had

been covered with respect to outright transfers of material and services (ASPR 15-204.2(n)(6)).

V. Research and Development Costs (ASPR 15-204.2(v)(3)). Unlike the question of disclosure of independent general research, the question of disclosure of independent related research was not covered at all in the draft for editing. In keeping with the recommendation as to disclosure of independent general research (see B. above), subparagraph (3) dealing with related research has been modified by the following addition in the third sentence:

> "and provided further that the contractor discloses to the Government the purposes and results of the research and development."

VI. Training Costs (ASPR 15-204.2(bb)). The attached draft provides that where training is conducted "by" an educational institution, the cost of "part-time" training which is of the "on-the-job type" is allowable without a specific contract provision. Discussions by the joint subcommittees, however, indicate that further clarification may be needed in regard to the meaning of "on-the-job type" training.

In regard to the costs of training "in" educational institutions, the proposed draft would make them unallowable "except to the extent specifically provided for in the contract in accordance with Departmental instructions." The words "in accordance with Departmental instructions" were included by the joint subcommittees in recognition of the fact that an area of increasing industry interest is involved and that it would be unwise not to develop a basis for consistent treatment. The added words appeared to afford the best means of achieving reasonable consistency within the limited time available for discussion of this item. The problem may well require additional study.

VII. General and Administrative Costs (ASPR 15-203.5, page 4). Under enumeration "(ii)" of factors to be considered in determining whether the method used for the allocation of general and administrative expenses provides for an equitable result, the proposed draft includes, "the results obtainable by using the input cost method" and also sets forth a definition of said method. This paragraph was otherwise subjected to substantial redrafting in view of the consensus of opinion within the Section XV Subcommittee that clarification was necessary.

VIII. Precontract Costs (ASPR 15-204.3(i), page 24). The parenthetical reference to ASPR 15-lxx was included by way of compromise of an issue within the Editing Subcommittee and, accordingly, this paragraph was not discussed in the sessions of the joint subcommittees. If Part 2 is approved with this reference included, the full reference to the appropriate paragraph in Part 1 should be inserted before Part 2 is released for printing.

D. Matters Not Necessarily Requiring Final Action by the ASPR Committee Prior to Adoption of Part 2, Section XV.

I. Pension Plans (ASPR 15-204.2(q)(3)(iv)(B), page 15). Attention is invited to the matter of "Implementation of 'Side' Agreements" which is discussed in paragraph 4.A. of the Editing Committee report of February 27, 1956. In the draft there discussed, the problem was related to proposed ASPR 15-204.2(q)(3)(iii)(B) /ASPR 15-204.26d in the draft for editing/.

II. Overtime, Extra-Pay Shift, and Multi-Shift Premiums, (ASPR 15-204.2(o), page 12). Attention is invited to the recommendation with respect to this matter in paragraph 5.A. of the Editing Committee report of February 27, 1956. Discussions of the joint subcommittees emphasize that the term "authorization" and "prior approval" are not uniformly understood.

6. It has not been possible in the time available for submission of this report, to set forth all of the differences between the draft submitted for editing and the attached draft. In this connection, it is recommended that, when this Part 2 is given detailed consideration by the ASPR Committee, the members of the Section XV Subcommittee be invited to participate for purposes of isolating and explaining such changes and the reasons therefor to the extent deemed appropriate by the ASPR Committee. In view of the substantially different numbering scheme which has been employed in the attached draft with respect to the Principles and Standards for Selected Items of Cost, covered under proposed ASPR 15-204, a table has been prepared (TAB A attached) showing the title and lettered paragraph designation of each item

in the attached draft of Part 2 followed by brackets containing the corresponding paragraph reference in the draft submitted for editing.

Editing Subcommittee:

GEORGE W. MARKEY, JR.
Navy Member
Chairman

CHARLES W. WILKINSON*
Lt. Colonel, SS JAG
Army Member

JOHN W. PERRY*
Air Force Member

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Chairman, Section XV Subcommittee

Air Force:

Paul M. Southwell, AFMPP
George A. Rudigier, AFAUD

* Will submit separate report.

TABLE OF TITLES AND PARAGRAPH NUMBERS OF PRINCIPLES AND STANDARDS FOR SELECTED ITEMS OF COST (ASPR 15-204.2 and 15-204.3)

15-204.2 Costs Allowable in Whole or in Part.

(a) Advertising Costs. /15-204.1/

(b) Bidding Costs. /15-204.3/

(c) Civil Defense Costs. /15-204.5/

(d) Compensation for Personal Services. /15-204.6/

(e) Contributions and Donations. /15-204.8/

(f) Depreciation. /15-204.9/

(g) Employee Morale, Health, and Welfare Costs and Credits. /15-204.10/

(h) Food Service Costs and Credits. /15-204.4/

(i) Fringe Benefits. /15-204.14/

(j) Insurance and Indemnification. /15-204.15/

(k) Labor Relations Costs. /15-204.17/

(l) Maintenance and Repair Costs. /15-204.19/

(m) Manufacturing and Production Engineering Costs. /15-204.20/

(n) Material Costs. /15-204.21/

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. /15-204.24/

(p) Patent Costs. /15-204.25/

(q) Pension Plans. /15-204.26/

(r) Plant Protection Costs. /15-204.27/

(s) Professional Service Costs - Legal, Accounting, Engineering and Other. /15-204.29/

(t) Recruiting Costs. /15-204.32/

(u) Rental Costs (Including Sale and Leaseback of Facilities). /15-204.33/

(v) Research and Development Costs. /15-204.34/

(w) Royalties and Other Costs for Use of Patents. /15-204.35/

~~(x) Service and Installation Costs.~~ /15-204.36/ (deleted)

(x) Severance Pay. /15-204.37/

(y) Special Tooling Costs. /15-204.38/

(z) Taxes. /15-204.39/

(aa) Trade, Business, Technical, and Professional Activity Costs. /15-204.40/

(bb) Training Costs. /15-204.41/

(cc) Transportation Costs. /15-204.42/

(dd) Travel Costs. /15-204.43/

(ee) General. /15-204.23/

15-204.3 Unallowable Costs.

(a) Bad Debts. /15-204.2/

(b) Contingency Reserves. /15-204.7/

(c) Entertainment Costs. /15-204.11/

(d) Excess Facility Costs. /15-204.12/

(e) Fines and Penalties. /15-204.13/

(f) Interest and Other Financial Costs. /15-204.16/

(g) Losses on Other Contracts. /15-204.18/

(h) Organization Costs. /15-204.22/

(i) Precontract Costs. /15-204.28/

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. /15-204.30/

(k) Reconversion Costs. /15-204.31/

APR 2 1956

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Section XV, Contract Cost Principles
Separate Report of the Army and Air Force members,
Editing Subcommittee

1. The Army and Air Force members of the Editing Subcommittee understood that the Editing Subcommittee's report of March 9, 1956 was returned to that Subcommittee solely to resolve, with the Section XV Subcommittee, any substantive differences between that report and the materials approved by the ASPR Committee in December 1955. On the contrary, a great part of the time of the two Subcommittees in the past two weeks has been devoted to consideration of entirely new substantive concepts put forth by various members of the Section XV Subcommittee. Since the Army and Air Force members of the Editing Subcommittee do not consider most of the changes made in the past two weeks necessary to conform the edited draft substantively to the draft approved by the ASPR Committee, and since they do not know which, if any, of the many new concepts have already been considered and rejected by the ASPR Committee or by the individual ASPR Committee members from the Departments in which the concepts originated, they are not able to recommend approval of the materials now being submitted to the ASPR Committee.

2. As examples, attention is directed to the paragraphs listed below.

a. 15-200 has been revised to exclude supply contracts with contractors not having commercial type accounting systems, and to exclude clauses in supply or service contracts providing for the acquisition of facilities.

b. 15-203 (c) has been revised by adding the first and third sentences. The first sentence defines "base period." The third sentence was added to preclude the idea that all indirect costs allocable to a contract which ran for several years had to be charged to one selected fiscal year.

c. 15-203.5 has been revised to include the "input cost method" as a yardstick for determining whether the contractor's method of distributing general and administrative costs is equitable and has deleted direct reference to inventory variations.

d. 15-204.2(f)(2) as approved by ASPR and as originally edited provided that depreciation should be "based upon original acquisition cost." As now changed the paragraph ignores acquisition cost and bases depreciation on whatever base is used for Federal income tax purposes. Read in conjunction with 15-204.3(j) this paragraph originally required that the contractor ignore, for Government contract cost purposes, both profits and losses on trade-ins. In addition, application of this paragraph (f)(2) as now revised to tax-exempt corporations which have commercial type accounting systems, will be difficult.

e. 15-204.2(f)(5) has been changed to prohibit use charges on assets acquired without cost to the contractor.

f. 15-204.2(n)(5) which did require that inventory discrepancies be included in arriving at "the cost of material" now requires that they be included in arriving at "the cost of performance."

g. 15-204.2(u)(2) is an entirely new paragraph limiting the rentals which may be charged between plants, divisions, or organizations under common control.

h. 15-204. r)(3) has been changed to requi disclosure to the Government of the purposes and results of related research and development for which the contractor is reimbursed in whole or in part by the Government.

i. 15-204.2(aa)(1) has been limited to the costs of the contractor's membership in organizations, as distinguished from the costs of membership of contractor employees.

j. 15-204.2(bb) has been changed to limit on-the-job training conducted by educational institutions to part-time training, and to require Departmental implementation before training in educational institutions can be provided for in a contract.

k. 15-204.3(d) has been changed to:

(1) disallow costs of repairing idle and excess facilities;

(2) limit the provision to contractor-owned facilities; and

(3) clarify the assumed meaning of "standby purposes."

l. 15-204.3(j) has been changed by adding a cross reference which is in fact an exception.

3. If a generalization may be hazarded, the changes made in the past two weeks tend to negate the idea of looking to the "reasonableness" of costs incurred, and substituting therefor various rigid rules of allowability of costs. This trend in turn is attributable, at least in part, to the idea expressed by certain members of the Section XV Subcommittee that the doctrine of "reasonableness" expressed in 15-201.2 permits only questioning the reasonableness of the price paid as compared to what the contractor got but does not permit questioning the reasonableness of the contractor's incurring the cost in the first place. Possibly this limited interpretation of "reasonableness" is due to the school of thought which considers Part 2 of Section XV to be an audit manual.

4. The Army and Air Force members of the Editing Subcommittee recommend that the ASPR Committee review the materials now being submitted on the subject case as if they were an entirely new substantive submission from the subject Subcommittee, subject only to recognition that the submission has been edited.

Lt. Col. Charles W. Wilkinson
Army Member
Editing Subcommittee

John W. Perry
Air Force Member
Editing Subcommittee

(e) Fines and Penalties. /15-204.13/

(f) Interest and Other Financial Costs. /15-204.16/

(g) Losses on Other Contracts. /15-204.18/

(h) Organization Costs. /15-204.22/

(i) Precontract Costs. /15-204.28/

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. /15-204.30/

(k) Reconversion Costs. /15-204.31/

February 27, 1956

MEMORANDUM FOR THE ASPR COMMITTEE

Subj: ASPR Case 53-44, Revision of Section XV, Contract Cost Principles

1. The Editing Committee has substantially completed its task with respect to the draft of Part 2, Section XV, submitted for editing in accordance with Item 4 of the Minutes of the ASPR Committee Meeting of 13 December 1955. In accordance with instructions of the Staff the edited Part is not submitted herewith; however, it can be submitted in final edited form immediately after resolution of the following three matters.

A. Consideration by the ASPR Committee of certain new substantive matter introduced by the Editing Subcommittee in connection with Material and Supply Costs (proposed ASPR 15-204.2(n)(6)). This is discussed in paragraph 3.A. below.

B. Consideration by the ASPR Committee, in connection with Research and Development Costs (proposed ASPR 15-204.2 (v)(3), of the need for clarification of the term "product line" and, also, of the possibility of an inequity in regard to the allocation of costs allowable under the subject subparagraph. This is discussed in paragraph 3.B. below.

C. An issue within the Editing Subcommittee with respect to the costs of Pension Plans (proposed ASPR 15-204.2(q)). This is discussed in paragraph 3.C. below.

2. In addition to the foregoing there are certain other matters which the members of the Subcommittee wish to bring to the attention of the ASPR Committee. These matters are discussed in paragraphs 4 and 5 below. They do not necessarily require resolution by the ASPR Committee prior to reproducing the edited Part.

3. The matters requiring consideration by the ASPR Committee prior to reproducing the edited Part are discussed under A, B, and C of this paragraph. It should be noted that the numbering of the edited Part is entirely different from that in the draft for editing. For convenience of reference, the heading for each comment in this paragraph, as well as elsewhere in this report, sets forth the number of the applicable paragraph and subparagraph in the edited Part followed by brackets containing the corresponding number in the draft for editing.

A. Material and Supply Costs - ASPR 15-204.2(n)(6) /15-204.21f/

The subject subparagraph as edited provides:

"(6) Costs of material, services, or supplies, sold or transferred between plants, divisions, or organizations, under common control, are allowable only to the extent of the cost to the transferor /, or the cost to the transferee, or the prices of other suppliers for the same or substantially similar items, whichever is lowest;/ 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 either (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."

In editing this subparagraph, the Subcommittee has added the words in brackets at the end of the first sentence in the draft for editing, immediately following the word "transferor." The inclusion of these words presents an addition of substance which is for consideration by the ASPR Committee.

B. Research and Development Costs - ASPR 15-204.2(v)(3) / 15-204.34b(ii)/

The subject subparagraph as edited provides:

"(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 ASPR 15-204.2 (m)). 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 type production contract if allocated to all production work of the contractor; provided the research is related to the contract product or product line. Such research costs are unallowable under cost type research and development contracts."

From the above, it will be noted that independent related research and development costs are allowable only if related to the contract product or "product line", but that such costs must be allocated "to all production work of the contractor." The Editing Committee is of the view that the term "product line" is susceptible of different interpretations and, in the interests of clarity, suggests that the ASPR Committee give consideration to the use of more meaningful terminology or to the development of a precise definition. Also, it appears that the requirement for allocating related research and development costs to "all production work of the contractor" may create an inequity. Under the circumstances, it may be desirable to consider whether the current requirement for allocation to "all production work of the contractor" should be revised to require allocation to all production work in connection with the "product line" as that term may subsequently be defined or otherwise clarified.

C. Pension Plans - ASPR 15-204.2(q) /ASPR 15-204.26/

The Chairman and the Army and Air Force members are not in agreement with respect to the subject paragraph as to the matters set forth below.

I. Substantive Change. The major difference of opinion arises over the question whether the edited version of proposed ASPR 15-204.2(q)(iii) acceptable to the Army and Air Force members varies substantively from the corresponding paragraph /15-204.26d/ of the draft for editing. The latter paragraph provides:

"d. In determining the net costs allocable to military contracts, consideration will be given to the possibility of future abnormal termination credits or gains and the effect such credits or gains would have upon current costs. These termination credits or gains will arise with respect to individuals for whom current costs are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits purchased or funded by current costs. When such credits or gains are foreseeable and their worth can be evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to the anticipated future credits or gains will be made. Such equitable adjustment can be accomplished either by discounting 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 discount for the abnormal termination credits or gains which are anticipated. However, most often such abnormal credits or gains, if foreseeable at all, are not susceptible of being evaluated at the time of contracting because neither the timing nor the severity of the termination actions will be known. Under these circumstances, the Government's interest in such abnormal credits or gains will be preserved for retrospective evaluation and accounting. If a contractor has but one or relatively few Government contracts, an appropriate contractual provision may be used to preserve the Government's interest by providing retrospective accounting and any necessary adjustment to pension plan cost incurred under the contract. In other cases, where a contractor is not limited to one or few Government contracts or there is reasonable probability he will receive follow-on contracts, a separate contractual "side" agreement will be negotiated having application to all pension costs allowed under contracts with the particular contractor and provide for an accounting of abnormal credits or gains, as that term is defined in the agreement, arising by reason of a cutback or cessation of Government contract work."

There is set forth below, as proposed ASPR 15-204.2(q)(3)(iii), a consolidated edited version of the preceding paragraph. The Army and Air Force members are in agreement with all except the words in brackets which the Chairman considers necessary to avoid a substantive change in the draft for editing. If the Chairman's version is adopted, the underlined word "and" preceding the "or" in each of the first two sets of brackets should be deleted.

> "(iii) in determining the net costs allocable to military contracts, consideration shall be given, in accordance with (A) and /or/ (B) below, to the effect upon current costs of possible future abnormal termination credits or gains which may arise with respect to individuals for whom current costs are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits purchased or funded by current costs —

"(A) when such credits or gains can be currently evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to the 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 /or/

"(B) /when such credits or gains cannot be currently evaluated with reasonable accuracy,/ such pension plan costs incurred under the contract shall be subject to retrospective accounting and any necessary adjustment for subsequent termination credits unless the Government and the contractor agree in writing upon any necessary adjustment, or the method of determining such adjustment."

II. Consistency with Interpretation in Part 6, Section XV. A lesser difference also exists within the Editing Subcommittee with regard to proposed ASPR 15-204.2(q)(2). Here, the disagreement does not involve the question whether the edited version acceptable to the Army and Air Force members is substantively different from the corresponding subparagraph /15-204.26c/ in the draft for editing but the question whether it was intended that the latter draft should be significantly different from the interpretation set forth in Part 6, Section XV. The Chairman is of the view that an apparently unexplained significant difference does exist with respect to the coverage of pension plans for nonprofit and other tax exempt organizations.

Subparagraph 15-204.26c of the draft for editing provides:

"c. The costs of a pension plan approved by the Military Department concerned, to the extent such costs are claimed and deductible for income tax purposes (or are determined to be reasonable in the case of nonprofit or tax exempt organizations), are allowable except

as otherwise determined unallowable under this paragraph. Such costs may include excess contributions to the extent such contributions are claimed and allowed for Federal income tax purposes in the current taxable period. In cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract cost will be made for contributions disallowed for tax purposes which previously had been allocated to and allowed as contract costs."

It is the Chairman's understanding that no particular reason existed within the Section XV Subcommittee for significant departure from the current treatment of the pension plans of nonprofit or tax exempt organizations, set forth in part in ASPR 15-601.2(b), as follows:

"(b) Pension or retirement plans of a contractor which are subject to approval of the Bureau of Internal Revenue must have been so approved before costs under the plans may be accepted as charges to Government contracts. Many plans of nonprofit or other tax exempt organizations are also reviewed and approved by the Bureau of Internal Revenue -- when not so reviewed and approved, each such plan will be reviewed, and approved or disapproved, by the Department to which audit cognizance is assigned, using, insofar as applicable, the criteria and standards of the Internal Revenue Code and the regulations of the Bureau of Internal Revenue. In any case where the Bureau of Internal Revenue withdraws approval of a plan, approval of amounts allocated to contract costs will be withdrawn accordingly."

Since Part 6, Section XV, received extended consideration by a Subcommittee addressing itself to that specific problem, the Chairman is of the view that significant departures therefrom should be avoided unless clearly intended and adequately justified.

There is set forth below, as proposed ASPR 15-204.2(q)(2) and (3)(i) and (ii), a consolidated edited version of the above subparagraph 15-204.26c, with the controversial portions favored by the Army and Air Force members underlined and those favored by the Chairman in brackets.

"(2) Consideration, and approval or disapproval, of all pension plans and the method of determination of the costs thereof / of approved plans/ 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. Plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the cognizant Department; 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. Pension plans of nonprofit or other tax exempt organizations are not required to be reviewed and approved by the Internal Revenue Service. / Many pension plans of nonprofit or other tax exempt organizations are reviewed and approved by the Internal Revenue Service although such review and approval is not required. When the plans of such organizations are not reviewed and approved by the Internal Revenue Service, the cognizant Department shall review, and approve or disapprove, such plans, using, insofar as applicable, the criteria and standards of the Internal Revenue Code and the Regulations of the Internal Revenue Service./

"(3) Reasonable costs of pension plans approved by the cognizant Military Department are allowable subject to the following conditions:

"(i) except in the case of nonprofit or tax exempt organizations, such costs, including excess contributions, are allowable only to the extent claimed and allowed for Federal income tax purposes in the current taxable period;

"(ii) in cases where the Internal Revenue Service withdraws approval of a plan, /whether or not review of the plan by Internal Revenue Service was mandatory,/ an appropriate adjustment of contract costs shall be made for /which, except in the case of nonprofit and tax exempt organizations, shall take into account/ contributions disallowed for tax purposes which previously had been allocated to and allowed as contract costs;"

The Chairman is of the view that the underlined third sentence of subparagraph (2) treats the problem of pension plans of non-profit and other tax exempt organizations in a manner which is too cryptic. If it is desired that the treatment of the problem be substantially parallel to that in existing ASPR 15-601.2(f), the Chairman recommends the deletion of the underlined sentence and substitution of the material in brackets which follows in both subparagraphs (2) and (3).

Attached as TAB A is a consolidated edited treatment of Pensions Plans -- ASPR 15-204.2(q) /15-204.26/ in which the controversial portions favored by the Army and Air Force members are underlined and those favored by the Chairman are in brackets.

4. The Chairman further invites the attention of the ASPR Committee to the following which is one of the matters referred to in paragraph 2 above as not necessarily requiring final action by the ASPR Committee prior to reproduction of the edited Part.

Pension Plans - ASPR 15-204.2(q)(3)(iii)(B) /15-204.26d/

A. Implementation by "Side" Agreements. In connection with subject subparagraph (see TAB A attached), it is noted that the ASPR Committee recently considered the development of an agreement for Government-wide or DOD-wide use to provide for the recovery of reversionary credits of costs of pension plans (see ASPR Case 55-111, Item 11 of the Minutes of December 13, 1955). This case was withdrawn by the Army ASPR Committee Member on the basis of the prior consideration given to the general problem of reversionary credits by the ASPR Conference in Case 51-34 (see Item 8 of the Minutes of April 8, 1952). In that case, the ASPR Conference approved the report of the Contract Cost Subcommittee of 13 March 1952, which recommended as follows:

> "The Committee feels that what is needed here is appropriate implementation by the military departments to their auditors and contract negotiators so that pension costs will be questioned and proper action taken thereon where appropriate. It does not believe that any action by the ASPR Conference beyond concurrence with this viewpoint is necessary or desirable at this time." (Emphasis added.)

It is understood that each of the Departments has been experimenting with the development of agreements to provide for the recovery of reversionary credits, of the same general type as referred to in Case 55-111, and that, in the interests of achieving uniformity, there has been informal coordination among representatives of the Departments. Paragraph 15-204.26d of the draft for editing (set forth in paragraph 3.C. above) refers to similar agreements as "side" agreements. Under the circumstances, the ASPR Committee may wish to consider whether further action on the matter of DOD-wide agreements providing for the recovery of reversionary credits is appropriate at the present time.

B. Further Implementation. It is suggested that it may be desirable to consider whether further implementation of the subject subparagraph is appropriate. Attention is invited to ASPR Case 55-47 - Cost Reimbursement Type Contracts - Development of Standard Basic Forms for Release and Assignment of Credits, Refunds, and Rebates, for possible consideration in this regard.

5. The Editing Subcommittee invites the attention of the ASPR Committee to the following as one of the matters referred to in paragraph 2, which do not necessarily require final action by the ASPR Committee prior to reproduction of the edited Part.

Overtime, Extra-Pay Shift, and Multi-Shift Premiums- ASPR 15-204.2(o) / 15-204.24/

The subject paragraph provides as follows:

"(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees may be classified as either direct or indirect labor costs, but the amount of such premiums shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government (see ASPR 12-102 for further information concerning the policy regarding such authorization). When direct labor cost is the base for distribution of overhead, the premium portion of overtime payments shall not be included in that base. The premium portion of overtime,

extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work. When such premium costs are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs."

It is considered that an appropriate subcommittee familiar with the policy set forth in ASPR 12-102 should be asked to reconsider that ASPR provision in the light of proposed ASPR 15-204.2(o). It is considered that particular attention should be addressed to the terms "authorization" and "prior approval", and to the matter of premium pay to indirect labor employees which is not now specifically treated in ASPR 12-102.

6. It is requested that the Editing Subcommittee be furnished instructions with respect to the matters set forth in paragraph 3 and that the ASPR Committee take such action as may be appropriate with respect to the matters set forth in paragraphs 4 and 5.

GEORGE W. MARKEY, JR.
Navy Member
Chairman

CHARLES W. WILKINSON
Lt. Colonel, SS JAG
Army Member

JOHN W. PERRY
Air Force Member

February 27, 1956

PROPOSED ASPR 15-204.2

* * *

(q) Pension Plans.

(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, either the 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 (q).)

(2) Consideration, and approval or disapproval, of all pension plans and the method of determination of the costs thereof / of approved plans/ 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. Plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the cognizant Department; 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. Pension plans of nonprofit or other tax exempt organizations are not required to be reviewed and approved by the Internal Revenue Service. / Many pension plans of nonprofit or other tax exempt organizations are reviewed and approved by the

Internal Revenue Service although such review and approval is not required. When the plans of such organizations are not reviewed and approved by the Internal Revenue Service, the cognizant Department shall review, and approve or disapprove, such plans, using, insofar as applicable, the criteria and standards of the Internal Revenue Code and the Regulations of the Internal Revenue Service. /

(3) Reasonable costs of pension plans approved by the cognizant Military Department are allowable subject to the following conditions:

(i) except in the case of nonprofit or tax exempt organizations, such costs, including excess contributions, are allowable only to the extent claimed and allowed for Federal income tax purposes in the current taxable period;

(ii) in cases where the Internal Revenue Service withdraws approval of a plan, /whether or not review of the plan by Internal Revenue Service was mandatory,/ an appropriate adjustment of contract costs shall be made for /which, except in the case of nonprofit and tax exempt organizations, shall take into account/ contributions disallowed for tax purposes which previously had been allocated to and allowed as contract costs;

(iii) in determining the net costs allocable to military contracts, consideration shall be given, in accordance with (A) and /or/ (B) below, to the effect upon current costs of possible future abnormal termination credits or gains which may arise with respect to individuals for whom current costs are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits purchased or funded by current costs —

(A) when such credits or gains can be currently evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to the 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 /or/

(B) /when such credits or gains cannot be currently evaluated with reasonable accuracy,/ such pension plan costs incurred under the contract shall be subject to retrospective accounting and any necessary adjustment for subsequent termination credits unless the Government and the contractor agree in writing upon any necessary adjustment, or the method of determining such adjustment.

(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.

NOTE — The above proposed ASPR 15-204.2(q) is a consolidated edited version of paragraph 15-204.26 of the draft for editing. The controversial material favored by the Army and Air Force members is underlined and that favored by the Chairman is in brackets.

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

November 1, 1955

MEMORANDUM FOR THE ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Part 2, Section XV

Your Subcommittee has reviewed the comments of the following with respect to subject: NSIA, MAPI, RETMA, NAM, AMA, C. of C., AIA, American Institute of Accountants, Council of Profit Sharing Industries, and Comptrollers Institute of America. These comments resulted in numerous revisions of our 3/23/55 draft.

At the outset, the subcommittee wishes to draw attention to certain major issues with industry which are historic and have not been resolved in this draft to the complete satisfaction of industry. While these issues have been taken up separately in this report, they are mentioned here because of their importance and long standing differences. They are (1) 15-203.3, Selling and Distribution Expenses, (2) 15-204.1, Advertising, (3) 15-204.11, Entertainment, (4) 15-204.16, Interest and (5) 15-204.18, Losses on Other Contracts.

Industry made the following general observations which the subcommittee believes worthy of mentioning. First, they object to the requirement, in many cases, that some costs to be allowable must be upon authorization by special contract provision or by written authorization of the contracting officer, rather than just the approval of the contracting officer.

Second, throughout the proposed draft there is interjected a requirement that the auditor evaluate the equities of the situation, in addition to his usual function of measuring the reasonableness of the amount and the proper allocability of the item. Section XV should be limited to indicate types and amounts of cost which are or are not allowable in cost-type contracts and it should not be made an audit manual for the various services.

The third observation is that detailed implementing instructions of the departments should be prepared prior to the publishing of this section.

The following paragraphs contain what the Subcommittee considered to be major unresolved issues with industry, certain differences which developed within the Subcommittee, and other comments on particular paragraphs of the draft.

15-200 Scope of Part.

INDUSTRY POSITION

A statement should be included to the effect that Section XV is not applicable to fixed price contracts, including those with price redetermination provisions.

SUBCOMMITTEE POSITION

The proposal is not acceptable since audit agencies have no alternative at present other than to use Section XV as a guide in auditing these contracts.

15-201(b) Factors Affecting Allowability of Costs.

INDUSTRY POSITION

Costs should not be measured by the new criterion "significant deviation in the established practices of the contractor which substantially increase the contract costs."

SUBCOMMITTEE POSITION

This new criterion is only one of the factors affecting allowability of costs. This does not take anything away from the contractor. If the reason for the deviation is justified, costs may still be allowed.

15-203.2 Indirect Engineering Expenses.

AIR FORCE MINORITY POSITION

The Air Force Procurement member does not agree with the subcommittee's change of inserting the parenthetical phrase "(including independent research projects)" in paragraph 15-203.2.

The Subcommittee's purpose in inserting this phrase was to cover those few situations where contractors do not have a separate research department but perform their research in their engineering departments. To meet these situations, the subcommittee wanted a statement in Section XV to provide that where independent research is performed in an engineering department, allocation of indirect engineering expenses will be made to such research work.

The objection of the Air Force procurement member stems from the belief that such statement is unnecessary since the purpose of inserting the parenthetical statement is already accomplisned by the present wording of recognizing independent research expenses in paragraph 15-204.34c:

> "Independent research projects will absorb their appropriate share of indirect expenses of the department where research work is performed."

Furthermore, the insertion of the parenthetical statement makes paragraph 15-203.2 subject to misinterpretation since a literal reading of the paragraph with the insertion is likely to be to the effect that indirect engineering expenses of the engineering department should be allocated to research projects even though such work is performed in a research department independent and apart from the location of the engineering department. This, of course, was not what was intended. The Air Force procurement member, therefore, recommends the deletion of the parenthetical statement.

15-203.3 Selling and Distribution Expense.

INDUSTRY POSITION

Selling and distribution expenses are generally a cost which should be acceptable as allocable to Government contracts by associating such expenditures with an indirect benefit to Government work. It contends that the Government stands to benefit by being able to place orders for standard commercial products or specially designed products with companies which, through expenditures for advertising, sales promotion and selling activities, have capacities to produce efficiently and quickly the requirements of the Government that otherwise could not be possible without delays and expenditures. Industry would like the allowable costs more clearly defined. However, it is noted that the American Institute of Accountants says: "This treatment of selling expenses seems entirely satisfactory to me, and is in agreement with good industrial and contract practice."

SUBCOMMITTEE POSITION

Pure selling expense of the contractor as such is unallowable for the reason that it is not necessary and does not contribute anything to the performance of the contract. Generally, any type of marketing expense in the ordinary sense is not considered to be necessary in contract performance and is not required in doing business with the Government. However, the Subcommittee does feel that a reasonable demonstration that his technical, consulting and related beneficial services which are for purposes of application and adaptation of the contractors products may justify allocation of Government contracts. Any further liberalization would be unjustified.

15-203.4 General and Administrative Expenses.

INDUSTRY POSITION

It is not necessary to enumerate factors to be considered in determining whether a method of distributing general and administrative expenses will produce equitable results. The inclusion of such a listing will lead only to further confusion and may cause overemphasis on the use of the factors enumerated.

SUBCOMMITTEE POSITION

It is recognized that this paragraph involves a controversial matter and one which requires the consideration of many different points. However, it is felt that inclusion in this paragraph of several illustrative factors to be given consideration will not only insure that the listed factors are considered but will tend to indicate that there are many facets to the problem.

15-203.5 Base Period for Allocation of Indirect Expenses.

INDUSTRY POSITION

This paragraph is inconsistent with 15-203(b) and permits Government personnel to select the periods which must be used.

SUBCOMMITTEE POSITION

The Subcommittee fails to see any inconsistency between this paragraph and 15-203(b). One deals with the method of allocation and the other with the base period for allocation.

15-204.1 Advertising.

INDUSTRY POSITION

The present limitations on advertising are too restrictive, and overlook the fact that any advertising is a normal cost of doing business from which the Government has derived benefit and as such should bear a portion of the expenses.

SUBCOMMITTEE POSITION

Advertising, generally, is not necessary in order for industry to conduct business with the Government. On the other hand, in the modified version, Government recognition has been accorded that portion of industry advertising which encourages dissemination of technical information within industry itself through certain media, the results of which benefit both industry and the Government, and the Government will share in its portion of same. One slight concession made by the Subcommittee is the deletion in the third line of paragraph a. (1) after the word "placed" of the phrase, "for the purpose of offering financial support to", and substituting the word "in". The change was made because of the difficulty of determining a contractor's intent and the words were not helpful in determining cost allowances. The Subcommittee set forth its views on this subject in greater detail in previous reports.

15-204.6 Compensation for Personal Services.

The DOD position on profit sharing has not been determined by higher authority. Accordingly, the Subcommittee found it impracticable, because of cross references, to write this entire paragraph in final form until policy guidance is forthcoming.

15-204.8 Contributions and Donations.

INDUSTRY POSITION

Industry has two objections to the proposed recognition of contributions and donations. First, industry objects to the exclusion of religious contributions and donations as a reimbursable cost. Next, industry feels that aside from the reasonableness of the amount of donations and the contractor's consistent practice of making such donations that the only additional limitation for the recognition of these donations is that the amount be deductible for federal income tax purposes. Accordingly, industry objects to the phrase "but the deductibility of the contribution for income tax purposes does not in itself justify its allowability as a contract cost."

SUBCOMMITTEE POSITION

(1) Religious donations should not be a reimbursable contract cost because (a) it cannot be said that religious donations are an ordinary and necessary business expense and (b) it is believed that the reimbursement to contractors of their religious donations from Public and Defense Funds would violate public policy.

(2) The deductibility of an item for federal income tax purposes should not be the only consideration for its recognition as a contract cost. For example, propriety and reasonableness are other standards. Hence, the phrase quoted above and objected to by industry is necessary in regarding the recognition of contributions and donations.

15-204.9e Depreciation.

Protracted discussions in the Subcommittee failed to resolve the question of whether the term "emergency facility" or "emergency facilities" should be used in this paragraph.

MAJORITY POSITION

The issue arises because of the Army and Air Force policy of allowing contractors to select categories of facilities, for which separate findings are made on a determination, for true depreciation and those for normal depreciation.

NAVY MINORITY POSITION

Navy policy is that once a true depreciation determination is made, a contractor must elect to take true or normal depreciation for all the facilities covered by the determination. Hence, Navy insistence on the words "emergency facilities"

15-204.11 Entertainment Expense.

INDUSTRY POSITION

Industry objects to the words "social activities" as it may create conflict with the provisions of 15-204.10 and 15-204.40. It further contends that unless there is an overriding public policy to the contrary, entertainment expenses reasonably allocable to Government contracts should be recognized, to the extent that it can be demonstrated that such expenses are ordinary and necessary to the business of a contractor.

SUBCOMMITTEE POSITION

There is no conflict with this paragraph and paragraphs 15-204.10 and 15-204.40. Furthermore, this type of expense is solely for the benefit of the contractor, serves no purpose to Government work and has been traditionally disallowed. The contractor may be placed in a favored class should he be allowed to recoup entertainment expense through Government contracts and is considered to be against public policy.

15-204.15(f) Insurance and Indemnification.

AIR FORCE MINORITY POSITION

The Air Force procurement member disagrees with the Subcommittee's wording of subparagraph (f) and believes that the following proposed wording would permit a more practicable application of accepting uninsured losses as a contract cost. The proposed change would remove uncertainty as to the Government commitments and liability in this area. It also makes the Government's commitment known at the time of contracting. Furthermore, it eliminates the Departmental approval of such cost (as the present language provides) and places it at the level of the procuring activity. It is proposed that (f) read:

> "f. losses resulting from failure to insure (through self insurance or otherwise) are not allowable unless authorized by special contract provision."

OSD MINORITY POSITION

It is recommended that the words, "unless approved by the Department concerned" be deleted in paragraph (f) since only one known Navy case was cited in substantiation of the phrase.

15-204.16 Interest and Other Financial Expenses.

INDUSTRY POSITION

Industry contends that interest should be allowable.

SUBCOMMITTEE POSITION

Interest has always been considered as unallowable because it represents a distribution of profits to persons who have advanced capital on a loan basis. The Subcommittee sees no reason why this position should be changed. More detailed reasons for disallowance are set forth in previous reports. In this connection, it should be noted that DOD Directive requires interest to be charged on advance payments.

15-204.18 Losses on Other Contracts.

INDUSTRY POSITION

Industry, in effect, requests that the portion of cost-participation contracts not reimbursed by the Government under that contract be allowed as a cost on other contracts.

SUBCOMMITTEE POSITION

This proposal is rejected since a contractor in accepting a cost-participating R&D contract expects that later production contracts will be obtained resulting in profit to compensate for earlier costs of participation.

15-204.19(b) Maintenance and Repairs.

INDUSTRY POSITION

Industry objects to the restriction of recognizing deferred maintenance expenses only by specific contract provision.

SUBCOMMITTEE POSITION

The requirement of a specific contract provision for recognition of this expense is necessary in order that the Government may exercise some control over the amount of deferred maintenance expense which may be charged against cost-type contracts. The contract provision requirement in no way lessens the recognition of this expense. Since such expenses could be substantial and the possibility of a dispute would always be present as to the amount which should be accepted as a contract cost, it seems best that this be covered by a contract provision.

15-204.21b. Materials and Supplies (Cash Discounts)

INDUSTRY POSITION

Industry questions the requirement of the Government that cash discount be taken as a credit against the cost of materials, their theory being that cash discount is actually financial income comparable to interest as a financial expense, and since interest is not considered an allowable cost, cash discount credits should be omitted from consideration.

SUBCOMMITTEE POSITION

The subject of cash discount credit is in an area completely separate from that of financial expense or financial income. Classifying cash discount as financial income is fallacious since realized income cannot arise through the operation of buying. Net prices are substantially on a cash basis and therefore represent the most effective costs. It is the net price which a seller expects to receive, and a buyer expects to pay. The cost of materials therefore is represented by the total outlay of cash or its equivalent for the purchase of the materials; if the cash paid out includes a reduction for allowances or credits taken by the contractor, the net amount paid represents the true cost of the material.

AIR FORCE MINORITY POSITION

The Air Force Procurement member believes the third sentence of this subparagraph is subject to misinterpretation since it gives the impression that a contractor has the election to credit discounts, rebates, etc. to material costs or to indirect costs. The Air Force Procurement member would clarify the 3rd sentence by adding the following: "which ever method has been consistently followed by the contractor." These added words are considered necessary since it is believed that the requirement for a consistent application of these credits is not necessarily found by reading the questioned sentence in light of the Basic Principles and Standards (15-201).

15-204.21e. Materials and Supplies (Write-down of Inventory Values).

INDUSTRY POSITION

Write-down of inventory value should be allowed as a contract cost.

SUBCOMMITTEE POSITION

Although this item is not a major objection by industry, the Subcommittee's position is that there is little, if any, merit to industry's contention in cost-type contracts. Write-down of material costs would, of necessity, have to apply to material costs unrelated to a Government cost-type contract and, therefore, should be absorbed by the business to which the (write-down of value) applies.

15-204.24 Overtime, Extra Pay Shift and Multi-Shift Premiums.

INDUSTRY POSITION

Industry wants restriction lifted with respect to cost of overtime and shift premium on indirect labor. The suggested change in the draft may remove some of the objection. As to such cost on direct labor industry wants no restriction except as provided by contract terms in accordance with the contractor's practices and procedures, this being a standard operating procedure for most companies and such provision is often made for such procedures in union contracts. This argument does not in any way appear to bind the Government.

SUBCOMMITTEE POSITION

For the contractor to be required to identify separately shift premium and overtime on his books is a sound practice and one which requires but little or no overhead cost to segregate. This has been traditional with the Government to restrict and control overtime and extra pay shift cost. Not to do so would invite the contractor to work normal hours on commercial work and run up lage amounts of extra pay and overtime cost. Extra pay cost and overtime premium on indirect labor is allowable on a pro rata basis to commercial and Government provided it is otherwise reasonable.

15-204.25 Patent Expenses.

INDUSTRY POSITION NO. 1

Costs of filing patent applications by a contractor should be allowed even though the Government may not obtain any rights under the patents because, by obtaining a patent, a contractor avoids the necessity of eventually being required to pay a royalty to some other person who may obtain a patent on the same invention.

SUBCOMMITTEE POSITION NO. 1

This comment was rejected on the basis that the contractor gets title to the patents and the primary benefits therefrom. This would amount to a windfall to the contractor if the Government paid.

INDUSTRY POSITION NO. 2

Add to allowable costs "the defense of patent infringement litigation".

SUBCOMMITTEE POSITION NO. 2

Under the Act of June 25, 1910, as amended, (28 USC 1498), only the Government can be sued for patent infringement on contractor's production for the Government. If a contractor is sued for patent infringement, it must be for its own commercial production. Therefore, there can be no costs to industry for defense of patent infringement litigation, except such as are passed on to industry by the Government through the Patent Indemnity clause. To allow such costs would conflict with the purpose of the Patent Indemnity Clause.

15-204.29c. Legal Fees.

INDUSTRY POSITION

The cost of successful anti-trust suits brought by the Government and the cost of successful prosecution of claims against the Government should be allowable on the premise that these are ordinary, necessary and proper expenses of doing business and therefore should be considered allowable.

SUBCOMMITTEE POSITION

Costs incurred in these connections, whether the results of the actions are successful or not, are unallowable. Reimbursement of litigation costs where the Government is a party to the suit is obviously untenable. The Government can not financially support the party with which it is engaged in legal dispute.

15-204.30 Profits and Losses on Disposition of Plant, Equipment or Other Capital Assets.

INDUSTRY POSITION

Such profits and losses should be allowable to the extent that they represent adjustments to depreciation on assets acquired for Government business.

SUBCOMMITTEE POSITION

The subcommittee agrees with this contention but feels that it would be impractical, if not impossible, to distinguish between that portion of a profit or loss which represents an adjustment of depreciation and that which was caused by fluctuations in the general price level.

15-204.31 Reconversion Expenses.

INDUSTRY POSITION

Industry comments ran the complete gamut from general agreement with the item as drafted to an extreme statement by Auto Manufacturers Association that "we can see no reason for disallowing any conversion expenses".

SUBCOMMITTEE POSITION

It is apparent that industry should seek a birth-to-burial treatment of reconversion expenses; however, the comments furnished no valid reasons for changing the principle. Specific provision in the contract of those reconversion expenses which are allowable appears the best method of assuring fair treatment of the Government's and contractors' interests. All items not specifically provided for in the initial contract or by modification are not allowable.

15-204.33 Rentals of Plant and Equipment.

INDUSTRY POSITION

The restriction on amounts of allowable rent for facilities covered by sale and lease-back agreements is not equitable. As long as the rents are reasonable in the light of the type, condition and value of the facilities leased, options available and other provisions of the rental agreement the Government's interests are adequately protected. In addition, the Government would be penalizing companies who have sale and lease-back agreements as contrasted with companies holding conventional leases.

SUBCOMMITTEE POSITION

Sale and lease-back agreements are primarily entered into to provide additional working capital, without borrowing funds, or issuing additional capital stock. Another reason could be to obtain tax benefits. To accept the risk, financing and profit factors included in the rental of sale and lease-back facilities would be contrary to our position regarding interest as a nonallowable cost. Furthermore, the accelerated amortization usually included in the rental may represent an unreasonable contract cost.

15-204.34b(i) Research and Development (General Research)

The subcommittee concurs with the violent objection of industry to placing a ceiling of 25% on general research costs. The draft takes a new approach of allowing "the allocable portion of 75% of the allowable costs of a contractor's independent general research". Under this arbitrary formula, there is no penalty for being predominantly a defense contractor but some restriction is placed on such a contractor from going whole hog on general research by forcing him to place some of his own funds into such projects. Some Subcommittee members are not adamant in the position on the percentage figure and are willing that the figure be as high as 90%. Other Subcommittee members feel that 75% is a reasonable figure but should be followed by the parenthetical insertion "(or such other percentage as may be agreed upon and set forth in the contract Schedule)" since flexibility is desirable in this area.

15-204.35 Royalty Payments.

INDUSTRY POSITION

Industry takes objection to the limitation on the allowability of royalties where royalties paid or payable for the right to use patents necessary

for the proper performance of a contract and where the Government does not already have a royalty-free license to use such patents, the royalties are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the Contracting Officer. Industry contends that it should be permitted to manufacture products under license agreements which they would otherwise have to purchase and that payment for same should not be subject to such limitations.

SUBCOMMITTEE POSITION

In the Subcommittee's opinion, the payment of royalties to contractors under the circumstances described should be circumscribed by contract provisions or effected under the Contracting Officer's cognizance. Because fees for use of patents, where the Government does not have a royalty-free license to use same, may often be predicated on the highest rates the market will bear, and since payment limitations are difficult to establish where effective competition does not exist, the Government has established procedures leading to the reduction of royalties where royalty payments in connection with contract performance are deemed excessive. The inclusion of the limitations in the revision permits review of the circumstances surrounding the incurrence of royalty payment costs and assures control by the Contracting Officer. In addition to the cost feature, review by the Government can be effected to assure that the Government does not already have a royalty-free license to use the patent concerned. In summary, Contracting Officers can determine if the royalty costs are bona fide and reasonable.

15-204.36 Service and Installation Expenses.

BACKGROUND

The 3/23/55 draft contained a provision (now deleted) concerning correcting product defects and replacing defective parts.

ASPR POSITION

ASPR 7-203.5 - Inspection of Supplies and Correction of Defects - provides that the Government will pay these costs unless caused by high officials of the contractor.

SUBCOMMITTEE POSITION

When such costs are incurred due to failure to comply with contract terms or specifications, or from causes considered to be beyond the area or reasonableness, such costs including any applicable overhead should be unallowable. The Subcommittee will present an actual case in substantiation of its recommendation that the ASPR Committee give serious consideration to amending ASPR 7-203.5 along the above lines.

15-204.37 Severance Pay.

INDUSTRY POSITION

The portion of the revised provision relating to contract costing of mass or

abnormal severance pay is impractical and would be difficult and cumbersome to apply, and the cost of severance pay, generally, should be handled on a basis conforming with accepted accounting principles and practices and the established policy of a contractor, rather than policy which constitutes an implicit agreement on the contractor's part. Industry also feel that perhaps allowability should be provided for on either an actual or an accrual basis.

SUBCOMMITTEE POSITION

The treatment as proposed for mass severance pay is the most practical and realistic approach to a problem which concerns an unpredictable contingency. It is felt that a contingency reserve for mass severance pay is too conjectural to be considered a cost. The Government should not obligate itself for more than its pro rata share of severance wage payments actually made, in accordance with a policy reflecting implicit agreement by a contractor, on the basis of its ratio of participation in the contractor's total business during the period of employment of the individual involved.

15-204.39a(3) Taxes

INDUSTRY POSITION

This clause should be eliminated as in many cases the cost of securing the exemption exceeds the amount to be saved.

AIR FORCE MINORITY POSITION

The Air Force members believe there is merit in industry's comment and propose the clause be revised to read as follows:

> "Taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the Government."

15-204.39b. Taxes.

INDUSTRY POSITION

Industry generally contends that this paragraph should be revised to allow cost of taxes, interest, penalties and expenses of contractor's acts in resisting assessments or attempting to secure refunds, without the imposition of the restrictions presently included in this paragraph as in certain situations contractors cannot possibly or reasonably comply with these requirements.

SUBCOMMITTEE POSITION

The restrictions imposed by this paragraph are reasonable in that they merely require the contractor to obtain and follow instructions from the contracting officer in cases where there is a doubt as to the legality or correctness of a tax assessment.

15-204.40 Trade, Business and Professional Activities (Exhibitions).

INDUSTRY POSITION

The expenses of holding exhibitions is a required cost of doing business, as normal and essential as expenses incident to meetings and conferences, and as such should be allowable. Further, the revision is unduly restrictive in that it relates only to expenses incurred at meetings and conferences when the primary purpose of the incurrence is the dissemination of technical information or information aimed at the stimulation of production, and does not include expenses of exhibitions incurred for dissemination of information to the trade, the public, prospective employees, etc., about the particular business.

SUBCOMMITTEE POSITION

This matter is quite similar to the problem of allowability of advertising. Doing business with the Government does not presume that dissemination of information about the business to the trade or public through exhibitions is necessary. The Government is agreeable, however, to accepting its pro rata share of expenses incurred for the dissemination of technical information or information aimed at stimulation of production through meetings or conferences. The exhibitions referred to by industry are those held for purposes other than these; therefore, the costs thereof are considered unallowable.

GENERAL COMMENTS

1. Some existing subcommittee members do not necessarily concur with every view expressed by their predecessors but concurred in the Report to expedite consideration.

2. The need for editing is recognized.

3. GAO concurrence has not been obtained.

4. Prior to publication, Part 1 must also be revised (the Subcommittee has made considerable progress on revised Part 1) and certain cross-referencing accomplished on existing Parts 3 and 4.

SECTION XV SUBCOMMITTEE

MEMBERS:

H. H. Gallup (Chairman)
Maj. J. O. Hunnicutt
Mr. E. M. Wiseman
Mr. James Ruttenberg
Mr. A. C. Sawallisch
Mr. P. M. Southwell
Mr, George Rudigier

27 April 1955

MEMORANDUM FOR: CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44 - Depreciation Cost Interpretation for Inclusion in Part 6, Section XV, ASPR

1. Reference is made to the memorandum for the Chairman, ASPR Committee, dated 24 March 1955, subject as above, in which the Editing Committee presented an edited proposed ASPR 15-602. This was discussed at the ASPR Committee meeting on 5 April 1955, and returned to the Editing Committee for further revision, as indicated in the minutes of that meeting.

2. The Editing Committee has reviewed proposed ASPR 15-602 in the light of the mentioned minutes, and recommends only that ASPR 15-602.1 be revised to read as follows:

15-602.1 - Applicability and Effective Date. This cost interpretation pertains to ASPR 15-204(d), 15-205(b), and 15-205(c), with regard to contracts executed on or after the date of its issuance. It shall also apply to existing contracts in those cases where such interpretation was (i) specially provided for in the contract or in the record of contract negotiations, or (ii) in the absence of specific agreement, where the parties have reserved final resolution of the question of cost allowance in regard to depreciation pending the issuance of an interpretation by the Departments with respect to the applicability of Section 167 of the Internal Revenue Code of 1954.

3. The Editing Committee has considered other suggestions contained in the minutes, but does not feel that the proposed ASPR 15-602 should be further revised to quote or paraphrase the statute, or to make reference to "assets" involved.

MEMO FOR: ASPR COMMITTEE 27 Apr 55
SUBJECT: Case 53-44...

4. The Navy Member presented to the Editing Committee, for consideration, a memorandum to him, (Tab 1), recommending further change to ASPR 15-602.2, as set forth in Inclosure 1 to mentioned memorandum from the Editing Committee, dated 24 March 1955. The Editing Committee feels that this proposal should be considered by the ASPR Committee, and, therefore has taken no affirmative action on the recommendation.

1 Incl
(Tab 1)

MAURICE LEVIN
Lt. Colonel, JAGC
Army Member
Chairman

GEORGE W. MARKEY, JR.
Navy Member

WILLIAM MUNVES
Air Force Member

M18/RKM:dmc

6 April 1955

MEMORANDUM FOR MR. GEORGE W. MARKEY, JR.

Subj: Case 53-44 - Depreciation Cost Interpretation for Inclusion in Part 6, Section XV, ASPR

1. In accordance with our conversation today and as requested by you, I would offer the following suggestion for inclusion in the Editing Subcommittee's draft regarding subject case to be added to your last sentence in paragraph 15-602.2:

> "Allowances for "true depreciation" as that term is defined in DOD Instruction 4105.34, 1 July 1954, shall be in accordance with said Instruction."

Change period to comma and follow with:

> and applied on a straight line method, for both the emergency and the post emergency periods, as those periods are defined in the Instruction.

2. In other words, it is felt that since "true depreciation" in most cases allows some accelerated depreciation, it is not felt that the contractor should have a further acceleration factor because of the application of the new allowable "tax methods" of depreciation. As stated to you in today's conversation this device has already been attempted unsuccessfully by one contractor who has been given a determination of true depreciation by the Navy Emergency Facilities Depreciation Board.

Very respectfully,

R. K. MAAS
LCDR., SC, USN
Member, Navy Emergency
Facilities Depreciation
Board

Copy to:
Mr. G. C. Bannerman

dwd1

24 March 1955

MEMORANDUM FOR: CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44 - Depreciation Cost Interpretation for Inclusion in Part 6, Section XV, ASPR

1. Reference is made to paragraph 4 of the minutes of the ASPR Committee meeting of 15 March 1955.

2. In the light of the discussion at that meeting, the Editing Subcommittee has prepared the attached draft of ASPR 15-602 (Incl 1) (i) to make clear that the issuance of this regulation effective from the date of publication was not intended to alter in any way any like interpretations that have been followed in the past with respect to contracts; (ii) to include reference to "true depreciation"; and (iii) to delete the quotation of the text of Section 167 of the Internal Revenue Code of 1954.

3. With reference to proposed ASPR 15-602.1 your Subcommittee considered the desirability of clarifying the effect of this interpretation on past or current contracts by an appropriate note accompanying the issuance of this regulation or through language to be included in 15-602.1. The latter was considered the more practicable method. Such notice, if inserted in a note, might readily be overlooked.

4. Your Subcommittee has considered the desirability of including the text of Section 167 of the Internal Revenue Code of 1954. It is felt that the inclusion of the text alone would be incomplete unless there were also included the regulations issued by the Internal Revenue Service. It was not felt by your Subcommittee that there was any need for encumbering the ASPR with such matter. Those charged with the responsibility of evaluating depreciation must necessarily acquaint themselves with all necessary material on the subject and consult with appropriate personnel.

5. All of the undersigned concur.

1 Incl
Draft of ASPR 15-602

MAURICE LEVIN
Lt. Colonel, JAGC
Army Member - Chairman

GEORGE W. MARKEY, Jr.
Navy Member

WILLIAM MUNVES
Air Force Member

15-602 - Depreciation.

15-602.1 - Applicability and Effective Date. This cost interpretation pertains to ASPR 15-204(d), 15-205(b), and 15-205(o), and is effective from the date of its issuance; provided that, where this cost interpretation has been and is being followed, the statement herein of an effective date is not intended to affect such interpretation.

15-602.2 - Allowances for Depreciation. Allowances for depreciation (other than "true depreciation") as provided in Section 167 of the Internal Revenue Code of 1954, subject to the limitations set forth in paragraph 15-602.3, shall be acceptable for contract costing purposes. Allowances for "true depreciation" as that term is defined in DOD Instruction 4105.34, 1 July 1954, shall be in accordance with said Instruction.

15-602.3 - Interpretation. Depreciation computed in accordance with paragraph 15-602.2 above is allowable provided it meets the test of reasonableness and allocability to defense contracts and other applicable provisions of this Section. Meeting these tests may depend upon whether (i) the depreciation allowance in the particular case is acceptable for tax purposes, and (ii) the costing of defense contracts is on a basis consistent with the costing of the contractor's non-defense work and is so reflected in its books and records.

Incl 1

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

Washington 25, D. C.

Supply and Logistics

ead 53-44

11 March 1955

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Depreciation-Cost Interpretation for Inclusion in Part 6, Section XV, ASPR.

1. In accordance with instructions contained in item 1 of the minutes of the ASPR Committee meeting of 3/1/55 this Subcommittee met on 3/10/55 for the purpose of developing a cost interpretation to provide guidance with respect to depreciation pursuant to Section 167(b), as limited by Section 167(c) of the Internal Revenue Code of 1954.

2. Attached hereto is a proposed cost interpretation unanimously recommended by the Subcommittee for inclusion in Part 6, Section XV of the ASPR.

3. In the development of this proposal it was the opinion of the Subcommittee that the full text of Section 167 of the Internal Revenue Code of 1954 should be included for two reasons, (i) to avoid problems which might arise from paraphrasing or excerpting the provisions thereof, and (ii) to assure that the information contained therein was readily accessible to all procurement and audit personnel throughout the Department of Defense.

Lt. Col. J. E. Ellis
Maj. S. L. Baird
Maj. J. O. Hunnicutt, Jr.
R. M. Kee
A. C. Sawallisch
J. T. Regardie
P. J. Wedel
J. F. Lenahan

Attachment

15-602 Depreciation

15-602.1 Applicability and Effective Date. This cost interpretation pertains to paragraphs 15-204(d), 15-205(b), and 15-205(o) and is effective from the date of its issuance.

15-602.2 Allowances for Depreciation. Allowances for depreciation as provided in Section 167 of the Internal Revenue Code of 1954 (quoted below), subject to the limitations set forth in paragraph 15-602.3, shall be acceptable for contract costing purposes.

"Section 167. Depreciation.

(a) General Rule.-- There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)--

(1) of property used in the trade or business, or
(2) of property held for the production of income.

(b) Use of Certain Methods and Rates.--For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

(1) the straight line method,
(2) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1),
(3) the sum of the years-digits method, and
(4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in paragraph (2).

Nothing in this subsection shall be construed to limit or reduce an allowance otherwise allowable under subsection(a).

(c) Limitations on Use of Certain Methods and Rates.-- Paragraphs (2), (3), and (4) of subsection (b) shall apply only in the case of property (other than intangible property) described in subsection (a) with a useful life of 3 years or more--

(1) the construction, reconstruction, or erection of which is completed after December 31, 1953, and then only to that portion of the basis which is properly attributable to such construction, reconstruction, or erection after December 31, 1953, or
(2) acquired after December 31, 1953, if the original use of such property commences with the taxpayer and commences after such date.

(d) Agreement as to Useful Life on Which Depreciation Rate is Based.-- Where, under regulations prescribed by the Secretary or his delegate, the taxpayer and the Secretary or his delegate have, after the date of enactment of this title, entered into an agreement in writing specifically dealing with the useful life and rate of depreciation of any property, the rate so agreed upon shall be binding on both the taxpayer and the Secretary in the absence of facts or circumstances not taken into consideration in the adoption of such agreement. The responsibility of establishing the existence of such facts and circumstances shall rest with the party initiating the modification. Any change in the agreed rate and useful life specified in the agreement shall not be effective for taxable years before the taxable year in which notice in writing by registered mail is served by the party to the agreement initiating such change.

(e) Change in Method.-- In the absence of an agreement under subsection (d) containing a provision to the contrary, a taxpayer may at any time elect in accordance with regulations prescribed by the Secretary or his delegate to change from the method of depreciation described in subsection (b) (2) to the method described in subsection (b) (1).

(f) Basis for Depreciation.-- The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 (Adjusted Basis for Determining Gain or Loss) for the purpose of determining the gain on the sale or other disposition of such property.

(g) Life Tenants and Beneficiaries of Trusts and Estates.-- In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust, the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.

(h) Depreciation of Improvements in the Case of Mines, Etc.--

For additional rule applicable to depreciation of improvements in the case of mines, oil and gas wells, other natural deposits, and timber, see section 611 (Allowance of Deduction for Depletion).

15-602.3 Interpretation. Depreciation computed in accordance with paragraph 15-602.2 above is allowable provided it meets the test of reasonableness and allocability to defense contracts and other applicable provisions of this Section. Meeting these tests may depend upon whether (i) the depreciation allowance in the particular case is acceptable for tax purposes, and (ii) the costing of defense contracts is on a basis consistent with the costing of the contractor's non-defense work and is so reflected in its books and records.

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

Supply and Logistics 15 December 1954

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44 Revision of Section XV Cost Principles.

1. In accordance with item 5 of the minutes of the ASPR Committee meetings of 11/30/54, 12/2/54 and 12/6/54, together with verbal instructions and guidance provided at these meetings, this Subcommittee met on 12/11/54 and 12/14/54 for the purpose of reconsidering and revising certain paragraphs of the 15 November 1954 draft as follows:

15-204.6 (c) Delete subparagraph as written and substitute the following therefor: "The cost of options to purchase stock of the contractor corporation granted to employees as part of their compensation may be allocated to Government contracts within the following limitations:

(i) The cost of stock options to the grantor corporation is the excess, if any, of the fair market value of the stock over the option price on the date the option is granted to a specific individual and shall not exceed 15% of the fair market value on such date.

(ii) Costs to be recognized will be only those resulting when options are exercised by the employee.

(iii) For allowance purposes, the cost of options exercised will be amortized equally over a period of not less than 5 years from the date option was exercised.

(iv) The cost will be allocated to all work of the contractor, including Government contracts."

15-204.6 (d) 2. Delete second sentence; statement to be made the subject of new subparagraph 15-204.6 (g) below.

15-204.6 (e) 1. At end of sentence add cross-reference, "and g below".

15-204.6 (e) 2. In first sentence after words "under subparagraph d", add cross-reference "and g below".

15-204.6 (f) In second sentence after words "under paragraph d above", add cross-reference "and g below".

15-204.6 (g) Redesignate entire subparagraph as paragraph 15-204.6 h; in lieu thereof insert the following in order to accomplish rearrangement of text:

"For the purpose of determination of reasonableness, the employer contribution under profit sharing plans and stock bonus plans shall not exceed, in the aggregate, 15% of the total basic compensation paid or accrued to each of the participating employees in the year under consideration."

15-204.6 (h) Same as subparagraph g in the original draft.

15-204.9 A staff proposal presented at the 12/6/54 meeting giving effect to the new revenue legislation (Section 167 of Internal Revenue Code of 1954) for interim use pending the promulgation of the revised Section XV was considered and discussed at length by the Subcommittee. The resulting consensus was that no formal change in the existing provisions of Section XV is required in order to recognize the depreciation methods acceptable under the new tax code. It was suggested that specific inquiries in this regard could best be answered via departmental audit channels. It was likewise the consensus that the present language in the proposed revision of Section XV was adequate to permit recognition of all of the depreciation methods provided for in the new tax code and that specific reference to the Internal Revenue Code in this Section was unnecessary and undesirable. It should be noted that the recommendation with respect to this subject did not receive the unanimous support of the Subcommittee.

15-204.22 Inasmuch as some of the material in this paragraph was rearranged as well as revised, the entire paragraph as recommended by the Subcommittee, is quoted for purposes of clarity:

"

(a) This item includes the net costs of such items as raw materials, parts, sub-assemblies, components, and manufacturing supplies, whether purchased outside or manufactured by the contractor, and may include such collateral items as inbound transportation and intransit insurance. These costs are allowable subject, however, to the provisions of subparagraphs b through f below.

(b) Costs of materials and supplies shall be suitably adjusted for applicable portions of income and other credits. Such income and other credits include trade discounts, refunds, rebates and allowances. Cash discounts available, and credits for scrap and salvage and materials returned to vendors. However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond his control, such lost discounts will be allowed.

(c) When materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to the contract.

(d) If materials are issued from stock, any generally recognized method of pricing such materials will be acceptable, provided the method is consistently applied and the results obtained are equitable. Where materials in stock at the commencement date of the contract are subject to Government material controls and have a provable replacement cost significantly higher than book cost, the contractor and the Government may, by contract provision, agree upon the use of a method of pricing based upon the fair value of the materials as of the date of the contract, but not in excess of replacement cost on such date. Such agreement should include identification of the types or kinds of materials involved and should be made at the time the contract is entered into and provided for therein.

(e) Reasonable charges arising from differences between periodic physical inventory quantities and related material control records will be included in arriving at the cost of materials, provided that such charges (i) do not include "write-downs" of values, and (ii) relate to the period of performance of the contract. All credits arising from differences between periodic physical inventory quantities and related material control records shall be taken into account.

(f) Ordinarily, sales or transfers of materials and supplies between plants, divisions, or organizations, under a common control, shall be stated on the basis of cost to the transferor. A departure from this cost basis is permissable provided that the price charged to the contract does not exceed the lower of (i) the transferors sales price to its most favored customer for the same item in like quantity, or (ii) the prices of other supplies for the same or substantially similar items."

Lt. Col. J. H. Railing
Lt. Col. J. E. Ellis
P. M. Southwell
J. T. Regardie
A. C. Sawallisch
R. M. Kee
J. F. Lenahan
H. H. Gallup

15 November 1954

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Section XV

1. Attached for consideration of the members is a copy of the latest draft of Part 2, Section XV, which has been revised in the light of the comments received from the various activities in the Military Departments and the policy guidance established by your Committee on 26 October 1954.

2. For the purposes of the record, the history of this project is set forth below:

DATE in 1954	STATUS
9 February	Project assigned to Subcommittee.
8 March	McNeil-Webster Agreement on cost principles.
22 June	Draft submitted to Military Departments for comment by 1 August.
24 August	Subcommittee commensed to consider comments.
26 October	Policy guidance on two issues given by ASPR.

The Subcommittee has been devoting two full days a week to this effort since 27 April 1954, except for a vacation recess of one month.

3. The Subcommittee wishes to point out that the attached effort represents a new approach to cost principles and numerous ideas were discussed at length prior to Subcommittee agreement on the manner in which the various principles should be stated.

4. With respect to the future activities of this Subcommittee, further guidance is requested from the ASPR Committee. Considerable work has been accomplished on revising Part 1 of Section XV, but the effort has not been completed since the Subcommittee does not know what parts are to be included in the new Section XV. It should be pointed out that there are several statements in the attachment which provide that the cost is not allowable unless specifically provided for in the contract. While some effort has been expended in preparing guidelines as to when these costs may be allowable and provided for in the contract, it is the consensus that additional work should not be done on these guidelines until Part 2 is accepted.

H. K. Gallup

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

SUPPLY AND LOGISTICS

PP

Case 53-44

8 March 1954

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

FROM: Director of Procurement & Production Policies

SUBJECT: Agreement Reached by Panel of Department of Defense and Service Representatives in Mr. McNeil's Office, 1600 - 1700, 1 March 1954

1. The memorandum submitted by Mr. Webster was accepted in principle. These principles are as follows:

a. There will be included in the revision of Section XV, relating to cost-type contracts, a definite statement that the instructions covering "cost principles" for use in connection with cost-type contracts are not applicable to fixed-price type contracts.

b. In connection with fixed-price contracting, including redeterminable prices or incentive prices, the analysis and interpretation of costs shall avoid the use of such terms as "allowable" and "unallowable".

c. Any instructions to negctiators as to how to deal with cost data or as to the considerations to be examined in connection with negotiating fixed prices should not be in a publication which is available to contractors.

d. There should be furnished to industry guidance as to reporting of costs.

2. In addition, the following principle was agreed to:

a. Under fixed-price contracts, auditors perform a service function, which is primarily to explain the nature and content of the various elements of cost submitted by the contractor.

3. It was agreed to proceed as follows:

a. The ASPR sub-committee will expedite revision of Section XV for submission to the ASPR Committee. The revision will pertain solely to cost-type contracts and will substantially expand the cost interpretations.

b. The Office of the Assistant Secretary of Defense (Comptroller) will prepare a document relating to the reporting and analysis of costs on fixed-price type contracts. Decision as to whether this document will be incorporated in an Audit Manual or in ASPR as a new Section or a sub-division of Section XV will be postponed until the various projects mentioned above are completed.

c. The cost principles in draft documents heretofore prepared by Mr. Bordner and by the ASPR sub-committee will be reviewed in the above drafting.

d. This work to be undertaken concurrently with a sufficient interchange of ideas to incorporate all basic principles.

e. The above drafts will be submitted to the panel of Department of Defense and Service representatives for review and for the following decisions:

(1) Will ASPR include a Section or Sub-section on the reporting of cost data for fixed-price type contracts or will this material be included in a revised Audit Manual?

(2) Action to be taken on Joint Letter #12?

(3) What vehicle is to be used to furnish information to contractors?

F. W. HESSER
Rear Admiral SC USN
FOR
WARREN WEBSTER, JR.
DIRECTOR OF PROCUREMENT
AND PRODUCTION POLICY

6/17/54

MEMORANDUM FOR CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Section XV

1. Attached is the Subcommittee draft of a revised Part 2 of Section XV. As directed, in making this revision, all existing departmental papers having a bearing on this subject were considered. Part 2 has been revised to amplify the treatment of certain items of cost in the present Section XV, to assist in uniform departmental implementation, and to include coverage of additional items of cost incurred by Contractors. In this revision, each item of cost contains a definition, a statement as to the extent of allowability, unallowability, and whether provision must be made in the contract to make the item allowable.

2. Two issues have been raised in the development of Part 2 as follows:

(a) The Army Subcommittee members do not concur in paragraph 15-204.46(c) on education of individuals, but are willing for comments to be obtained on the present text.

(b) Should profit-sharing plans and stock-bonus plans be an unallowable item of cost as provided in paragraph 15-204.7 and by definition in 15-204.29 ? The Army and Air Force Subcommittee members believe that they should not be allowed and the paragraphs reflect their view. The Navy submits that they should be allowable. The two arguments on this question are also attached hereto.

3. While the Subcommittee members have developed the individual paragraphs of the Part, time has not permitted review of the draft as a whole in order to reconcile any possible inconsistencies.

4. The Subcommittee is now proceeding with the redrafting of Part 1. In addition, it is developing criteria or guide lines for use of contracting personnel which will set forth the limitation of and conditions under which those costs may be allowed which are not allowable unless specifically provided for in the contract in accordance with Part 2.

Lt. Col. J. M. Railing
R. M. Kee
J. T. Regardie (for E. T. Cook)
A. C. Sawallisch
Lt. Col. H. T. Critchlow
Lt. Col. J. Ellis (for A. B. Thomas)
H. H. Gallup

ARMY - AIR FORCE

15 June 1954

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Section XV, ASPR Issue Relative to Whether or Not Part 2, Section XV, ASPR Shall Include Provision for Allowability of Costs of Profit-Sharing Plans and Stock Bonus Plans

1. An issue has developed among the conferees of the subcommittee as to whether or not profit-sharing plans and stock bonus plans shall be considered an allowable item of cost. The Army and Air Force representatives believe that contributions to such plans should not be considered as allowable costs under cost reimbursement type contracts.

2. First, it is important to clearly distinguish between a "pension plan" and a "profit-sharing plan."

a. As defined under the regulations issued by the Commissioner of Internal Revenue, the following is a description of a "pension plan", as set forth in regulations 118, Section 39.165-1(a)(2):

"A pension plan within the meaning of section 165(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Retirement 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 retirement 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 service, 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 will, for the purpose of section 165(a), be considered a pension plan if under the plan either the benefits payable to the employee or the required contributions by the employer can be determined actuarially".

b. Also taken from Regulation 118, Section 39.165-1 (a)(2), immediately following the above, is the definition of a "profit-sharing plan":

"A profit-sharing plan, on the other hand, is a plan established and maintained by an employer to provide for the participation in his profits, by his employees or their beneficiaries, based on a definite predetermined formula for determining the profits to be shared and a definite predetermined formula for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as illness, disability, retirement, death, or severance of employment. A formula for determining the profits to be shared is definite, for example, if it provides for a contribution equal to (i) a specified percentage of the

annual profits, (ii) a specified percentage of the annual profits in excess of the sum of dividend commitments plus a fixed amount with an overall limitation, or (iii) a specified percentage of the annual profits not to exceed a specified percentage of the salaries of the participants or their contributions, if any, to the fund. A formula for distributing the accumulated funds among the participants is definite, for example, if it provides for a distribution in proportion to the basic compensation for each participant."

c. In summary, a pension plan is dependent upon an actuarial determination of either the employee benefits or the employer contributions. Consequently, the employer contributions are in the form of a fixed cost. Under a profit-sharing plan the employer contributions are contingent upon profits. Such profit-sharing benefits may be in the form of pension or retirement payments. Under the provisions 15.205.39 employer contributions to pension plans are allowable costs. However, in the opinion of the undersigned, employer contributions to profit-sharing plans should be unallowable.

3. The present regulations Part 6, Section XV, issued 1 March 1951, provides in subparagraph 15-601.2(f) that:

"Where contributions to pension or retirement plans are based on profits, providing that provisions of the Internal Revenue Code and regulations of the Bureau of Internal Revenue have been met, the amount allowable for apportionment to

contracts in any one year shall be the amount contributed to the pension trust (s) for that year but not to exceed fifteen (15) per cent of the total compensation otherwise paid or accrued in that year to the individuals concerned under the plan(s)." This subparagraph is inconsistent and contradictory in referring to cases "where pension or retirement plans are based on profits," since by definition (of the Internal Revenue Code) a pension plan is one in which "The determination of the amount of retirement benefits and the contributions to provide such benefits are not dependent upon profits". The current revision of Section XV, ASPR should provide clarity on this point by separate treatment of the two types of plans in conformity with the definitions given by the Internal Revenue Service.

4. The reasons for the position taken by the Army and Air Force representatives are as follows:

a. A business organization may make use of its earnings in many ways, such as,

(1) Investments

(2) Increase to working capital

(3) Dividend payments to stockholders

(4) Contributions to profit-sharing plans for employees

A distribution of earnings however accomplished cannot in equity be considered as a cost of performing a contract.

b. Under cost-reimbursement type contracts, the fixed fee negotiated is intended to represent the contractor's

entire profit. To allow contributions to profit-sharing plans as reimbursable costs is, in effect, giving the contractor an extra profit margin equal in amount to his contribution to the plan. If the contractor is, in fact, entitled to higher margins of profit, it should be through an increase in fixed fee rather than under the disguise of "costs".

5. With regard to stock bonus plans the Army and Air Force representatives consider that such bonus plans constitute a distribution of ownership or profits shared directly or indirectly by the other owners of the business. The cost of this distribution of ownership or profits is not a cost of production and therefore should not be allowed.

6. In essence, the issue in its simplest terms is whether any payments to employees (regardless of their form, such as bonuses, stock bonuses, deferred compensation or retirement trusts, etc., and regardless of the time, conditions or method of payment) which are contingent upon profits, present or future, should be excluded from allowable contract costs, however commendable or desirable the payments may be from the standpoint of efficiency or other business purpose. In conclusion our firm position is that such payments should not be recognized as allowable costs.

ARMY	AIR FORCE
R. M. Kee, Army Audit Agency	Lt. Col. H. T. Critchlow, AFMPE
Lt. Col. J. M. Railing, CS G-4	Lt. Col. J. E. Ellis, Jr. AFAUD

6/17/54

NAVY POSITION

Issue relative to whether Part 2, Section XV, ASPR shall include provision for allowability of costs of profit-sharing retirement plans.

1. An issue has been raised by the conferees of the subcommittee as to whether or not profit-sharing retirement plans shall be considered an allowable item of cost. Paragraph 15.601.2(f) of Part 6, Section XV states:

> "Where contributions to pension or retirement plans are based on profits, providing that provisions of the Internal Revenue Code and regulations of the Bureau of Internal Revenue have been met, the amount allowable for apportionment to contracts in any one year shall be the amount contributed to the pension trust(s) for that year but not to exceed 15 per cent of the total compensation otherwise paid or accrued in that year to the individuals concerned under the plan(s)."

The Navy representatives see no reason for departing from the basic principle herein involved, that costs of profit-sharing retirement plans (subject to the restrictions embodied in Part 6,Section XV) are allowable. The Army and Air Force conferees are of other opinions.

2. The practical question faced by many businessmen is not whether to provide for the payment of retirement income to employees, but how to provide for it. A growing number of companies now realize that a deferred-distribution profit-sharing trust is an excellent way of financing retirement income for their employees. Unlike a formal pension plan which provides for fixed contributions year-in and year-out, profits or no profits, a profit-sharing plan provides for contributions when a company's earnings, if any, warrant such contributions. The plans providing for these contributions are subject to review and approval by the Internal Revenue Service prior to acceptance by the Military Departments, and are hedged with restrictions and limitations. The contributions under such plans are:

(a) Paid into a trust
(b) Irrevocable
(c) Subject to qualifications and limitations of the agreement and the plans setting up the trust
(d) For the exclusive benefit of the employees and of their beneficiaries
(e) For the purpose of providing retirement income to their employees at a stated age, or at death or after termination of services or disability.

3. The issue here resolves itself around the term "profit-sharing". The Navy representatives are of the view that although this is a part of the terminology used, the fact remains that the contributions for the purposes

are no different in principle from contributions made for similar fringe benefits, such as pension costs. Almost 30% of the approximately 365 plans in the category of pension and profit-sharing retirement plans submitted to the Internal Revenue Service for the fiscal year ended 30 June 1953 were of a profit-sharing nature and the percentage is steadily increasing. Not to recognize the fact that profit-sharing is becoming an integral part of industrial operations is to overlook an important phase of industrial costs of operations.

4. The Navy conferees consider that a profit-sharing contribution is one which is measured or determined by the amount of a contractor's earnings. It is true that if there are no earnings, no contributions are made. However, it is considered by some that this is no different in principle from production workers piece-rate compensation and bonuses, or commissions paid to salesmen and others.

5. It should be pointed out that the contributions are irrevocably made to a trust fund and that the employees do not participate in the benefits (except as may be provided for in the plan at termination of service, disability or death) until the employees reach retirement age. One of the several requirements (all of which must be satisfied prior to approval of a plan by the Internal Revenue Service) is that the sole purpose of the trust is to provide benefits for the employees and their beneficiaries and that no part of the trust can revert to the employer.

6. A contribution to a profit-sharing trust is in the nature of compensation for personal services rendered by the covered employees and represents a necessary and ordinary business expense. Consequently it is provided that before a contractor may deduct contributions to a profit-sharing retirement plan, the requirements of the Internal Revenue Code as to reasonableness of compensation must be met.

7. To the extent that a contractor provides for reasonable fringe benefits, such as retirement, by one method or another, whether as a cost before determination of profits (as in the case of contributions under a pension trust) or after determination of profits appears to be immaterial provided the cost is reasonable and is in accord with the concept of a cost of doing business and other factors to be considered in determining allowability of costs. The mechanics of the method of computing the cost should not be the controlling criteria as to its allowability. The broader question to be considered is whether it is a necessary and ordinary business expense, which from a competitive standpoint other contractors provide for by different methods and yardsticks.

8. It is submitted that no business man will take the position that costs of profit-sharing retirement plans are not legitimate fringe benefits and consequently will provide for them in his costs of doing business.

9. While the above comments apply specifically to profit-sharing <u>retirement</u> plans, they also apply in principle to profit-sharing plans in general and stock bonus plans.

6/17/54

MEMORANDUM FOR CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Section XV

1. Attached is the Subcommittee draft of a revised Part 2 of Section XV. As directed, in making this revision, all existing departmental papers having a bearing on this subject were considered. Part 2 has been revised to amplify the treatment of certain items of cost in the present Section XV, to assist in uniform departmental implementation, and to include coverage of additional items of cost incurred by Contractors. In this revision, each item of cost contains a definition, a statement as to the extent of allowability, unallowability, and whether provision must be made in the contract to make the item allowable.

2. Two issues have been raised in the development of Part 2 as follows:

(a) The Army Subcommittee members do not concur in paragraph 15-204.46(c) on education of individuals, but are willing for comments to be obtained on the present text.

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3. While the Subcommittee members have developed the individual paragraphs of the Part, time has not permitted review of the draft as a whole in order to reconcile any possible inconsistencies.

4. The Subcommittee is now proceeding with the redrafting of Part 1. In addition, it is developing criteria or guide lines for use of contracting personnel which will set forth the limitation of and conditions under which those costs may be allowed which are not allowable unless specifically provided for in the contract in accordance with Part 2.

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ARMY - AIR FORCE

15 June 1954

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Section XV, ASPR Issue Relative to Whether or Not Part 2, Section XV, ASPR Shall Include Provision for Allowability of Costs of Profit-Sharing Plans and Stock Bonus Plans

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upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of service, 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 will, for the purpose of section 165(a), be considered a pension plan if under the plan either the benefits payable to the employee or the required contributions by the employer can be determined actuarially".

b. Also taken from Regulation 118, Section 39.165-1 (a)(2), immediately following the above, is the definition of a "profit-sharing plan":

"A profit-sharing plan, on the other hand, is a plan established and maintained by an employer to provide for the participation in his profits, by his employees or their beneficiaries, based on a definite predetermined formula for determining the profits to be shared and a definite predetermined formula for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as illness, disability, retirement, death, or severance of employment. A formula for determining the profits to be shared is definite, for example, if it provides for a contribution equal to (i) a specified percentage of the

annual profits, (ii) a specified percentage of the annual profits in excess of the sum of dividend commitments plus a fixed amount with an overall limitation, or (iii) a specified percentage of the annual profits not to exceed a specified percentage of the salaries of the participants or their contributions, if any, to the fund. A formula for distributing the accumulated funds among the participants is definite, for example, if it provides for a distribution in proportion to the basic compensation for each participant."

c. In summary, a pension plan is dependent upon an actuarial determination of either the employee benefits or the employer contributions. Consequently, the employer contributions are in the form of a fixed cost. Under a profit-sharing plan the employer contributions are contingent upon profits. Such profit-sharing benefits may be in the form of pension or retirement payments. Under the provisions 15.205.39 employer contributions to pension plans are allowable costs. However, in the opinion of the undersigned, employer contributions to profit-sharing plans should be unallowable.

3. The present regulations Part 6, Section XV, issued 1 March 1951, provides in subparagraph 15-601.2(f) that:

"Where contributions to pension or retirement plans are based on profits, providing that provisions of the Internal Revenue Code and regulations of the Bureau of Internal Revenue have been met, the amount allowable for apportionment to

contracts in any one year shall be the amount contributed to the pension trust (s) for that year but not to exceed fifteen (15) per cent of the total compensation otherwise paid or accrued in that year to the individuals concerned under the plan(s)." This subparagraph is inconsistent and contradictory in referring to cases "where pension or retirement plans are based on profits," since by definition (of the Internal Revenue Code) a pension plan is one in which "The determination of the amount of retirement benefits and the contributions to provide such benefits are not dependent upon profits". The current revision of Section XV, ASPR should provide clarity on this point by separate treatment of the two types of plans in conformity with the definitions given by the Internal Revenue Service.

4. The reasons for the position taken by the Army and Air Force representatives are as follows:

a. A business organization may make use of its earnings in many ways, such as,

(1) Investments

(2) Increase to working capital

(3) Dividend payments to stockholders

(4) Contributions to profit-sharing plans for employees

A distribution of earnings however accomplished cannot in equity be considered as a cost of performing a contract.

b. Under cost-reimbursement type contracts, the fixed fee negotiated is intended to represent the contractor's

entire profit. To allow contributions to profit-sharing plans as reimbursable costs is, in effect, giving the contractor an extra profit margin equal in amount to his contribution to the plan. If the contractor is, in fact, entitled to higher margins of profit, it should be through an increase in fixed fee rather than under the disguise of "costs".

5. With regard to stock bonus plans the Army and Air Force representatives consider that such bonus plans constitute a distribution of ownership or profits shared directly or indirectly by the other owners of the business. The cost of this distribution of ownership or profits is not a cost of production and therefore should not be allowed.

6. In essence, the issue in its simplest terms is whether any payments to employees (regardless of their form, such as bonuses, stock bonuses, deferred compensation or retirement trusts, etc., and regardless of the time, conditions or method of payment) which are contingent upon profits, present or future, should be excluded from allowable contract costs, however commendable or desirable the payments may be from the standpoint of efficiency or other business purpose. In conclusion our firm position is that such payments should not be recognized as allowable costs.

ARMY	AIR FORCE
R. M. Kee, Army Audit Agency	Lt. Col. H. T. Critchlow, AFMPE
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6/17/54

NAVY POSITION

Issue relative to whether Part 2, Section XV, ASPR shall include provision for allowability of costs of profit-sharing retirement plans.

1. An issue has been raised by the conferees of the subcommittee as to whether or not profit-sharing retirement plans shall be considered an allowable item of cost. Paragraph 15.601.2(f) of Part 6, Section XV states:

> "Where contributions to pension or retirement plans are based on profits, providing that provisions of the Internal Revenue Code and regulations of the Bureau of Internal Revenue have been met, the amount allowable for apportionment to contracts in any one year shall be the amount contributed to the pension trust(s) for that year but not to exceed 15 per cent of the total compensation otherwise paid or accrued in that year to the individuals concerned under the plan(s)."

The Navy representatives see no reason for departing from the basic principle herein involved, that costs of profit-sharing retirement plans (subject to the restrictions embodied in Part 6,Section XV) are allowable. The Army and Air Force conferees are of other opinions.

2. The practical question faced by many businessmen is not whether to provide for the payment of retirement income to employees, but how to provide for it. A growing number of companies now realize that a deferred-distribution profit-sharing trust is an excellent way of financing retirement income for their employees. Unlike a formal pension plan which provides for fixed contributions year-in and year-out, profits or no profits, a profit-sharing plan provides for contributions when a company's earnings, if any, warrant such contributions. The plans providing for these contributions are subject to review and approval by the Internal Revenue Service prior to acceptance by the Military Departments, and are hedged with restrictions and limitations. The contributions under such plans are:

(a) Paid into a trust
(b) Irrevocable
(c) Subject to qualifications and limitations of the agreement and the plans setting up the trust
(d) For the exclusive benefit of the employees and of their beneficiaries
(e) For the purpose of providing retirement income to their employees at a stated age, or at death or after termination of services or disability.

3. The issue here resolves itself around the term "profit-sharing". The Navy representatives are of the view that although this is a part of the terminology used, the fact remains that the contributions for the purposes

are no different in principle from contributions made for similar fringe benefits, such as pension costs. Almost 30% of the approximately 365 plans in the category of pension and profit-sharing retirement plans submitted to the Internal Revenue Service for the fiscal year ended 30 June 1953 were of a profit-sharing nature and the percentage is steadily increasing. Not to recognize the fact that profit-sharing is becoming an integral part of industrial operations is to overlook an important phase of industrial costs of operations.

4. The Navy conferees consider that a profit-sharing contribution is one which is measured or determined by the amount of a contractor's earnings. It is true that if there are no earnings, no contributions are made. However, it is considered by some that this is no different in principle from production workers piece-rate compensation and bonuses, or commissions paid to salesmen and others.

5. It should be pointed out that the contributions are irrevocably made to a trust fund and that the employees do not participate in the benefits (except as may be provided for in the plan at termination of service, disability or death) until the employees reach retirement age. One of the several requirements (all of which must be satisfied prior to approval of a plan by the Internal Revenue Service) is that the sole purpose of the trust is to provide benefits for the employees and their beneficiaries and that no part of the trust can revert to the employer.

6. A contribution to a profit-sharing trust is in the nature of compensation for personal services rendered by the covered employees and represents a necessary and ordinary business expense. Consequently it is provided that before a contractor may deduct contributions to a profit-sharing retirement plan, the requirements of the Internal Revenue Code as to reasonableness of compensation must be met.

7. To the extent that a contractor provides for reasonable fringe benefits, such as retirement, by one method or another, whether as a cost before determination of profits (as in the case of contributions under a pension trust) or after determination of profits appears to be immaterial provided the cost is reasonable and is in accord with the concept of a cost of doing business and other factors to be considered in determining allowability of costs. The mechanics of the method of computing the cost should not be the controlling criteria as to its allowability. The broader question to be considered is whether it is a necessary and ordinary business expense, which from a competitive standpoint other contractors provide for by different methods and yardsticks.

8. It is submitted that no business man will take the position that costs of profit-sharing retirement plans are not legitimate fringe benefits and consequently will provide for them in his costs of doing business.

9. While the above comments apply specifically to profit-sharing <u>retirement</u> plans, they also apply in principle to profit-sharing plans in general and stock bonus plans.

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 commercial organizations and with non-profit institutions having commercial type accounting systems.

15-201 BASIC PRINCIPLES AND STANDARDS.

(a) Composition of Total Cost. The total cost of a cost-reimbursement type contract is the net sum of (i) the allowable direct costs, (ii) the properly allocable portion of allowable indirect costs and (iii) applicable income and other credits.

(b) Factors Affecting Allowability of Costs. The factors to be considered in determining the allowability of costs include (i) reasonableness, (ii) application of generally accepted accounting principles and practices, (iii) exercise of good business judgment in incurrence of cost, (iv) significant deviations from the practices of the contractor prior to the award of the contract, and (v) any limitations as to types or amounts of cost items set forth in this Part 2 of Section XV or otherwise included in the contract. Failure to mention any item of cost in this part is not intended to imply that it is either allowable or not allowable.

(c) Credits. The applicable portion of income and other credits which are related to any allowed cost will be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

(d) 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).

15-202 DIRECT COSTS. Subject to the provisions of paragraph 15-201, allowable direct costs are those items of cost, or aggregate thereof, which can be identified specifically with any objective, service, program or project under the contract and are chargeable directly thereto. Major items of cost readily identifiable with the contract or with other work of the contractor should be charged directly thereto. This principle may often be applicable to such elements of expense as freight, travel, communications, engineering services, etc., as well as the normal items of materials and productive labor. However, this principle must be applied consistently to the costing of both defense and non-defense products or services, when the contractor is engaged in mixed production, in order to produce equitable results. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect expenses.

15-202.1 DIRECT MATERIALS. The cost of direct materials includes the cost of items purchased, supplied, manufactured or fabricated, which enter directly into the end product or which are used or consumed directly in connection with furnishing such product.

15-202.2 DIRECT LABOR. The cost of direct labor includes salaries and wages specifically identifiable with and properly chargeable directly to the performance of the contract or other work of the contractor. It may also include

other associated costs such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.3 OTHER DIRECT COSTS. Where other items of cost are charged directly to the contract consistent with paragraph 15-202 above, the contractor must demonstrate that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable to other work of the contractor must be eliminated from indirect costs allocated to the contract.

15-203 INDIRECT COSTS.

(a) Indirect costs are expenses which are incurred for common or joint objectives, are accumulated for accounting purposes by departmental activity or other logical cost grouping and are charged to the contract and other work of the contractor by a process of allocation. Each element thereof is subject to the limitations of this part as to allowability.

(b) No specific rules can be stated as to the method of allocation of indirect costs because the actual condition in each instance must be taken into account in determining the most suitable method or methods. The objective should be the selection of a method or methods which will distribute the indirect costs in the fairest and most equitable manner possible. The method used in connection with Government contracts must, in order to be acceptable, conform with generally accepted accounting practices, be applied consistently, and produce equitable results. Any significant change, such as in the nature of the business, the volume of sales, the volume of production, manufacturing

processes, or the products being produced, may require reconsideration of the methods previously in use to determine whether they continue to be equitable. Further discussion relative to allocation of the individual categories of indirect costs will be found in the subparagraphs below.

15-203.1 INDIRECT MANUFACTURING AND PRODUCTION EXPENSES. Indirect manufacturing and production expenses consist of costs which are necessary to the productive process as a whole and are not readily subject to treatment as direct costs in accordance with paragraph 15-202. Allocation of indirect manufacturing and production expenses on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable bases, in appropriate circumstances, include direct labor dollars (exclusive of overtime premium), units processed and prime costs of units processed. In some instances, it may be necessary to departmentalize or establish cost centers in order to distribute equitably the indirect costs. The factors to be considered in determining the extent of departmentalization or establishment of cost centers include variety of products, complexity of processes and relative labor and facility requirements for the various products.

15-203.2 INDIRECT ENGINEERING EXPENSES. Indirect engineering expenses consist chiefly of engineering administrative expense and general supplies. These expenses arise out of engineering activities which 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 expenses should be allocated to the benefited activities, i.e., the contract and other work of the contractor on the basis

of direct engineering man-hours expended, direct engineering labor dollars, or other equitable basis. NOTE: Direct costs of engineering activities should be charged directly to the benefited activities, i.e., the contract and other work of the contractor in accordance with paragraph 15-202.

15-203.3 INDIRECT SELLING AND DISTRIBUTION EXPENSES. The expenses in this group consist of items which represent the cost of marketing the contractor's products and include sales promotion, advertising, distribution costs and other related items. Generally, such expenses are not considered to be allocable to Government cost-reimbursement type contracts for the reason that marketing, in the ordinary commercial sense, is not necessary for doing business with the Government. However, in some instances, depending upon a showing of benefit to, or necessity for, the performance of the contract, some expenses which ordinarily are included in this group may be determined to constitute allowable costs. Because of the special problems that arise in this area, it is usually desirable for the contractor to identify in its records by means of subaccounts or otherwise, the items of these expenses considered properly allocable to Government contracts.

15-203.4 GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses consist of costs incurred in the over-all management, supervision and conduct of the business. Any recognized method of allocating general and administrative expense is acceptable provided equitable results are thereby obtained. Some of the generally recognized bases are as follows:

(a) Total costs incurred (exclusive of general and administrative expenses, but including materials purchased).

(b) Factory input (charges to work in process or equivalent accounts).

(c) Cost of goods manufactured.

(d) Processing costs (direct labor, plus direct and indirect production costs, exclusive of direct material).

(e) Cost of sales.

(f) Sales.

Among the factors that should receive consideration in determining whether the results are equitable are (i) the cost pattern of the Government contracts (that is, the percentage of the total cost of the contract, exclusive of general and administrative expenses, represented by each of the several cost components thereof) in relation to the cost pattern for the plant or activity as a whole, and (ii) the ultimate objective of distribution of these expenses in approximate ratio to the general and administrative effort involved in the two categories of work.

The "total costs incurred" basis will usually result in an equitable distribution of expense where the cost elements which make up the base are representative of all activities which require general administrative and supervising effort. The "sales" basis is usually not equitable where there is a distorting profit factor and the concurrency of sales with production varies between Government and commercial products. In the evaluation of these and other methods, consideration should be given to any significant variations of inventories between accounting periods, variations in the ratio of contract inventory levels to all other inventory levels, and any other relevant factors such as those mentioned in paragraph 15-203(b).

15-203.5 BASE PERIOD FOR ALLOCATION OF INDIRECT EXPENSES. The base period for allocation of indirect expenses should approximate the period of contract performance or should be representative of that period. The base period should

be sufficiently long to avoid inequities in the allocation of costs.

15-204 APPLICATIONS OF BASIC COST PRINCIPLES AND STANDARDS TO SELECTED ITEMS OF COST. This paragraph states, in some detail, applications of the basic cost principles and standards set forth in the preceding paragraphs of this part to certain selected items of cost. Failure to mention any particular item of cost herein is not intended to imply that it is either allowable or unallowable. With respect to those items not specifically covered, determination as to allowability will be made in the light of the basic principles and standards and, where appropriate, the treatment of similar or related items in this Part. The statements herein apply irrespective of whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. All of the subparagraphs below are subject to the factors affecting allowability of costs as set out in paragraph 15-201(b).

15-204.1 ADVERTISING. Advertising expenses include the costs of advertising media and corollary administrative expenses. Advertising media include magazines, newspapers, radio and television programs, direct mail, trade papers, outdoor advertising, dealer cards and window displays, conventions and exhibits, free goods and samples, and sales literature.

(a) The following advertising costs are allowable:

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

(ii) Publication of maintenance catalogs, price lists, and technical

pamphlets any of which aid users of the contractor's products, including the Government or defense contractors; provided that the product purchased by the Government under the contract is comparable to the items described in such publication

15-204.2 ANTICIPATORY COSTS. Anticipatory costs are those which are incurred prior to the effective date of the contract and which if incurred after such date, would be allowable thereunder. Such costs will not be allowable unless specifically set forth in the contract and may be limited to a period or time as well as to the type and amount of such costs.

15-204.3 BAD DEBTS. Bad debt expenses consist of losses (whether actual or estimated) arising from uncollectible customers' accounts and other claims, and include collection expenses and related legal expenses. These costs are unallowable.

15-204.4 BIDDING EXPENSE. Bidding expenses are the costs of preparing bid estimates on potential contracts or projects, including the development of engineering and cost data necessary to support the contractor's price proposal or estimated cost of work performance. Current bidding expenses of both successful and unsuccessful bids normally will be treated as indirect expenses and allocated currently to all business of the contractor, in which event no bidding expenses of past accounting periods will be chargeable to the Government contract. However, if the contractor's established and consistent practice had been to treat bidding expenses by some other recognized method, the results obtained may be accepted only if found to be reasonable and equitable.

15-204.5 CAFETERIAS, DINING ROOMS AND OTHER FOOD SERVICES. This class of expense consists of the cost, less revenue for the furnishing of facilities or

of the operation of cafeterias, dining rooms, canteens, lunch wagons or other type of food services, provided for the contractor's employees at their regular duty station. Such net costs are allowable when the services are reasonably required by the nature of the contractor's operations, plant location, established policies, or employer-employee agreement. Such net costs must be allocated to all contractor activities which benefit from the food service operation. Similarly any profit on these operations shall be allocated as a credit to all benefitted activities including Government contracts.

15-204.6 CIVIL DEFENSE. Civil defense costs are those incurred in the planning for and the protection of life and property against the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by local and state civil defense authorities. Examples of civil defense costs include cost in excess of normal plant protection expenses and may consist of first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions and other approved civil defense measures. Reasonable costs of 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. In the case of capital assets, acquired for civil defense purposes the costs thereof will be depreciated over a reasonable number of years in conformity with generally accepted accounting principles. Contributions to local civil defense funds or projects not on the contractor's premises are unallowable.

15-204.7 COMPENSATION FOR PERSONAL SERVICES.

a. This item includes salaries, wages, deferred compensation and fringe benefits for services rendered to the contractor by employees as well as fees paid to directors and committee members.

Subject to specific limitations set forth hereunder, such costs are allowable when the total compensation is reasonable in light of the services rendered.

b. Generally, the amount of compensation established by the contractor will be considered commensurate with the services rendered. However, compensation of individuals such as corporate officials, directors, executives, department heads, partners and sole proprietors may be subject to special consideration and limitation as to allowability for contract cost purposes where amounts appear excessive. Some situations which may give rise to excessive compensation are where (i) the individual or member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization; or (ii) ownership of the contractor is limited to a small cohesive group; or (iii) the volume of Government contracts when related to the contractor's total business is such as to influence the amount of compensation.

c. The cost of options to purchase stock of the contractor corporation granted to employees as a part of compensation is not allowable.

d. Special consideration will be accorded the following types of compensation benefits:

(1) Bonus plans. Bonuses to employees, such as production incentives and suggestion or safety awards, represent a part of their total compensation and are allowable when appropriately allocated, if they are: (i) reasonable in amount, (ii) paid in connection with an established plan consistently followed by the contractor, (iii) paid for services currently rendered by the employee, (iv) available to all employees of the contractor, or to all employees within a group or salary classification which is not unreasonably restricted, bonuses will not be allowed when they are

based upon or contingent upon profits or constitute a distribution of profit rather than reasonable compensation for services. Bonuses will not be allowed when they are restricted to officer or other employee stockholders or are distributed in relation to stockholdings.

(2) Profit-sharing plans. A profit-sharing plan is a plan established and maintained by an employer to provide for the participation in his profit by his employees or their beneficiaries, based on a definite predetermined formula for determining the profits to be shared and a definite predetermined formula for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as illness, disability, retirement, death or severance of employment. Although such plans provide certain incentives to employees, any profit-sharing plan, however designed, constitutes a distribution of profits in the same sense that profits are likewise distributed to stockholders or are retained for operating capital and cannot, therefore, be considered as a cost of performing the contract. Amounts paid to or set aside for employees under profit-sharing plans are unallowable.

(3) Stock Bonus plans. A stock bonus plan is a plan established and maintained by an employer to provide benefits similar to that of a profit-sharing plan except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the contractor. Charges for provisions under stock bonus plans are not allowable.

(4) The determination of allowability of the cost of pension and retirement plans, training expense, overtime, extra pay and multi shift premiums and other fringe benefits will be in accordance with paragraphs

15-204.29, 15-204.46, 15-204.27, and 15-204.16 respectively. Any form of compensation to an employee not specifically mentioned in this Part 2, in addition to those set forth in this paragraph, will be given consideration as a part of total compensation.

15-204.8 CONTINGENCIES. This type of charge results from the creation and maintenance of reserves to provide for an event whose occurrence cannot be foretold with certainty as to time, intensity or even an assurance of its happening. These costs are not allowable.

15-204.9 CONTRIBUTIONS AND DONATIONS. Contributions and donations to established nonprofit charitable, scientific, and educational organizations are properly allocable to Government contracts; provided that such costs (i) may reasonably be expected to result in future benefits to the contractor through advancing, directly or indirectly, the technology of his industry or increasing the supply of trained manpower available to it; (ii) are in lieu of the cost of similar facilities, which facilities the contractor would otherwise have to provide, as for example, employee medical or recreational facilities; or (iii) are expected of the contractor by the community and it can reasonably be expected that the prestige of the contractor in the community would suffer through the lack of such contributions. In general, contributions and donations under item (iii) will not be allowable unless it is the practice of most business firms in the same community to make contributions to such organizations.

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.

15-204.10 DEPRECIATION.

(a) Depreciation as described herein is a charge to current operations intended to distribute the cost of tangible capital assets, less estimated salvage value, over their estimated useful life in a systematic and rational manner. It involves a process of allocation, not of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

(b) Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, provided the amount thereof is based upon original acquisition cost. Depreciation will be accounted for by consistent application of any generally accepted accounting principles and should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation charged in any accounting period may vary with volume of production or use of multishift operations, provided the method followed is consistent with basic objectives set forth in subparagraph a above

(c) Charges for depreciation on idle or excess facilities will not be allowed except on such facilities as are reasonably necessary for contract performance standby purposes and on facilities representing additional plant capacity contractually reserved for Defense production.

(d) Unless otherwise provided in the contract, no charges for depreciation will be allowed on assets still in use which have been, in accordance with the contractor's consistent accounting practice, fully depreciated

on the contractor's books of account.

(e) Allowances for depreciation on emergency facilities will normally be determined in accordance with subparagraphs a through d above. However, where the contractor has applied for and received a determination of "true depreciation" from an Emergency Facilities Board covering emergency facilities acquired under certificates of necessity, the amounts so determined for "true depreciation" over the emergency period (5 years) will be recognized in lieu of normal depreciation. After the expiration of the emergency period for the facilities concerned where a determination of "true depreciation" has been made, the remaining undepreciated portion of the cost of such facility will be depreciated over its remaining useful life and will be the only amount recognized as allowable cost.

15-204.11 EMPLOYEE MORALE, HEALTH AND WELFARE. Included in this category are expenses of health and welfare activities incurred for the improvement of working conditions and the improvement of employer-employee relations and employee performance. Examples of these activities are house publications, illness or first-aid clinics, and employee counselling services. These costs are allowable when incurred in accordance with the contractor's established practice or custom in the industry or area and are equitably allocated to all classes of work performed in the contractor's plant.

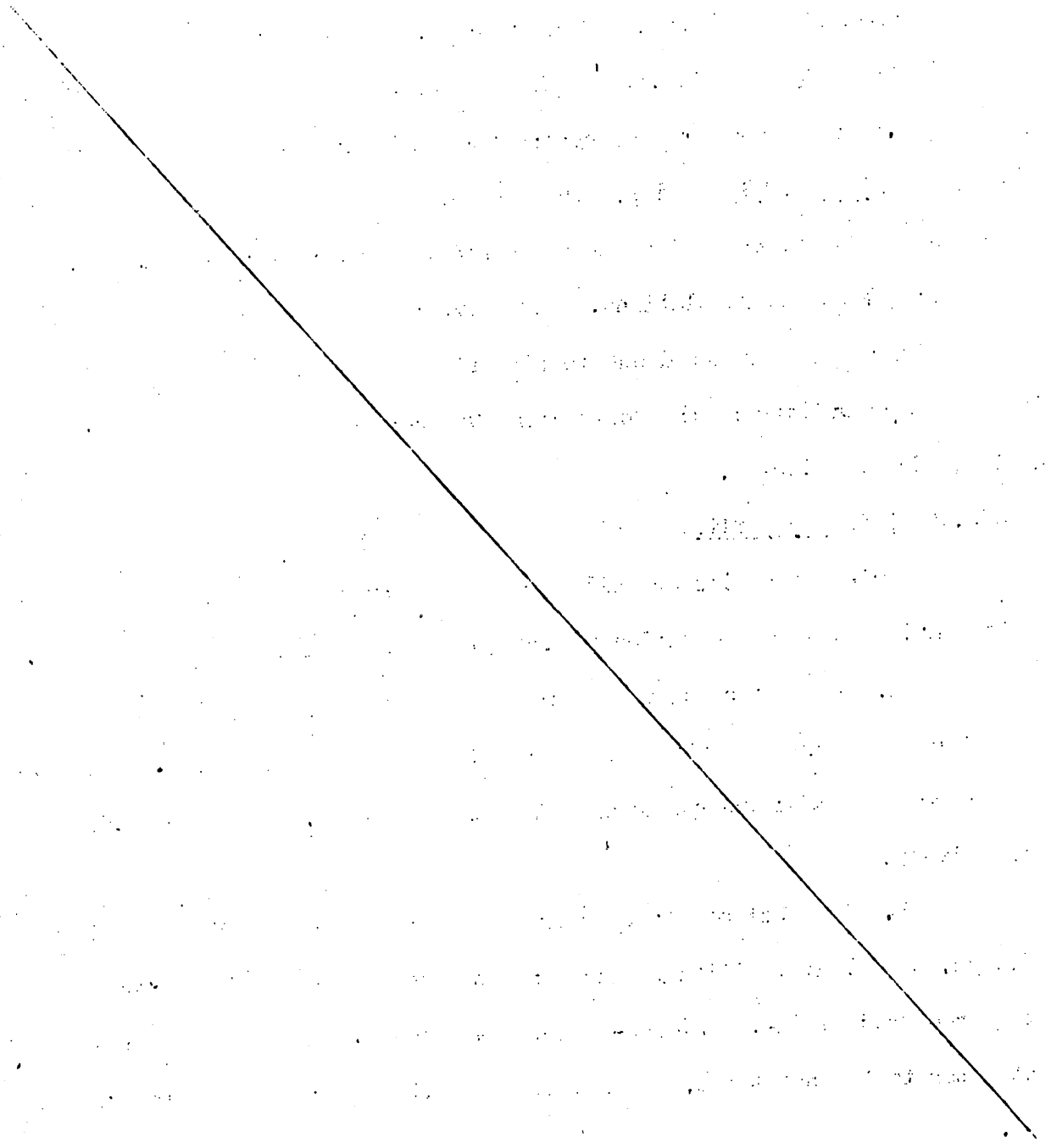
15-204.12 ENTERTAINMENT EXPENSE.

(a) This item includes the cost of amusement, diversion, social activities and incidental costs, such as, meals, lodging, rentals, transportation and gratuities.

(b) Expenses representing the purchase of meals, local transportation,

rental of facilities for meetings, and other incidental costs, when the primary, purpose of the incurring of such expenses is the dissemenation of technical information for the stimulation of production are allowable.

(c) All other entertainment expenses, including those classified as gratuities in accordance with paragraph 7-204.13, are unallowable.



15-204.13 Excess Facilities. This item includes the cost of maintaining and housing idle and excess facilities, except those reasonably necessary for contract performance standby purposes. These costs are unallowable unless specifically required by the terms of the contract.

15-204.14 Fidelity and Surety Bonds. The cost of bonds include net premiums paid for fidelity and surety bonds. Examples of such bonds are performance and payment bonds, forgery bonds, fidelity bonds, patent infringement bonds, etc. The cost of surety and fidelity bonds are allowable to the extent required by the contract or approved by the contracting officer both as to type and amount.

15-204.15 Fines and Penalties. Included in this item are those costs resulting from violations of, or failure of the contractor to comply with, local, state and Federal laws and regulations. These expenses are not allowable. However, fines and penalties incurred due to situations in which the contractor has been instructed in writing by the Contracting Officer to follow a certain course of action, will be allowed.

15-204.16 Fringe Benefits

Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries.

a. The determination as to the allowability of the cost of pension and retirement plans, profit sharing and other bonuses, and severance pay will be in accordance with sub-paragraphs 15-204.29, 15-204.7, and 15-204.41 respectively.

b. The cost of other fringe benefits such as pay for vacations, holidays, sick leave, military leave and employee insurance is allowable to the extent required by law, employer-employee agreement, or established policy of the contractor that constitutes, in effect, an implicit agreement on the contractor's part.

15-204.17 INITIAL PRODUCTION COSTS. Initial production costs, also known as "starting-load costs", are non-continuing costs that arise in early stages of production because of the Contractor's lack of experience with particular materials, manufacturing processes or techniques involved. Such costs may consist of excessive material costs resulting from abnormal scrap losses, excessive direct labor costs and related overhead resulting from idle time due to testing and change in production methods, cost of training employees, and excessive defective work due to inexperienced labor.

While initial production costs are allowable, the contractor will be expected to work actively to minimize or eliminate them as rapidly as possible. In cases where these costs continue to an unwarranted extent after the contractor has been allowed reasonable time to learn to make the product efficiently, the excessive costs will be disallowed.

15-204.18 INSURANCE AND INDEMNIFICATION

(a) Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative, and (2) those types of insurance which the contractor carries on his own account. The kinds of insurance ordinarily included in the first category are set out in ASPR 10-501. Examples of the kinds of insurance included in the second category are fire insurance on contractor-owned buildings and equipment, use and occupancy insurance, and employee fidelity bonds.

(b) Costs of Government required insurance are allowable within the limitations as to the extent of coverage and premium rates approved by the Government. To the extent that any part of a contractor's insurance program has not been disapproved by the Military Departments, the costs of such other

insurance are allowable where the types of coverage, extent of coverage, and rates are reasonable under the circumstances; however, costs allowed for use and occupancy insurance will be limited so as to exclude coverage of profit, interest, federal income taxes, and unallowable selling and distribution expenses.

(c) Costs of insurance of any kind pertaining to Government-owned property for which the Government has assumed the risk of loss under the terms of the contract are not allowable. The cost of insurance covering contractor owned materials used or usable exclusively on work other than that required under the cost reimbursement type contract is not allowable under such contract.

(d) The costs of a self insurance program under which a contractor assumes its own insurable risks are allowable provided that (i) the program has been approved by the Military Departments and (ii) the hazards so insured against are not unusual or inconsistent with reasonable and prudent business practice, and (iii) the rates charged are estimated not to exceed available insurance rates for insurance as reduced by an amount equal to the acquisition expenses of the equivalent commercial insurance (commissions, fixed expenses, excess losses, etc.). Actual losses sustained under such a self-insurance program are not allowable.

(e) Insurance on the lives of officers, partners or proprietors, where the contractor is the beneficiary, is not an allowable cost.

(f) Losses resulting from failure to insure (through self insurance or otherwise) against a contingent loss or damage, where a reasonably prudent business organization would have insured against such loss or damage, are not allowable.

(g) Costs of indemnification, in lieu of insurance, will be allowable only to the extent expressly provided for in the contract. By the term

"indemnification" is meant Government assumption of losses arising from (i) lack of insurance coverage of risks of an insurable nature or (ii) restrictions on the amount of such insurance coverage.

15-204.19 INTEREST AND OTHER FINANCIAL EXPENSES. This item includes interest paid or accrued (regardless of the nature of the obligation which gives rise to the interest cost), bond discount and expenses, and the cost of financing and refinancing operations as well as legal and professional fees paid in connection with the preparation of a prospectus, costs of preparation and issuance of stock rights and expenses related thereto. (See also 15-204.26) These costs are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in subparagraph 15-204.44.

15-204.20 LABOR RELATIONS. This item covers expenses incurred in maintaining the satisfactory relations between the contractor and his employees. It includes the costs of shop stewards, labor management committees, employee publications and other related activities. Costs incurred for these purposes are allowable.

15-204.21 LOSSES ON OTHER CONTRACTS. This item covers any excess of costs over income under any and all other contracts, whether such other contracts are of a supply, research and development, or other nature. Costs of this nature are not allowable as a cost of performance of the Government contract.

15-204.22 MAINTENANCE AND REPAIRS. (a) This item includes those costs necessary for the upkeep of property which neither adds to the permanent value of the property nor appreciably prolongs its intended life but keeps it in its efficient operating condition. These costs are allowable. Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation will be allowable only on a depreciation

basis. Cost of maintenance and repairs of excess facilities and of idle facilities (other than reasonable standby facilities) are not allowable.

(b) Deferred maintenance is defined as maintenance and repairs which for some reason such as abnormal operating conditions or lack of funds, is delayed to a future period. The cost of maintenance and repairs which has been deferred from a period prior to the contract is not allowable unless specifically provided for in the contract. Likewise, the estimated cost of maintenance and repairs normally required but not accomplished during the period of the contract will not be allowed as a cost unless specifically provided for in the contract or an amendment thereto.

15-204.23 MANUFACTURING AND PRODUCTION ENGINEERING. Manufacturing and production engineering includes the cost of engineering activities in connection with (1) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement and (2) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production. These costs are allowable. For purposes of distribution, such costs should ordinarily be divided into two categories: (i) those which directly benefit a contract, a project, or a product line and (ii) those expenses which are not subject to direct costing. Items in category (i) should be charged directly to the contract or project or allocated to the products in the product line. Costs in category (ii) should be allocated to all benefitted work.

15-204.24 MATERIALS AND SUPPLIES.

(a) This item includes the net costs of such items as raw materials, parts, sub-assemblies, components, and manufacturing supplies, whether purchased outside or manufactured by the contractor. Costs of materials and supplies

may include such collateral items as inbound transportation and intransit insurance. These costs are allowable subject, however, to the provisions of subparagraphs (b) through (d) below.

(b) Any generally recognized method of pricing materials issued from stock may be employed for determining actual cost, provided it has been consistently used by the contractor, is acceptable for internal revenue purposes, and does not discriminate against the Government. However, when materials in inventory at the commencement date of a Government contract have a provable replacement cost significantly different from book cost, the contractor and the Government may agree upon the use of a different method of pricing based upon the fair value of the materials (but not in excess of replacement cost). Such agreement should include identification of the types or kinds of materials involved and should preferably be made at the time the contract is entered into and provided for therein.

(c) Ordinarily inter-company or inter-divisional sales or transfers of materials shall be stated on the basis of cost to the transferor. A departure from this cost basis is permissible when the transactions involve items regularly manufactured and sold by an affiliate or division through commercial channels except as to items on which the Government is ultimately the sole user. In these latter cases, however, the price charged to the contract must not exceed the lower of (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. In other situations where consideration of the minority interest in an affiliate would warrant departure from the cost basis, such departure may be permitted but only if expressly authorized or approved by the contracting officer.

(d) Costs of materials and supplies shall be suitably adjusted for applicable portions of income and other credits. Such income and other credits include trade discounts, refunds, rebates and allowances, cash discounts taken, credits for scrap and salvage and materials returned to vendors, and credits arising from differences between book and physical inventories. If the contractor does not exercise reasonable precautions in taking advantage of cash discounts available, all cash discounts lost may be deducted in determining allowable costs.

15.204-25 ORGANIZATION EXPENSES. This item consists of expenditures in connection with organization or reorganization of a business. Examples of such costs are incorporation fee, attorneys fee, fees to promoters and organizers and costs of raising capital. These costs are unallowable. (See also 15-204.19).

15-204.26 OTHER BUSINESS EXPENSES. Included in this item are such recurring expenses as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of annual reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies and incidental costs of directors and committee meetings. The above listed costs are allowable when incurred in reasonable amounts in accordance with the contractor's established practices and are allocated on an equitable basis to all classes of work. The above and similar costs are allowable when incurred in reasonable amounts.

15-204.27 OVERTIME, EXTRA PAY SHIFT AND MULTI SHIFT PREMIUMS. This item consists of the premium portion of overtime and shift payments to employees. Such premiums may be classified as either direct or indirect labor costs, but

the amount thereof should be separately identified in either event. When treated as direct labor cost, overtime and shift premiums should not be included in the base for distribution of overhead. Cost of overtime and shift premiums are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government. See ASPR 12-102 for further information concerning the policy regarding such authorization. The amount of overtime and shift premium cost charged on Government contracts shall be equitable in relation to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant and the factors which necessitate the incurrance of the cost.

15-204.28 PATENT EXPENSES. Included in this item are all costs leading to the issuance of patents, as well as the cost of infringement investigation and litigation. Amortization of the cost of purchased patents owned by a contractor applicable to products or processes covered by a contract are allowable when approved by the contracting officer. The cost of research and development work leading to patents is treated in subparagraph 15-204.37. These costs are unallowable except for the cost of preparing required disclosures and of preparing assignment and other papers in connection with the filing of a patent application for the Government. Charges for the use of patents where the Government has a license or the right to free use thereof are unallowable.

15-204.29 PENSION AND RETIREMENT PLANS

(a) As used herein, a pension or retirement plan is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to his 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 retirement benefits. Retirement 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 retirement benefits and

contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of service 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 will be considered a pension plan, if, under the plan, either the benefits payable to the employee or the required contributions by the contractor can be determined actuarially.

(b) Pension and retirement plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the Military Department; however, approval of the plan by the Internal Revenue Service does not necessarily assure acceptance by the Military Department. Consideration of the plans will be the responsibility of the Department to which audit cognizance is assigned and the subsequent action taken by that Department will generally be accepted by the other Departments. In cases where the Internal Revenue Service withdraws approval of a plan, amounts allocated to contract costs will be withdrawn accordingly. Where pension and retirement plans of non-profit or other tax-exempt organizations are not required to be reviewed and approved by the Internal Revenue Service, it will be the responsibility of the Department to which audit cognizance is assigned to give consideration to the acceptability of such plans.

(c) The costs of acceptable pension and retirement plans, which are properly deductible from taxable income are allowable except as otherwise determined unallowable under this paragraph. Costs of acceptable pension and retirement plans established by nonprofit or other tax-exempt organizations are also allowable except as otherwise determined under this paragraph.

(d) Pension and retirement costs constitute a part of the total compensation by a contractor to the individuals covered by the plan, and accordingly, are subject to the provisions of this section with respect to reasonableness of the total compensation paid to the individual for the services rendered. (See 15-204.7)

(e) The carryover provisions of the Internal Revenue Code with respect to contributions under pension and retirement plans shall not be recognized for the purpose of determining allowable pension and retirement costs under Government contracts.

(f) Credits which arise under pension plans from various sources, such as dividends and cancellation of employee benefits which have not vested at the time of termination of their employment, must be taken into account in an equitable manner in the determination of the allowable pension and retirement contribution. Special provision for these credits is usually necessary when the contractor's organization has substantially expanded for the performance of military contracts and there is a reasonable expectation that the employment of a large number of the additional employees will be terminated upon curtailment of military work. Under these circumstances, 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. There are two general methods which may be used, individually or in combination, in making such arrangements:

(1) A lump sum or percentage discount (of current pension costs) allowance negotiated and agreed upon in advance. Determination of such allowance is not often an actuarial problem involving a calculation based upon known factors, but rather is an attempt to reach a negotiated agreement as to various uncertain or variable factors in a complex situation.

(2) A retrospective determination at some time in the future when a more accurate estimate can be made by virtue of experience which may have developed. Until such determination, current costs, which should be net of current credits, may be allowed provided an appropriate contractual agreement can be reached which reserves the Government's right to future credits. Such recapture provisions will vary in the extent and duration of application and time of determination. For example, such provisions may be contract-wide or contractor-wide and the determination may be made at termination of a defense contract or defense contracts, at mass layoff of contractor's employees or at the time of substantial decline in proportion of contractor's total sales under defense contracts.

15-204.30 DELETED

15-204.31 PLANT PROTECTION EXPENSES. This item includes the cost of plant protection measures such as wages of guards, equipment of guards (uniforms, firearmes, etc.), burglar alarm systems, and fencing. For the purpose of contract costing, these expenses are devided into two categories, namely, normal plant protection expenses and special plant protection expenses. Normal plant protection costs are allowable and are allocable to all work in the plant. Special plant protection costs, which term refers to an extension of the contractor's normal plant protection program at the specific direction of the contracting officer or other cognizant Government authority, are also allowable and allocable to specific Government contracts requiring special protection.

15-204.32 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER.

(a) This item includes the cost of professional services rendered, whether performed by the contractor's own employees or by the members of the particular profession separately engaged. These costs generally are allowable when reasonable in relation to the services rendered and are not contingent upon recovery of the costs from the Government.

(b) Factors to be considered (among others) in determining the allowability of costs in a particular case are: (i) 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 organization; (iv) the nature of any conflict of interest which may exist between the contractor and the U. S. Government; and (v) whether or not the proportion of Government production of the contractor's total production 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 production under Government contracts. Retainer fees to be allowable must be reasonably supported by evidence of services rendered.

(c) Professional services relating to patents are subject also to the limitations provided for in paragraph 15-204.28.

15-204.33 PROFITS AND LOSSES ON DISPOSITION OF PLANT, EQUIPMENT OR OTHER CAPITAL ASSETS. Included herein are gains or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments. Profits or losses on sale or exchange of capital assets, including investments, will be excluded in computing contract costs.

15-204.34 RECONVERSION EXPENSES. Reconversion expenses are those incurred in the restoration of the contractor's facilities to approximately 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 expenses, except for the removal of Government property, are incurred for the benefit of future production and are, therefore, properly chargeable thereto. Accordingly, except for the cost of removing Government property and the restoration and rehabilitation costs caused by such removal which are specifically provided for in the contract, reconversion expenses are not allowable.

15-204.35 RECRUITING EXPENSE. This item includes the costs of "help wanted" advertising and the operating costs of an employment office necessary to secure and maintain an adequate labor force. It further includes the costs of operating an educational and aptitude testing program, travel expenses of employees

while engaged in recruiting personnel, and travel expenses of applicants for interviews for prospective employment. These costs are allowable. Where the contractor uses private employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs incident to special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are not allowable.

15-204.36 RENTALS OF PLANT AND EQUIPMENT. (Including sale and leaseback of facilities.)

This item includes expenses for (a) use of land, buildings, and equipment or other personal property, and (b) rental expenses under sale and lease-back agreements incurred by contractors through sale of plant facilities to investment organizations (such as insurance companies) or to private investors and concurrently leasing back the same facilities on long term leases.

(a) Rentals of plant and equipment under (a) above, if the rates are reasonable in light of the type, condition, and value of the facilities leased, options available, and maintenance on other provisions.

(b) Rentals specified in sale and lease-back agreements are allowable only to the extent that such rentals do not exceed normal costs (such as depreciation, taxes, insurance and maintenance expenses) which would have been incurred had the contractor retained legal title to the facilities.

15-204.37 RESEARCH AND DEVELOPMENT. Research and development expenses (sometimes referred to as general engineering expenses) for the purpose of contract costing are divided into two major categories, (i) product research and/or development and (ii) general research.

(a) In the first category are included costs for design, improvement, and utilization of a particular product or product line. The allocable

portion of these costs are allowable under cost-reimbursement type production contracts where the research is reasonably related to the end items being purchased under the contract. These costs are allowable under cost-reimbursement type research and development contracts, only to the extent that such costs are directly chargeable to such contracts.

(b) In the second category, are included costs of all research other than that described in subparagraph (a) above. Reasonable costs of general research wich are not otherwise reimbursed are allowable under cost-reimbursement type production contracts. Costs of general research are not allowable under cost-reimbursement type research and development contracts, unless specifically provided for in such contracts.

(c) Research and development costs, regardless of the nature, which were incurred in accounting periods prior to the award of a particular military contract (including amounts capitalized in the costs of patents obtained) shall not be allocated to that contract.

15-204.38 ROYALTY PAYMENTS. This item covers amounts paid for the right to use patents. Where the use of such patent is necessary for the proper performance of the contract and where the Government does not already have a license or other right to use such patents, the royalties are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the contract officer.

15-204.39 SELLING AND DISTRIBUTION EXPENSES. This group of expenses includes the costs of marketing, sales engineering, sales promotion, salesmen's and agents' compensation, and other related expenses. It also includes costs of advertising, bidding, outbound transportation, entertainment, service and

warranty which are specifically covered elsewhere in this part.

(a) Generally, selling and distribution expenses are not allowable. However, there frequently are cases in which expenses in this group relate in whole or in part to contract negotiation and administration and technical, consulting, and other services of application and adaptation of products to the use and requirements of the Government. These costs are allowable when properly allocated.

(b) No fee, commission, percentage, or brokerage fee shall be allowed as a contract cost which violates the provisions of paragraph 7-203.20.

15-204.40. SERVICE AND WARRANTY EXPENSES. This item includes such costs as providing service in installation, training personnel in the use, operation and maintenance of the product, correcting defects in the product, replacing defective parts, refunds in case of inadequate performance and other related costs. Actual costs to be reimbursed to the contractor will include such of the fore-going costs as must be borne by the Government under the clause of the contract entitled "Inspection of Supplies and Correction of Defects" (See paragraph ASPR 7-203.5).

15-204.41 SEVERANCE PAY. Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated.

The cost of severance pay is 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 implicit agreement on the contractor's part, or (iv) the circumstances of the particular employment.

For contract costing purposes severance pay is divided into two categories as follows:

(a) Normal Turnover Severance Pay. The cost of severance payments arising from normal severances should be allocated to all classes of work being performed in the contractor's plant at the time of payment. Where the contractor provides for accrual of normal severance pay such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made over a representative past period.

(b) Mass Severance Pay. The cost of abnormal or mass severance pay 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 to the period in which the severance pay was actually earned and equitably apportioning such cost to all business of the contractor performed during that period.

A reservation in the final release of claims (see ASPR 7-203.4) may be made in the case of completed cost-reimbursement type contracts when it is reasonable to assume that severance pay allocable to the contract must be made in the future.

15-204.42 SPECIAL TOOLING. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or to the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. The cost of special tooling, when acquired for and its usefulness is limited to government contracts, is allowable and will be charged directly to the government contracts. When such special tooling

is acquired it shall be subject to the provisions of the contract clause set forth in paragraph 13-503 entitled "Government Property" and to the provisions of Appendix B, ASPR, applicable to Government-owned special tooling. The cost of special tooling which is useful under both government contracts and other work of the contractor is allowable when properly allocated.

15-204.43 STRIKES AND LOCKOUTS, EXPENSES OF. The situations and conditions surrounding strikes and lockouts are so varied that it is impossible to establish a general principle providing for allowance or disallowance of costs incurred during such occurrences. Each case must be considered on its own merits.

15-204.44 TAXES. Taxes are charges levied by a government unit. They do not include fines and penalties except as otherwise provided herein.

(a) In general, taxes which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for Federal income and excess profits taxes; taxes in connection with financing, refinancing or refunding operations (see paragraph 15-204.19); and special assessments on land which represent capital improvements.

(b) Taxes which are believed to be illegally or erroneously assessed against the contractor, may be allowed as a cost of work performed, provided that the contractor; (1) promptly requests instructions from the contracting officer concerning such taxes; (2) agrees to comply with such instructions; and (3) if so directed by the contracting officer also agrees to take all necessary action in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer, shall be allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting

officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs.

(c) Any refund of taxes, penalties or interest thereon shall be credited to contract costs in the proportion in which contract costs absorb the costs of taxes, interest or penalties. If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

15-204.45 TRADE, BUSINESS, AND PROFESSIONAL ACTIVITIES.

(a) Memberships. This item includes costs of membership in trade, business, and professional organizations and such costs are allowable when incurred in accordance with the following standards:

(i) Memberships are consistent with the established practice of the contractor, particularly his practice prior to the award of Government contracts. However, if the nature or volume of the contractor's production had been altered significantly by Government contracts, departure from the prior program may be justified.

(ii) When the organization is a local one; is primarily for trade, business, or professional purposes; and membership would be expected of all similar business firms in the business community. The costs of social, cultural, or recreational activities of such organizations are not allowable.

(iii) If the organization is regional, national or international in scope, membership therein should be held by a majority of like firms in the same industry.

(iv) The costs must be reasonable. In determining reasonableness of particular membership costs which appear to be excessive, a review of the nature of the activities of the organization may be necessary in order to reduce the allowable portion of the contractor's membership costs to an amount which

would, in effect, exclude a contribution to lobbying or public relations activities.

(b) Subscriptions. This item includes the cost of subscriptions to trade, business, professional, or technical periodicals or services which are allowable when incurred in accordance with the contractor's established practice and the costs are reasonable in amount.

15-204.46 TRAINING EXPENSES.

(a) This item includes the costs of preparing and maintaining a program of instruction designed to increase the over-all effectiveness of employees. Included are the costs of the director of training and staff, training materials and text books when the training program is conducted by the contractor; and tuition, fees, training materials and text books when the training is in educational institutions.

(b) Such costs which are limited to training for specific jobs in the plant are allowable when properly allocated.

(c) Such costs for educational advancement will not be allowed except in scientific engineering and technical fields related to the contractor's business, and then only if it can be established that the value thereof to the individual employee was equitably taken into account as a part of the total compensation of the employee. (See paragraph 15-204.7)

15-204.47 TRANSPORTATION EXPENSES. Transportation expenses include the cost of freight express, cartage and postage relating either to goods purchased, in process, or delivered.

When such costs can readily be identified with the items involved they may be directed costed or added to the cost of such material. (See paragraph 15-204.24) Where identification with the materials received cannot readily be made, inbound transportation expense may be charged to the appropriate indirect expense accounts, provided the contractor follows a consistent procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as direct charges.

15-204.48 TRAVEL EXPENSES. This includes costs of transportation, lodging, subsistence and incidental expenses incurred by contractor personnel in a travel status while on official company business.

(a) Travel expenses incurred in the normal course of overall administration of the business and applicable to the entire business are allowable when properly allocated.

(b) Travel expenses directly attributable to contract performance may be charged to the contract in accordance with the principle of direct costing.

(c) Subsistence and lodging including tips or similar incidental expenses may be reimbursed either on an actual or per diem basis. The basis selected should be consistently followed.

(d) Costs of premium transportation may be allowed when it is shown to be necessary to performance of the contract.

(e) Entertainment expenses are not allowable.

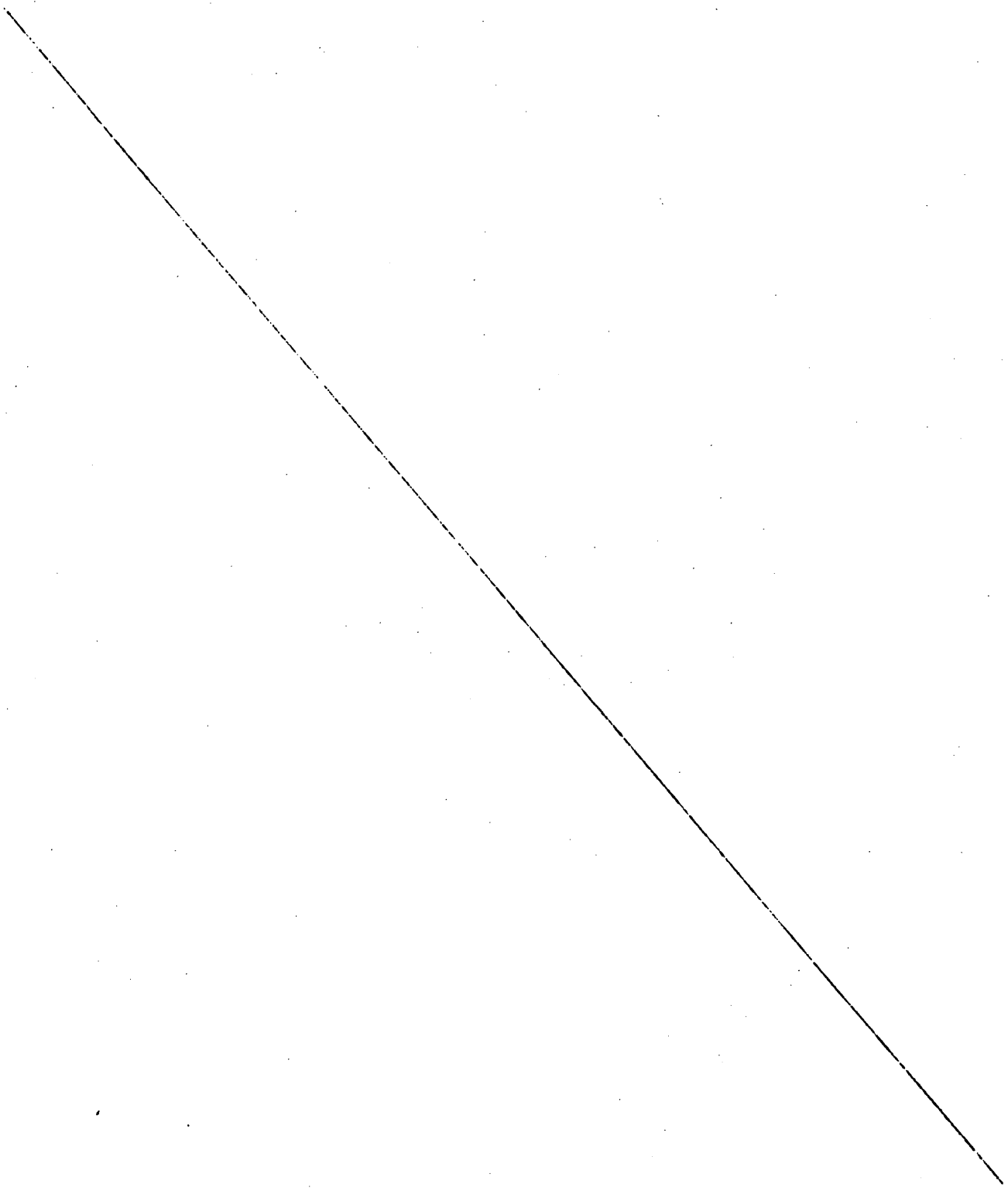
(f) Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the Contracting Officer.

15-204.49 UNCLAIMED WAGES. Unclaimed wages are compensation earned but not claimed by employees normally represented by pay checks not presented for payment and liability to such employees or former employees for sums left over from amounts originally drawn for payrolls.

Unclaimed wages, previously reimbursed to contractor will be reviewed at intervals and particularly at the completion of the contract to determine what portion of these unclaimed wages shall accrue as a credit to the contract or subsequent refund to the Government.

Costs should reflect a credit for unclaimed wages based upon agreement as to the amount thereof reasonably expected not to be paid

subsequent to the date of completion or settlement. In this event, all unclaimed wage liability rests with the contractor. When such an agreement cannot be reached, the Government will assume liability for payment of unclaimed wages and eliminate all allowances therefor from reimbursement to the contractor.



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 commercial organizations and with non-profit institutions having commercial type accounting systems.

15-201 BASIC PRINCIPLES AND STANDARDS.

(a) Composition of Total Cost. The total cost of a cost-reimbursement type contract is the net sum of (i) the allowable direct costs, (ii) the properly allocable portion of allowable indirect costs and (iii) applicable income and other credits.

(b) Factors Affecting Allowability of Costs. The factors to be considered in determining the allowability of costs include (i) reasonableness, (ii) application of generally accepted accounting principles and practices, (iii) exercise of good business judgment in incurrence of cost and (iv) any limitations as to types or amounts of cost items set forth in this Part 2 of Section XV or otherwise included in the contract. Failure to mention any item of cost in this part is not intended to imply that it is either allowable or not allowable.

(c) Credits. The applicable portion of income and other credits which are related to any allowed cost will be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

(d) 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).

15-202 DIRECT COSTS. Subject to the provisions of paragraph 15-201, allowable direct costs are those items of cost, or aggregate thereof, which can be identified specifically with any objective, service, program or project under the contract and are chargeable directly thereto. Major items of cost readily identifiable with the contract or with other work of the contractor should be charged directly thereto. This principle may often be applicable to such elements of expense as freight, travel, communications, engineering services, etc., as well as the normal items of materials and productive labor. However, it must be applied consistently to the costing of both defense and non-defense products or services, when the contractor is engaged in mixed production, in order to produce equitable results. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect expenses.

15-202.1 DIRECT MATERIALS. The cost of direct materials includes the cost of items purchased, supplied, manufactured or fabricated, which enter directly into the end product or which are used or consumed directly in connection with furnishing such product.

15-202.2 DIRECT LABOR. The cost of direct labor includes salaries and wages specifically identifiable with and properly chargeable directly to the performance of the contract or other work of the contractor. It may also include other associated costs such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.3 OTHER DIRECT COSTS. Where other items of cost are charged directly to the contract consistent with paragraph 15-202 above, the contractor must demonstrate that they are specifically related to the performance of the con-

tract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable to other work of the contractor must be eliminated from indirect costs allocated to the contract.

15-203 INDIRECT COSTS.

(a) Indirect costs are expenses which are incurred for common or joint objectives, are accumulated for accounting purposes by departmental activity or other logical cost grouping and are charged to the contract and other work of the contractor by a process of allocation. Each element thereof is subject to the limitations of this part as to allowability.

(b) No specific rules can be stated as to the method of allocation of indirect costs because the actual condition in each instance must be taken into account in determining the most suitable method or methods. The objective should be the selection of a method or methods which will distribute the indirect costs in the fairest and most equitable manner possible. The method used in connection with Government contracts must, in order to be acceptable, conform with generally accepted accounting practices, be applied consistently, and produce equitable results. Any significant change, such as in the nature of the business, the volume of sales, the volume of production, manufacturing processes, or the products being produced, may require reconsideration of the methods previously in use to determine whether they continue to be equitable. Further discussion relative to allocation of the individual categories of indirect costs will be found in the subparagraphs below.

15-203.1 INDIRECT MANUFACTURING AND PRODUCTION EXPENSES. Indirect manufacturing and production expenses consist of costs which are necessary to the productive process as a whole and are not readily subject to treatment as

direct costs in accordance with paragraph 15-202. Allocation of indirect manufacturing and production expenses on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable bases, in appropriate circumstances, include direct labor dollars (exclusive of overtime premium), units processed and prime costs of units processed. In some instances, it may be necessary to departmentalize or establish cost centers in order to distribute equitably the indirect costs. The factors to be considered in determining the extent of departmentalization or establishment of cost centers include variety of products, complexity of processes and relative labor and facility requirements for the various products.

15-203.2 INDIRECT ENGINEERING EXPENSES. Indirect engineering expenses consist chiefly of engineering administrative expense and general supplies. These expenses arise out of engineering activities which 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 expenses should be allocated to the benefited activities, i.e., the contract and other work of the contractor on the basis of direct engineering man-hours expended, direct engineering labor dollars, or other equitable basis. NOTE: Direct costs of engineering activities should be charged directly to the benefited activities, i.e., the contract and other work of the contractor in accordance with paragraph 15-202.

15-203.3 INDIRECT SELLING AND DISTRIBUTION EXPENSES. The expenses in this group consist of items which represent the cost of marketing the contractor's products and include sales promotion, advertising, distribution costs and other related items. Generally, such expenses are not considered to be

allocable to Government cost-reimbursement type contracts for the reason that marketing, in the ordinary commercial sense, is not necessary for doing business with the Government. However, in some instances, depending upon a showing of benefit to, or necessity for, the performance of the contract, some expenses which ordinarily are included in this group may be determined to constitute allowable costs. Because of the special problems that arise in this area, it is usually desirable for the contractor to identify in its records by means of subaccounts or otherwise, the items of these expenses considered properly allocable to Government contracts.

15-203.4 GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses consist of costs incurred in the overall management, supervision and conduct of the business. Any recognized method of allocating general and administrative expense is acceptable provided equitable results are thereby obtained. Some of the generally recognized bases are as follows:

(a) Total costs incurred (exclusive of general and administrative expenses, but including materials purchased).

(b) Factory input (charges to work in process or equivalent accounts).

(c) Cost of goods manufactured.

(d) Processing costs (direct labor, plus direct and indirect production costs, exclusive of direct material).

(e) Cost of sales.

(f) Sales.

Among the factors that should receive consideration in determining whether the results are equitable are (i) the cost pattern of the Government contracts (that is, the percentage of the total cost of the contract, exclusive of general and administrative expenses, represented by each of the several cost components thereof) in relation to the cost pattern for the plant or activity

as a whole, and (ii) the ultimate objective of distribution of these expenses in approximate ratio to the general and administrative effort involved in the two categories of work.

The "total costs incurred" basis will usually result in an equitable distribution of expense where the cost elements which make up the base are representative of all activities which require general administrative and supervising effort. The "sales" basis is usually not equitable where there is a distorting profit factor and the concurrency of sales with production varies between Government and commercial products. In the evaluation of these and other methods, consideration should be given to any significant variations of inventories between accounting periods, variations in the ratio of contract inventory levels to all other inventory levels, and any other relevant factors such as those mentioned in paragraph 15-203(b).

15-203.5 BASE PERIOD FOR ALLOCATION OF INDIRECT EXPENSES. The base period for allocation of indirect expenses should approximate the period of contract performance or should be representative of that period. The base period should be sufficiently long to avoid inequities in the allocation of costs.

20 April 1954

MEMORANDUM FOR CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44 - Revision of Section XV

1. In accordance with paragraph 6 of the ASPR minutes of 2/9/54, this Subcommittee has proceeded in the redrafting of Section XV.

2. The Subcommittee has rewritten and expanded the introductory material in Part 2 of the Section. A copy of this effort is attached. While considerable time has been expended in drafting this introductory material, it should be noted that much of it will appear in the introduction of subsequent Parts. Part 1 has been reserved since it is introductory and cannot be written properly until all other Parts have been revised.

3. Pursuant to the McNeil-Webster agreement of 3/1/54, the ASPR Committee and the Office of the Comptroller were directed to undertake certain work concurrently "with a sufficient interchange of ideas to incorporate all basic principles". This progress report is submitted so that the ASPR Committee can comply with the direction.

4. The Subcommittee is actively proceeding with the Section XV revision on a one-day-a-week meeting basis.

H. H. GALLUP
Chairman
Section XV Subcommittee

53-44

DEPARTMENT OF THE ARMY
OFFICE OF THE ASSISTANT CHIEF OF STAFF, G-4, LOGISTICS
WASHINGTON 25, D. C.

4 December 1953

MEMORANDUM FOR: CHAIRMAN, ASPR COMMITTEE

SUBJECT: Proposed Section XV of ASPR, Draft dated November 1953

1. The undersigned members of the ASPR Section VIII Termination Subcommittee view with apprehension the far reaching effect of the proposed Section XV upon the area of terminations which, in our judgment and experience, has required special treatment that sets it apart from other elements of the procurement process. The Contract Settlement Act, the Joint Termination Regulation, and Section VIII of ASPR were all prepared along a broad background of Government purchasing but were devoted exclusively to the specialized field of termination. The preliminary examination which we have made of Section XV disturbs the Subcommittee in that the proposed new Section does not adequately cover the necessary provisions of the present Section VIII, Part 4.

2. At no time has the Section XV Subcommittee called upon the Termination Subcommittee for its views in connection with the substance of the proposed draft of Section XV, dated November 1953, as it affects Section VIII. Hence, the Section VIII Subcommittee feels it is necessary to request a reasonable period of time in which to prepare and present its objections to this draft.

Albert Alberi, Air Force
Albert Kornblum, Navy
Lt. Col. Brooks C. Preacher, Army

BROOKS C. PREACHER, Lt. Col, GS
Chairman, Section VIII, Subcommittee

12/10/53

FOR DEPARTMENT OF DEFENSE USE ONL.

1 December 1953

MEMORANDUM FOR CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Parts 1, 2, 3 and 4 of Section XV

1. Attached are drafts of Parts 1, 2, 3 and 4 of Section XV which have been revised in the light of the comments received from the various echelons of the Military Departments.

2. Set forth below are the issues developed at Subcommittee meetings, which represent, except for Comment "I", the unanimous views of the Subcommittee versus those of the OSD Comptroller's representatives. The OSD Comptroller representatives will present their views separately. In those instances in which the Subcommittee recommends deletion in the attached text, the material in question has been bracketed [ ] so that it may be more quickly identified.

A. Para. 15-101(a) (See page 1501) - The Subcommittee recommends deletion of the second and third sentences.

The Subcommittee position is that the substance of these is not questioned, but their presence in this Regulation will unduly delay negotiations by inviting unnecessary requests from contractors for special treatment in the contract which might not otherwise occur or be required. Furthermore, utilization of specific contract provisions to cover unusual circumstances is standard procurement practice which obviates the necessity for reference to such practice in this Section.

B. Para. 15-101(b) (See page 1501) - The Subcommittee members believe that the text, in its present wording, requires that Part 2 of the proposed revision be incorporated in all cost-reimbursement type contracts. It is felt that this is inappropriate with respect to contracts with educational institutions in that subparagraph 15-202(e) of Part 2 has no application to contract costing with such institutions and would, therefore, create confusion and misunderstanding. It is believed that there should be a separate part of Section XV devoted entirely to costing of contracts with educational or other non-profit institutions which do not use commercial cost accounting systems. Wording which would serve to give effect to the foregoing is as follows:

"(b) Cost-Reimbursement Type Contracts. Cost estimates shall be developed and evaluated, and reimbursements to the contractor for costs incurred shall be determined, through the application of these cost principles and standards. In the case of prime contracts with commercial organizations, and with educational or other non-profit institutions which have commercial type cost accounting systems, Part 2 and Parts 3, 4 and 5 (as appropriate to the type of work called for by the contract) shall be incorporated therein by reference in each instance. In the case of contracts with educational or non-profit institutions, which do not have commercial type

cost accounting systems, Part 6 shall be incorporated therein by reference in each instance. All cost-reimbursement type subcontracts shall incorporate by reference the appropriate Part or Parts of these cost principles and standards, depending upon the nature of the work called for in the subcontract and the type of organization with which the subcontract is let. For the purpose of determining the appropriate Part or Parts to be incorporated by reference in cost-reimbursement type subcontracts the criteria herein outlined for cost-reimbursement type prime contracts will be applicable."

The above text contemplates assignment of Part 6 to Cost Principles and Standards dealing with educational or other non-profit institutions. These comments also apply to paragraph 15-101(c).

C. Para. 15-101(c) (See pages 1501, 1502) - This Subcommittee has previously submitted this issue for consideration on the substitution of a new paragraph (c) on page 1502 for the one in brackets proposed by OSD Comptroller. The substitute paragraph not in brackets is the position of the ASPR Committee on this issue.

D. Para. 15-102.3 (See page 1503) - The Subcommittee recommends deletion of the last sentence.

The Subcommittee position is that this statement is not appropriate for inclusion in cost principles as such and belongs more appropriately in Section III of ASPR.

E. Para. 15-105 (See pages 1505, 1506)

(1) It is recommended that the second and third sentences and the first word of the fourth sentence be deleted. (See page 1505.) The Subcommittee position is the same as for 15-102.3 above.

(2) The Subcommittee recommends deletion of the last sentence. (See page 1506.) The Subcommittee position is that this last sentence is an open invitation to contractors to conceal or withhold actual product costs in favor of presenting only product line costs where it is to their advantage to do so. ASPR 3-101 provides that procurement by negotiation

> "will be made to the best advantage of the Government, price and other factors considered. Negotiation shall thereupon be conducted, by contracting officers and their negotiators with due attention being given to the following and any other appropriate factors:
>
> (a) Comparison of prices quoted, and consideration of other prices for the same or similar supplies or services, with due regard to production costs."

The reference to "or similar supplies or services" in the above quotation from Section III is adequate without reiteration in Section XV, to permit use of product line costs when only such costs are available.

The sentence in the proposed ASPR 15-105, which is recommended for deletion, would permit an option to the contractor which would be contrary to "the best advantage of the Government" in those cases in which the actual product costs are available, and its inclusion "in order not to impose impractical requirements on contractors for cost estimates" is considered to be both dangerous and contrary to existing fundamental policy.

F. Para. 15-106 (See page 1506) - The Subcommittee recommends deletion of the last two sentences and paragraph references.

The Subcommittee position on this recommendation is the same as that taken on Para. 15-101(a) above.

G. Para. 15-106½ (See page 1506) - The Subcommittee recommends deletion of this entire paragraph.

The Subcommittee position is that this reference to the Internal Revenue Code should be deleted since (1) the Code was not designed for determination of costs under contracts, (2) the Code is subject to constant change by laws, regulations, and court decisions, and (3) military contract negotiation and administration personnel are not trained in the intricacies of the Code nor do they have ready access to the Code or its revisions, or the time required to keep up with the changes.

H. Para. 15-110 and 15-111 (See pages 1508, 1509) - The wording of these paragraphs places undesirable restrictions on the operations of the military departments in the conduct of their business.

The Subcommittee position is that no necessity is seen for such restrictions prospectively nor are any past events known which would offer a justifiable reason for language more restrictive with regard to this proposed Section XV than the treatment afforded the other sections of ASPR as contemplated by the currently proposed revised paragraphs on implementations and deviations in Section I of this Regulation. Moreover, the reservation to the Office of the Secretary of Defense for exclusive judgment as to necessity and consistency as contemplated by paragraph 15-110(c) is inconsistent with past practices in matters affecting ASPR.

I. Para. 15-311.2(a) (See page 1513) - The Subcommittee recommends that an assignment be made to the Editing Subcommittee to develop a standard contract clause whereby the Government may exercise its option on the pricing of materials and inventories at the date of the contract in a manner consistent with this subparagraph.

J. Para. 15-311.2(c) (See pages 1514-1516) - The Subcommittee recommends deletion of the paragraph in brackets proposed by the OSD Comptroller and the substitution therefor of a new paragraph as drafted by the Subcommittee on page 1516.

The Subcommittee position is that its redraft has the desirable feature of emphasizing treatment of inter-company sales on the basis of cost to the transferor and of deemphasizing any interpretation which might result in the pyramiding of profits.

K. Para. 15-313.3(d) and (e) (See pages 1531, 1532) - The Subcommittee recommends that the bracketed material in these two paragraphs be deleted.

The Subcommittee position is that the material which it recommends for deletion would permit a contractor to elect the depreciation of assets on the basis of an appreciation in their value by reference to "current price levels by the use of a general price index." Such a concept is objected to for the following reasons: (i) it will result in an unwarranted additional cost in Government procurement, (ii) in periods of rising prices contractors will take the election of using current market index but will resist its use in periods of falling prices, (iii) a substantial administrative burden is created for contracting officers and auditors since current book values would never be static, and (iv) the concept is not generally recognized by the accounting profession.

L. Para. 15-313.9 (See pages 1537-1539) - The Subcommittee recommends the deletion of the bracketed paragraph proposed by OSD Comptroller and recommends adoption of the revised paragraph on page 1539 as drafted by the Subcommittee.

The Subcommittee position is that reconversion costs, except for the removal of Government property and restoration and rehabilitation costs caused by such removal, are incurred for the benefit of future production and as such should be properly charged only against future production and not against past production. This is considered to be in conformity with commercial practice in that reconversion costs are normally charged to the new line of business rather than the one being discontinued. As applied to Government contracts this means that we would pay the cost of converting the contractor's plant to our work but we would not pay for reconverting back to commercial work. It may be noted that at the end of WWII a definite stand was taken against allowance of these expenses - see the cost principles included in Appendix A of the Joint Termination Regulation which, under the category of excluded costs, reads as follows:

> (b) The expenses of conversion of the contractor's facilities to uses other than the performance of the contract.

The Subcommittee very strongly feels that procurement should be accomplished on the basis of reasonable profits to contractors for the work that they perform in producing end products as being the contractor's entire consideration in entering into Government business as compared with remaining in commercial business and that the allowances for reconversion costs should not be used as an inducement to contractors to accept government business. Moreover, on the basis of past unsatisfactory experience, it is known that such costs may run to very substantial dollar amounts.

M. Para. 15-330.6 (See page 1559) - The Subcommittee recommends deletion of the bracketed material in this paragraph.

The Subcommittee recommends this deletion since it is believed to be inconsistent to recognize a cost policy for lower tier subcontractors which differs from that for prime contractors or their first tier subcontractors. Further, many cases exist where prime contractors are also sub and lower tier subcontractors.

3. Paragraph 15-350 (See pages 1563-1565) of the Revision contemplates the deletion of the existing text of ASPR 8-402 and the substitution of an appropriate cross-reference to the revised Section XV. It is recommended that the paragraph be reviewed by the Section VIII Committee.

4. Since the Subcommittee effort was directed principally toward the basic concepts of the proposals in accordance with the instructions of the ASPR Committee, the necessity for extensive editing is recognized.

J. M. Railing, Lt. Colonel
R. M. Kee
E. T. Cook
A. C. Sawallisch
H. T. Critchlow, Lt. Colonel
A. B. Thomas
H. H. Gallup, Chairman

SPR 16 October 1953

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Section XV

1. This Subcommittee attended the ASPR Committee meeting on October 13, 1953 and was instructed (A) to revise the draft of 15-101(c) to state the use that will be made of Section XV by contracting officers in negotiating revised prices and (B) to draft a clause incorporating Section XV in price redetermination and incentive clauses.

2. With respect to problem (A), it is believed that the Subcommittee is in basic agreement with the intention of the use which will be made of Section XV by the contracting officer under redetermination and incentive clauses. The problem at the subcommittee level appears to be a choice of words to properly express that intention so that there will be no confusion in anyone's mind. It is not intended by incorporation to place a lever in the contractor's hands. It is contemplated that the members of this Subcommittee will be present at the meeting to express themselves on this matter. However, the Chairman of this Subcommittee in an attempt to clarify the problem believes that everyone agrees that it is intended that Section XV be used only as a yardstick in evaluating the contractor's cost estimates, and it is not intended to use it to establish the price. On the original draft the word "criteria" appears to avoid the confusing phrase "as a guide" which appears in the existing departmental instructions regarding the use of the present Section XV in redetermination proceedings. The Winston Dictionary defines the word "criterion" to mean "a standard by which a correct judgment can be formed, measure, test." Set forth below is a revision of para. 15-101(c) with three alternate second sentences:

"15-101(c) - Cost is but one of several factors to be considered in the negotiation of price or in negotiating settlements in the event of termination for the convenience of the Government.

Alternate (1) - When considering cost data as a basis for negotiation (as required by paragraphs 15-103 and 15-104) the cost principles or standards contained in this section shall be used as criteria for the evaluation of cost data submitted by contractors.

Alternate (2) - When considering cost data as a basis for negotiation (as required by paragraphs 15-103 and 15-104) cost principles and standards contained in this section shall be used as criteria to guide the commanding officer in the evaluation of cost data submitted by contractors.

Alternate (3) -When considering cost data in negotiations (as

required by paragraphs 15-103 and 15-104), the cost principles and standards contained in this section shall be used as criteria to guide the commanding officer in the evaluation of cost data submitted by contractors.

This applies to pre-award negotiations, negotiations during or upon completion of the contract, and negotiations in the event of termination for the convenience of the Government. Accordingly, Part 2 and either Part 3, 4, 5 or 6 (whichever is appropriate to the type of work called for by the contract) will be incorporated by reference in (i) the clause of every contract entitled termination for the convenience of the Government, and (ii) in all price redetermination and incentive clauses. Such incorporation shall further provide that such parts will be used as the basis for the development and submission of cost data by the contractor."

3. With respect to problem (3), Subcommittee drafted the following proposed provision establishing the proper tone for incorporation, recognizing that the placement of the provision in certain clauses will necessitate a proper introduction and revised wording. The clause agreed upon is as follows:

"Whenever cost data are required by this clause to be submitted by the contractor, the data submitted shall be developed in accordance with the cost principles and standards set forth in Parts 2 and ___ of Section XV of the Armed Services Procurement Regulation hereby incorporated herein by reference for this purpose."

H. H. GALLUP
Chairman, Subcommittee on
Section XV, ASPR

1 October 1953

MEMORANDUM FOR CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44 Revision of Section XV

1. Background - The Section XV Subcommittee is engaged in evaluating the comments of the various echelons of the Military Departments with respect to the drafts of Parts 1, 2 and 3 of Section XV. In this evaluation, a major issue of substance has been raised requiring resolution. This issue, together with a discussion thereof and the individual positions of the Subcommittee members and participants, is set forth below.

2. Issue - Should Section XV provide for the inclusion of the revised cost principles in contract with provision for redetermination of the price or an incentive clause on a mandatory or optional basis?

3. Discussion - Paragraph 15-101(c), as circulated to the echelons for comment, provides for the mandatory inclusion of a reference to Section XV in all price redetermination and incentive clauses. The same paragraph provided that, when Section XV was incorporated in such clauses, the following would be applicable:

> "Cost is but one of several factors to be considered in the negotiation of prices ..... In considering cost data as a basis for negotiation, the cost principles and standards contained in this Section shall be used as criteria for the evaluation of cost data submitted by contractors. . . . . "

It was contemplated by the Subcommittee that an appropriate provision, incorporating the substance of the above quotation, would be developed for inclusion in all price redetermination and incentive clauses.

4. Subcommittee Positions -

a. Mandatory inclusion - Messrs. R. H. Kee, E. T. Cook, H. Wright, E. Maerker, and E. H. Gallup are for mandatory inclusion for the following reasons:

> (1) Cost estimates submitted by contractors under price redetermination or incentive clauses are no different from cost estimates submitted in original pricing or contract termination, i.e. some formulae, guides, or criteria must exist to evaluate contractors' cost estimates. That is the sole purpose of the portion of paragraph 15-101(c) as set forth in the above discussion.
>
> (2) To negotiate a redetermination type contract originally utilizing Section XV, then redetermining on no agreed basis, then subsequently terminating on the basis of Section XV results

[illegible]-uniformity. The primary purpose of the revised cost principle was to have a uniform basis for the submission and [illegible] of all cost estimates.

[illegible] Col. J. H. Rolling concurs with the mandatory view but recommends [illegible] this interpretation clause is developed.

[illegible] Optional Inclusion - Col. L. V. Renton, Lt. Col. H. T. Crist, [illegible] C. Smallbeck advocate optional inclusion because:

(a) With respect to pricing, this philosophy tends to emphasize cost, in lieu of price. Price is the important [illegible]. Cost analysis, although a prime technique, is but one [illegible] techniques or yardsticks available to a negotiator. It is considered that the mandatory feature of this draft will cause [illegible] Government negotiators and contractors to become preoccupied with costs to the detriment of sound pricing.

(b) The mandatory feature of these provisions can result [illegible] in prolonged negotiations. In the absence of explicit [illegible] as to what detailed information is to be furnished in [illegible] by prospective contractors (other than that such [illegible] must conform to the principles) misunderstandings [illegible], and there will be a natural tendency on the part of negotiators to ask for more detail. Good vendor relations, however, dictate that information be obtained from prospective [illegible] with a minimum of discomfiture. More importantly, [illegible] will be demanded from many contractors that specific items of cost be specifically set forth in fixed price contracts subject to price redetermination. Based on experience under Section XV as it applies to cost reimbursable contracts, it will take time to [illegible] many of the differences of opinion and interpretations that are bound to arise in this area.

(c) More emphasis will be placed on audits than heretofore by buying personnel in the pricing field. Overemphasis on audit [illegible] recognized as a difficult problem, and procurement and audit personnel of the Air Force have been attempting to minimize this problem. Heretofore, the negotiator had to be prepared to defend a price. As a result of this mandatory concept he will now have to defend in addition to the price the elements of cost comprising the price. To satisfy himself in this regard he must naturally rely more and more on audit.

5. It is requested that the ASPR Committee expedite consideration of this [illegible] since it affects certain portions of Parts 2 and 3 of the Section which [illegible] Subcommittee is about to revise.

E. H. GALLUP
Chairman,
Section XV Subcommittee

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

Washington 25, D. C.

Supply & Logistics 17 September 1953

Signed Copy

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44 - Revision of Section XV - Contract Cost Principles

I. PROBLEM:

To amend the report of the Patents Subcommittee on the subject material in memorandum dated 16 September 1953, in view of action by the ASPR Committee at its 15 September 1953 meeting, rejecting the Subcommittee's proposal for a paragraph 9-107.6 dealing with the problem of allowance of costs for support of contractors' programs for both product research and improvement and for general research.

II. RECOMMENDATION:

Referring to Tab A to the memorandum dated 16 September 1953, delete proposed revision of paragraph 15-313.11(c) and substitute the following:

"(c) See paragraph 9-107 for instructions as to patent rights to be obtained when research or development work is called for or required in the performance of a contract or when allowances are made for costs for product research or improvement."

III. DISCUSSION:

1. While the Patents Subcommittee report commenting on subject case is dated 16 September 1953, it had actually been completed and processed for reproduction on 14 September 1953. The report of 16 September 1953 was predicated on acceptance by the ASPR Committee of the proposal for a new paragraph 9-107.6 contained in Tab A to the Subcommittee's report on Case 52-77 - Revision of paragraph 9-107 - Second Proposed Revision of Section IX, contained in memorandum for the Chairman, ASPR Committee, dated 4 September 1953. When the last mentioned report was considered by the ASPR Committee at its meeting of 15 September 1953, paragraph 9-107.6 was rejected. It is therefore

necessary for the Patents Subcommittee to revise its proposal for paragraph 15-313.11(c) in its 16 September 1953 report to conform with the action by the ASPR Committee.

PATENTS SUBCOMMITTEE

BY: George W. Seevers (Navy)

Jos. A. Hill, Capt. (Army)

Frank D. O'Connell (Air Force)

Ray M. Harris, Chairman (OSD)

TAB B

16 Sept. 1953

ASPR COMMITTEE

PATENTS SUBCOMMITTEE

Case 53-44

Proposed Revision of Section XV - Contract Cost Principles

Proposed Revision of Proposed Paragraph 15-313.11

15-313.11 Research and Development. Research and development expenses are incurred either as a result of work required in performing the contract or for programs of general research or product improvement maintained by the contractor, which programs are separate from and independent of the work which the contractor does for his customers under contract, and must therefore be supported by the contractor from his profits or personal funds, or by grants, or by charging to his customers as indirect costs in their contracts.

Product research or improvement is that effort which is directed toward the solution of specific problems encountered in the design or production of a particular product which has or is anticipated to have military or commercial use. General research is all other research. In the event that product improvement is done under the name of general research or if there is confusion between or intermingling of general research and product improvement programs of a contractor, the total effort shall be regarded as product improvement.

The costs of programs for product research or improvement or for general research are subdivided into costs of conducting and performing the work under such programs and costs of administering such programs.

(a) Work Required Under the Contract. Research and development expenses required or approved by the contracting officer in performing the contract are allowable as direct costs.

(b) Costs of Programs. Costs of programs for product research or improvement or for general research are not allowable except as specified hereinbelow:

(i) The proper share of the indirect costs of administering programs for either product research or improvement or for general research is allocable to all classes of work, including Department of Defense contracts.

(ii) Costs of conducting and performing the work under product research or improvement programs are allowable in Department of Defense contracts for supplies or services but only to the extent that the work done under such programs is applicable to said supplies or services. Such costs may be allocated to DOD contracts with the following limitations:

(A) The costs are current, i. e., are incurred in the contractor's accounting period or periods during which the contract is performed.

(B) The costs are incurred in accordance with the contractor's established practice.

(C) The costs are not reimbursed to the contractor under separate contracts for research or development.

Such costs shall not be allowed in nor allocated to Department of Defense contracts for product research and development.

(iii) The cost of conducting or performing work under general research programs is allocable to all classes of work, including Department of Defense contracts, and may be allowed with the following limitations:

(A) The costs are current, i. e., are incurred in the Contractor's accounting period or periods during which the contract is performed.

(B) The costs are reasonable in amount.

(C) The costs are incurred in accordance with the Contractor's established practice.

(D) The costs are not reimbursed to the contractor under separate contracts for general research.

(E) The contractor's organization is not devoted primarily to research work, as distinct from manufacturing.

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

Washington 25, D. C.

Supply & Logistics

16 September 1953

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

Signed Copy

SUBJECT: Case 53-44 - Revision of Section XV - Contract Cost Principles

I. PROBLEM:

To comment on proposed revision of Part 3, Section XV, dated 18 August 1953.

II. RECOMMENDATION:

A. The Patents Subcommittee recommends as follows:

1. In paragraph 15-313.11(a) and (b), change the term "product research and development" wherever it occurs to -- product research or improvement --.

2. That paragraph 15-313.11(c) be revised to read as shown in attached Tab A.

3. That paragraph 15-313.12 be revised as shown in Tab A.

B. The Patents Subcommittee attaches as Tab B, a re-write of paragraph 15-313.11(a) and (b) which it believes states more definitely the intent of this paragraph and which will avoid misinterpretation and misapplication of the paragraph.

III. DISCUSSION:

1. Reason for Recommendation 1 is that the term "product improvement" is believed to be in current usage to a much greater extent than "product development" for describing the situation to which the definition refers.

2. Revision of Paragraph 15-313.11(c) is recommended for the following reasons:

a. Cost allowances should not be dependent upon whether patent rights are obtained; rather, patent rights should be obtained whenever amounts for costs are allowed in sufficient quantity or proportion to justify an equitable division of patent rights developed with Government funds.

b. Patent rights should preferably be expressed in terms of a license to make or have made rather a waiver of royalties. The term "waiver of royalties" is generally thought of as applying to the following situations: (1) where the Government is purchasing from a licensee-manufacturer who pays royalties to the licensor patent owner, or (2) where the Government is itself a licensee under a royalty-bearing license. It is not customary, nor is it accounting policy, ever to allow patent royalties to the patent owner who is also making and selling the item covered by the patent.

c. The subject matter of subparagraph (c) is of substantive nature dealing with patent rights, and therefore should be in Section IX.

3. Change marked "W" in 15-313.12(b) is urged for the following reasons:

a. The statement that "Royalty costs may not be bona fide under the following circumstances" tends to imply that they are not bona fide in such situations, especially in view of the terminology used in describing the situations. It is believed that there should be no implication of a connection between bad faith and the circumstance, but rather a suggestion that the situation is one in which bad faith is more likely to occur.

b. There is no requirement in the language of the 18 August 1953 draft that the situation be reviewed or examined.

4. Change marked "X" presents third and fourth situations which are self-explanatory.

5. The recommendation for deletions from paragraph 15-313.12(b) of the matter designated as Change "Y" is for the reason that this provision with respect to reasonableness of the royalties in a bona fide agreement is basically unfair to the contractor. Notwithstanding the fact that the royalties are payable to the persons named in subparagraphs (b) (i) and (ii), the obligation to pay the royalties is a contractual one entered into by and between competent contracting parties. Therefore, while the Government because of its control of the situation might disallow the payment of the royalties to the contractor, as a cost in a cost-type contract or as an element of price in a negotiated fixed-price contract, the contractor must nevertheless pay the royalties. Disallowance by the Government of the royalties provides no relief to the contractor against his obligation to the licensor. He must therefore pay the royalties out of his profits or out of his separate funds. The Patents Subcommittee does not believe it is fair to ask the contractor to do this. There is no objection to the disallowance of the royalties if they are not bona fide, or if they are obviously unreasonable, on the ground that here the contractor is only being penalized for his own incompetence or attempted sham.

6. There is also the objection to the matter proposed to be deleted in Change "Y" that the test as to the amount of the royalty charge which is to be allowed appears impossible of application. How would the amount which would be allowed to the contractor under the provisions of 15-313.11 if the patent were owned by him be determined? Paragraph 15-313.11 is related to costs of research or development work. What are the costs to this contractor of research or development work which he did not do and which he might not be equipped to do? Over what period of time are such costs to be considered? It should also be pointed out that there is no correlation between the costs of research and development work and the value of the patent produced under such work.

7. It is believed that change marked "Z" in paragraph 15-313.12(c) is more completely descriptive and more informative of the situations in which, or methods by which, the Government may have acquired patent rights than a mere reference to Section IX. Also Section IX does not begin to cover the situation.

PATENTS SUBCOMMITTEE

BY: George W. Seevers (Navy)

Jos. A. Hill, Capt. (Army)

Frank D. O'Connell (Air Force)

Ray M. Harris, Chairman (OSD)

Attachments - 2
1. Tab A - Prop. Revs.
2. Tab B - Prop. Revs.

TAB A

16 Sept. 1953

ASPR COMMITTEE

PATENTS SUBCOMMITTEE

Case 53-44

Proposed Revision of Section XV - Contract Cost Principles

Proposed Revision of Proposed Paragraphs 15-313.11(c) and 15-313.12

(COMPOSITE DRAFT)

15-313.11

~~(c) At the option of the procuring agency, cost allowances for research and development work may be made contingent upon the contractor agreeing to waive any royalty charges, under all patents previously obtained or which may be obtained in the future from such work, to the extent such royalties are applicable to defense work, either directly or indirectly.~~

(c) See paragraph 9-107 for instructions and an appropriate contract clause securing to the Government patent rights when there is allowed a cost, either direct or indirect, for product research or improvement or for general research.

15-313.12 Patents and Royalties.

(a) Amortization of the cost of purchased patents owned by a contractor applicable to products or processes covered by a contract is an allowable element of cost to the extent reasonably allocable to the contract. Research and development costs leading to patents are treated in paragraph 15-313.11.

(b) Royalty costs are allowable if bona fide and reasonable. Special care should be exercised in determining reasonableness of royalties in cases in which amounts were arrived at as a result of

CHANGE W

less than arm's length bargaining. Royalty costs ~~may not be bona fide under~~ should be reviewed for bona fides or reasonableness in the following ~~circumstances~~ situations:

(i) Royalties are paid to persons, including corporations, affiliated with the contractor.

(ii) Royalties are paid to unaffiliated persons, including corporations, upon patents formerly owned by the contractor when the costs of such patents or the research and development work thereon were substantially recovered through charges against the costs of defense business.

CHANGE X

(iii) Royalties are paid to unaffiliated persons, including corporations, under an agreement entered into in contemplation that a Government contract would be awarded.

(iv) Royalties are paid under an agreement entered into after the award of the contract without the approval of the contracting officer.

CHANGE Y

~~In either case (i) or (ii) royalties will be limited to such charges as might be determined if the patent were owned by the contractor in accordance with the provisions of this paragraph and paragraph 15-313.11 relative to research and development.~~

(c) Care should be exercised in preventing charges for the use of patents when the Government, in fact, already has rights to such patents.

CHANGE Z ~~(See Section IX, ASPR)~~ The Government may have obtained a royalty free license or title to patents as a result of contract clauses such as contained in paragraphs 9-107 or 9-112 [9-112 is renumbered 9-108 in the Second Proposed Revision of Section IX] as a result of settlement of claims, as a result of the employer's right in employees' inventions provided under E. O. 10096, as a result of a royalty adjustment settlement, or as a result of separate purchase or gift.

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

24 July 1953

Case 53-44

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Proposed Revision of Section XV

1. This Subcommittee is presently considering the basic concepts of Part 3 of subject Revision.

2. In reviewing paragraph 15-313.15 entitled Taxes, this Subcommittee took the position that questions concerning what taxes should be included in contract estimates and reimbursements are primarily technical questions of policy and law which do not fall within the departmental responsibilities of the Subcommittee members.

3. In view of the above, it is unanimously recommended that paragraph 15-313.15 be referred to the Tax Subcommittee for accelerated consideration of the basic concepts which should be included in the proposal for coordination purposes.

H. H. GALLUP
Chairman
Section XV Subcommittee

RESTRICTED

24 July 1953

PROPOSED REVISION

OF

SECTION XV

CONTRACT COST PRINCIPLES AND STANDARDS

15-000 Scope of Section. This section sets forth, in general, principles and standards for (i) the determination of costs under contracts with a Department, and subcontracts thereunder, which provide for the determination of the historical (actual) cost of performance thereof and (ii) the preparation of estimates of cost used in the negotiation or administration of contracts with a Department, and of subcontracts thereunder subject to the review or approval of a Department.

15-001 Effective Date of Section. This Section shall be complied with on and after , 1953, although compliance is authorized from the date of its issuance.

PART I - INTRODUCTION

15-100 Scope of Part. This part sets forth instructions concerning the use of the contract cost principles and standards.

15-101 Applicability. The cost principles and standards set forth in Part 2 of this section, as implemented by Part 3, Part 4, Part 5, or Part 6 of this section (whichever implementing part is applicable) shall be followed in the preparation of all cost data used in the negotiation and administration of contracts with a Department and of subcontracts thereunder which are subject to the approval or review of a Department. In addition, and subject to the requirements of paragraph 15-104, these cost principles and standards shall be followed in determining cost under any contract with a Department, and any subcontract thereunder, which provides for the determination of the historical (actual) cost of performance thereof. Except as otherwise specifically provided, the same cost principles and standards of this section apply to the preparation of cost estimates as to the determination of historical (actual) costs. Nothing contained in this section shall be construed (i) as prohibiting the absorption by the Contractor of all or any portion of any element of cost or (ii) as requiring the allowance in the negotiation of contract prices all historical (actual) costs determined thereunder.

15-102 Use of Cost Estimates. In general, cost estimates shall be used in negotiating contracts, and modifications thereto affecting the contract consideration, unless other adequate valid pricing criteria exist. Though not necessarily adequate in any given situation, examples of such valid pricing criteria are:

RESTRICTED

1 July 1953

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Revision of Section XV - Case 53-44

1. In accordance with item 19 of the minutes of the ASPR Committee meeting of 9 June 1953, this Subcommittee proceeded on an accelerated basis to consider Parts 1 and 2 of the Deputy Comptroller's proposal.

2. The Subcommittee's initial consideration of Parts 1 and 2 has been completed and attached is a Second Draft of these Parts. Agreement was reached with representatives of the Accounting Policy Division (OSD) except for the below listed additional changes which are unanimously recommended by the Subcommittee:

a. Delete paragraph 15-102. The explanatory material in this paragraph is more appropriate for inclusion in a preface, news release or some other media of publication. It is recognized that this paragraph may have some value for industrial coordination and if left in for this purpose, should be deleted prior to publication.

b. Revise paragraph 15-105. Revised paragraph should define which paragraphs of Parts I and II (in addition to subsequent parts) are appropriate for inclusion in contracts as "cost principles and standards." As an initial consideration, it would appear that all of Part I and paragraphs 203, 204, 205, 207, 208, 209, 212 and 213.1 are not appropriate for inclusion in specific contracts. This recommendation can be best accomplished by segregating into different Parts the paragraph to be incorporated in the contract and those of an administrative and informative nature.

c. Delete paragraphs 15-202(c) and 15-208. These references to the Internal Revenue Code should be eliminated since (i) the code was not designed for the determination of costs under contracts, (ii) the code is subject to constant change by laws, regulations, and court decisions, and (iii) military contract negotiation and administration personnel are not trained in the intricacies of the Internal Revenue Code.

d. The last sentence of 15-203.3 and the second and third sentences of 15-204 concern selection of contract type and belong more appropriately in ASPR Section III. However, pending coverage of these subjects in Section III, there appears to be some justification for their inclusion here.

e. Delete paragraph 15-207. This paragraph relates to profit policies and the ASPR Committee has appointed a Subcommittee to undertake the formulation of policies in this area. This paragraph has been revised for the benefit of that Subcommittee and it is recommended for referral thereto. Upon the adoption of a DOD policy, cross-reference thereto in this Section is recommended.

3. The Subcommittee did not consider that its assignment included coordination responsibility with other elements of the military departments. Attention is invited to the fact that the adoption of this Section would require the simultaneous adoption of a change in Section VIII. It is also recognized that editing is essential prior to publication.

4. Consideration of Part 3 of the proposal is being continued on a three meeting a week schedule and a final report will be submitted when the project is completed.

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Howard Wright
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RESTRICTED

Second Draft
1 July 1953

PROPOSED REVISION

OF

SECTION XV

CONTRACT COST PRINCIPLES AND STANDARDS

15-000 Scope of Section. This section sets forth, in general, principles and standards to be applied uniformly (except as expressly qualified) in the determination of historical costs, the preparation and presentation of cost estimates by contractors, and the review, from a cost standpoint, of contractors' pricing proposals of those prime contracts and subcontracts which are subject to negotiation, approval or review within the Department of Defense as indicated in 15-103 and 15-104.

15-001 Effective Date of Section. This section shall be complied with on and after , 1953, although compliance is authorized from the date of its issuance.

PART 1 - APPLICABILITY AND PURPOSE

15-101 Applicability. These cost principles and standards are applicable wherever cost data are to be considered in the negotiation and administration of contracts. In connection with cost-type contracts, estimates of cost will be developed and evaluated and cost reimbursements to the contractor will be determined through the application of these cost principles and standards. Where price is to be negotiated, cost is but one of several factors to be considered in such negotiation. However, where cost data are used in negotiation, as required by this Section, such cost data will be developed and evaluated in accordance with the principles and standards contained herein.

15-102 Reasons for Issuance of This Statement. Defense procurement is a matter of great public interest. It is important that it be conducted on a plane that assures the Congress and the taxpaying public that defense materiel is being obtained at fair and reasonable prices without waste and extravagance. It is also important to assure defense manufacturers (especially competitors), of fair and equitable treatment, without discrimination, in contract pricing. A vast amount of defense materiel is obtained, especially in periods of emergency, under conditions where prices cannot be established simply by competitive bidding.

The nature of the inherent risks in defense production, especially in the time-length of contract performance, and the frequent absence of complete product specifications, result in the use of various forms of contracts in which prices are determined to a greater-or-lesser degree by the use of cost data — both estimated and actual. The gathering, analysis, and use of cost data are complex problems, both for contractors and Government negotiators, as well as industrial and Government accountants and auditors who are more skilled in such matters. Cost problems are serious and diverse, both with respect to more basic business practices and to application of appropriate accounting principles. An adequate statement of cost principles and standards is necessary in order to avoid misunderstanding as well as confusion, delay, and expense in contract negotiation and administration, including auditing and settlement of contracts. Every defense contractor, therefore, should recognize the necessity of the adoption of these principles and standards in the common good — not merely for cost-reimbursement-type contracts, but also for other special types of contracts the use of which has greatly increased.

15-103 Use of Cost Estimates. The proper use of cost estimates requires the exercise of judgment and discrimination. It is impractical to lay down hard and fast rules which would be completely comprehensive in this area. In general, cost estimates shall be obtained from contractors in all cases except where other valid and adequate pricing criteria exist or the estimates would not materially assist the Contracting Officer in negotiating prices.

(a) Examples of valid, but not necessarily adequate in a particular case, pricing criteria to be considered for the purpose of determining whether cost estimates will be of material assistance include, but are not limited to, the following:

(1) Competitive price proposals.
(2) Published market prices.
(3) Catalog prices, including discounts.
(4) Previous procurement experience on the same or similar items, with computed adjustments of the prices paid where appropriate to make allowance for changes in specification or quantities, or changes in labor, material and other cost indices.

(b) Examples of situations where cost estimates are ordinarily required are as follows:

(1) Under outright fixed-price contracts when there is an absence of competition, prior experience or other valid pricing criteria.

(2) Under fixed-price contracts containing price-redetermination provisions:

a. Negotiation of tentative initial prices.

b. Negotiation of firm prices on a forward basis.
c. In combination with historical costs to arrive at firm prices for retroactive and prospective application. both

(3) Under incentive-type contracts:

a. Negotiation of tentative target costs when firm targets cannot be initially determined.
b. Negotiation of firm target prices and target costs, including those cases where the targets are set during the course of the contract.

(4) Under cost-reimbursement-type contracts:

a. Initial estimates as a basis for establishing fixed fees.
b. Negotiation of fixed overhead rates.

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

a. Contract price ceilings.
b. Contract changes affecting the contract consideration.

15-104 Use of Historical (Actual) Cost. Historical (actual) cost shall be used for the following purposes:

(a) Under cost-reimbursement-type contracts:

(1) Determination of allowable cost.
(2) In combination with cost estimate to negotiate fixed overhead rates (where the contract provides for use of such rates)

(b) Under fixed-price contracts with retroactive price-redetermination; negotiation of retroactive fixed-prices.

(c) Under incentive-type contracts: determination of final prices after contract completion.

(d) Under contracts terminated for the convenience of the Government: as required by Section VIII hereof.

In addition to the above listing of purposes for which use of historical cost is mandatory, such cost data may be useful in other circumstances and should be applied where appropriate.

15-105 Contract Provisions. The principles and standards contained in this section shall be included directly or by reference in every cost-type contract to provide the basis for reimbursement to the contractor of costs incurred. Where a fixed-price-type contract requires or may involve future determinations of historical costs or the preparation of estimates of prospective costs (as specified in paragraphs 15-103 and 15-104) for purposes of negotiating contract prices, these principles and standards must be incorporated directly or by reference in the contract in order that no misunderstanding exist between the contracting parties as to the basis for a preparation and evaluation of cost data — estimated and historical. Inclusion of such contractual provisions in fixed-price-type contracts is solely for the purpose of preparation and evaluation of cost data which are not to be construed as rigid measures of a price to be negotiated. These principles and standards shall be thus made a part of every contract and subcontract whose costs are subject to the evaluation or review by the Department of Defense, or any of its subdivisions, executed as of a date on or after , 1953. Any such contract or subcontract may treat any element of cost thereunder more specifically than provided by this statement of principles and standards so long as there is no inconsistency therein.

15-106 Implementation by the Military Departments. This statement of contract cost principles and standards shall be followed in procurement operations within the Department of Defense without modification or expansion in any way except as to instructions on administrative procedures or as provided in the last sentence of the preceding paragraph. Any expansion of or change in this section, deemed to be desirable, will be referred to the Office of the Secretary of Defense for consideration. Any interpretations of these principles and standards made in the course of negotiation or administration of contracts shall be on a case-by-case basis in the light of the specific facts thereof — no system of written interpretations to be generally followed will be permitted. Administration of these problems is a matter for practical business judgment rather than rigid adherence to established precedents.

15-107 Deviations. The authority to deviate, as provided in paragraph 1-108 of this Regulation, is further restricted in respect to this Section 15, to permit such deviations only on a specific contract basis.

PART 2 - GENERAL PRINCIPLES AND STANDARDS FOR DETERMINATION OF COSTS

15-201 Composition of Total Cost. The ~~composition of~~ Total cost of work performed or to be performed under a contract or subcontract to which these principles are applicable is the net sum of (a) the allowable direct costs reasonably incident to the performance of the contract or subcontract, (b) the properly allocable portion of allowable indirect costs, and (c) less applicable income and other credits. According to the circumstances involved, these costs may be stated either in terms of the aggregate for an entire contract or in terms of individual units of products or services covered by the contract with equal application of these principles and standards.

15-202 Factors Determining Allowability of Costs. Factors to be considered in determining the allowability of costs include (a) conformity with the meaning of total cost outlined in paragraph 15-201; (b) reasonableness in the amounts of particular elements of costs; (c) allowability of the costs as deductions in determining taxable income under the Internal Revenue Code; (d) application of generally accepted accounting principles and practices; (e) avoidance of duplication of allowances for the same price component in both cost and profit; (f) exclusions of specific elements of costs as a matter of public or business policy, as set forth in this section; and (g) exercise of good business judgment in incurrence of the cost.

15-203 Actual and Estimated Costs. Costs used in negotiating contracts, or in making settlements thereunder, may be either of a historical nature (actual costs) or may be estimates of future costs, in whole or in part, whichever is appropriate for the specific type of contract pricing as indicated in paragraphs 15-103 and 15-104.

15-203.1 Applicability of Cost Principles to Determination of Cost Estimates as Well as Actual Costs. In general, the same cost principles apply to making cost estimates as to determination of actual costs. Therefore, this section will consider the cost principles set forth herein as applicable interchangeably to either cost estimates or actual costs, except as may be indicated specifically to the contrary.

15-203.2 Use of Standard Costs in Cost Estimates. Wherever future cost estimates are required, the use, where economically feasible, of modern standard cost methods should be encouraged, because they provide an excellent means of cost estimating and cost analysis, as well as enable more effective control of actual costs during contract performance. Such methods provide for pricing material costs on the basis of bills of materials, labor costs on the basis of studies of time requirements, and overhead costs on the basis of budgeted expenses for the expected volume and types of production, with reasonable allowances for cost variances indicated by experience to be expected for defective work and failure to achieve full efficiency. Such methods generally provide the assurance

of accuracy of cost estimates, as well as the means of more effective cost control, when variances of actual costs from standards are measured frequently and recorded in the formal accounts.

15-203.3 Use of Standard Costs in Determining Actual Costs. Wherever contract price negotiations or settlements depend upon actual costs, and contractors have satisfactory standard cost systems, standard costs of products, or parts thereof, with appropriate adjustments for variances from actual costs, may be considered to represent actual costs, provided such costs reasonably reflect the application of the principles and standards set forth in this section. Normally, where adequate standard costs are available for complete end-products, fixed-price contracts should be used.

15-203.4 Use of Job-Order or Process Cost-Accounting Method. The use of either the job-order or process cost-accounting method in determining historical costs of contract performance is acceptable. In any pricing negotiations which require consideration of work in process at an intermediate point in the period of contract performance, special care must be exercised in order to segregate any part of the work in process costs which is not applicable to the completed portion to the cut-off point.

15-203.5 Use of Historical Costs for Purposes of Cost Estimating. Regardless of the method used (standard, job-order or process), unmodified historical cost data, when used in the preparation of cost estimates, may not provide a satisfactory standard of future performance; in this event their use would be undesirable. Where no more satisfactory cost data are available, historical costs may be used in the preparation of estimates provided they are adjusted to eliminate nonrecurring costs and to reflect new conditions, if any, which may be applicable to future production.

15-204 Basis of Application of Principles and Standards to Pricing of Standard Commercial Products. Standard commercial products are those which are normally manufactured and sold in large volume to customers who are neither prime contractors nor subcontractors for defense work, notwithstanding the fact that substantial quantities may be sold to defense contractors or the Government with relatively little or no change in specifications. In general, it will be expected that standard commercial products will be purchased under fixed-price contracts, and that prices will be established without primary reference to the respective contractor's costs. The use of escalation clauses generally should take care of major contingencies which should not be added to estimated costs in contract pricing of such products. However, in those instances where cost analyses for standard commercial products are required in firm price negotiations under fixed-price contracts, these principles and standards will be applicable to the extent appropriate. Care must be used in such cases in order not ti impose impractical requirements on contractors for cost estimates — to meet which requirements might result in work entirely disproportionate to the amounts involved. Cost analyses in such cases may sometimes be based upon other data than current cost estimates — for example, when a manufacturer has no cost data for a specific standard commercial product, he may have available for analysis, historical sales,

costs and profit data on a group of products, including the specific one subject to price negotiation.

15-205 Application of Generally Accepted Accounting Principles. It is to be understood that generally accepted accounting principles with respect to product or contract costs are nowhere codified or reduced to rigid formulae. Such principles permit the use of alternative practices or conventions, particularly in different types of business activities; yet in the main there are generally accepted limits in principle regarding accounting practices, the violation of which would not be condoned by the accounting profession. To the extent there is a twilight zone between accepted and non-accepted practices, it is desirable that definite understandings be reached between the contracting parties. This section covers a number of subjects of this nature, so far as they can be covered for general application. Yet inevitably there will be many occasions where specific contractual provisions or supplementary interpretations of the contract terms in the application of cost principles will be needed. (See paragraphs 15-105 and 15-106.)

15-206 Contractor's Accounting System. Subject to the observance of the cost principles set forth in this section, any system of accounts and any method of cost accounting or estimating will be acceptable, if they are in accord with generally accepted accounting principles and practices and if they produce equitable results under the particular circumstances.

15-207 Relation of Contract Costs and Profits. The use of actual or estimated costs in procurement pricing is only one phase of establishing the total price or monetary consideration under a contract. The determination of reasonable profit is another important phase. These two phases of pricing are mutually dependent to the extent that certain factors may be considered in determining either costs or profit (or fee). Major factors to be considered in this respect include prolonged delivery schedules, unstable market conditions for material or labor, or uncertainty as to cost of performance. Depending upon the type of contract, either the contractor or the Government may assume such risks. Where the Government assumes all the risk of cost increases or additional unknown costs, or a substantial share thereof (as it generally does when these risks are great) through the use of cost-reimbursement-type contracts, escalation or price-redetermination clauses, or incentive-type contracts, the profit allowance for contingencies should be reduced to the extent appropriate. In negotiation of prices under outright fixed-price contracts, risks of loss or other cost increases, other than those reasonably certain and determinable, should be recognized in profit margins rather than in allowances for contingent increases in cost. However, no hard and fast line may be drawn here, but it is important that such allowances not be duplicated. For example, a contractor's cost estimates may properly include reasonable estimates of cost applicable to normally experienced defective work in manufacturing processes.

Where reasonably certain and determinable contingencies are recognized in cost estimates, such contingencies should not be considered as elements of risk in determining the allowable profit. There are other factors having a similar bearing on cost and profit determination; for example, in contracting for construction under cost-reimbursement-type contracts, it is customary practice to exclude general, administrative and financial expenses from costs, but to allow instead for these factors as a part of the fixed fee.

15-208 Relation of Contract Cost Principles to Federal Income Taxation. In general, all business costs allowable as deductions for the purpose of determining taxable income under the Internal Revenue Code should be allocated (assigned) to the extent appropriate, to the cost of performance of specific contracts, except as otherwise set forth in this statement of principles and standards.

15-209 Special Provisions Relating to Cost Determinations, Including Limitations. Because of the need for standards of reasonableness in determining either estimated or actual costs of performance of specific contracts, including the application of business and public policies, a considerable portion of this Section, namely Part 3, is devoted to standards of allowability of specific elements of costs under supply and research contracts with commercial organizations. Moreover, because of unusual accounting practices or problems involved in determining costs under facilities contracts, construction contracts and research and development contracts with non-profit institutions, Parts 4, 5, and 6 respectively, are devoted thereto.

15-210 Direct vs. Indirect Costs. Every acceptable method of cost accounting or estimating embodies the principle of direct costing of certain materials and subcontract work. Direct costing of productive labor is general practice. Other expenses may be costed directly sometimes, but generally many of them are allocated to products, job orders, or contracts, etc. on an arithmetical basis in ratio to appropriate measures of performance -- for this reason, such allocated expenses are termed "indirect costs."

15-211 Principle of Direct Costing. Every major item of cost (actual or estimated) should be identified with the unit being costed, whether it be the product, a job order, or a contract, when such items of cost do not, in fact, have substantially proportionate applicability to more than one class of work. This principle may often be applicable to such elements of expense (when of major consequence), as travel, commissions, advertising, engineering services, etc., as well as the normal items of materials and productive labor. This principle should be applied equally to the costing of both defense and nondefense products or services by any contractor who is engaged in mixed production. There are no absolute rules by which to determine which items or elements of cost should be direct costed. In applying the principle, any contractor must follow a consistent pattern of costing if the results are to be equitable. In some instances, this principle may be applied by direct costing only the major items of a given cost element to all products, leaving minor items, if appropriate, subject to indirect cost allocations.

15-212 Indirect Costs. Indirect costs, which have the character of common or joint costs, usually consist of indirect materials, indirect labor, and other items. These costs generally are grouped in classes, as follows:

(a) Manufacturing (shop, laboratory) expenses (often termed "manufacturing overhead" or "burden"), which are incurred in fabricating the article or service rendered;

(b) Engineering expenses to extent not included in (a) or (c);

(c) Selling and distribution expenses, incurred in marketing the products manufactured;

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

(e) Financial and other expenses.

15-213 Methods of Allocation of Indirect Costs. No general rules regarding allocation of indirect costs to products, job orders, or contracts can be stated for all individual cases, because the nature of the particular operations and the actual conditions in each instance determine the most suitable method or methods to be employed. Any method of allocation of indirect costs will be acceptable if it is in accord with generally accepted accounting principles and practices and if it produces equitable results under the particular circumstances. ~~The best general test which may be applied to determine an appropriate method is to find the answer to the question: Does the method result in an allocation of the indirect costs to the products, job orders, or contracts, most equitably in relation to the machine or other work being performed on each?~~

15-213.1 Use of Predetermined Rates for Indirect Expenses (Overhead Costs).

(a) Indirect expenses must always be predicted for purposes of cost estimates. This involves determination by the contractor of expense rates in accordance with whatever method or methods of expense allocation are followed. In accordance with the aim of encouraging the use of standard costs (paragraph 15-203.2), contractors should be encouraged to use accepted standard cost methods of budgeting based upon distinguishing between fixed and variable expenses and upon estimating variable expenses by cost centers in proportion to anticipated levels of production or work loads; such budgets provide the best means for estimating expense rates. Historical indirect expenses, or expense rates, should not be used indiscriminately as the equivalent of budgeted rates for this purpose without adjustment for nonrecurring expenses and adjustment of the portion of the rates representing fixed expenses when substantial changes in production or work loads are expected.

(b) The use of a fixed indirect expense rate negotiated prior to the expiration of a significant portion of the period to which such rate applies in lieu of the determination of historical indirect expense is acceptable where mutually agreeable to the contracting parties provided there is reasonable assurance that the results would be equitable when compared with actual rates. Consideration of cost elements in negotiating such rates must be consistent with the provisions of this Section concerning cost allowability and allocability. When predetermined expense rates are used the contract should specifically state the types of items which are to be treated as direct costs. The contractor must exclude from direct costs any cost element included in predetermined expense rates in order to avoid duplicate charges.

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

Supply and Logistics
PP

Case 53-44

8 March 1954

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

FROM: Director of Procurement & Production Policies

SUBJECT: Agreement Reached by Panel of Department of Defense and Service Representatives in Mr. McNeil's Office, 1600 - 1700, 1 March 1954

1. The memorandum submitted by Mr. Webster was accepted in principle. These principles are as follows:

a. There will be included in the revision of Section XV, relating to cost-type contracts, a definite statement that the instructions covering "cost principles" for use in connection with cost-type contracts are not applicable to fixed-price type contracts.

b. In connection with fixed-price contracting, including redeterminable prices or incentive prices, the analysis and interpretation of costs shall avoid the use of such terms as "allowable" and "unallowable".

c. Any instructions to negotiators as to how to deal with cost data or as to the considerations to be examined in connection with negotiating fixed prices should not be in a publication which is available to contractors.

d. There should be furnished to industry guidance as to reporting of costs.

2. In addition, the following principle was agreed to:

a. Under fixed-price contracts, auditors perform a service function, which is primarily to explain the nature and content of the various elements of cost submitted by the contractor.

3. It was agreed to proceed as follows:

a. The ASPR sub-committee will expedite revision of Section XV for submission to the ASPR Committee. The revision will pertain solely to cost-type contracts and will substantially expand the cost interpretations.

(Enclosure No. 1)

b. The Office of the Assistant Secretary of Defense (Comptroller) will prepare a document relating to the reporting and analysis of costs on fixed-price type contracts. Decision as to whether this document will be incorporated in an Audit Manual or in ASPR as a new Section or a sub-division of Section XV will be postponed until the various projects mentioned above are completed.

c. The cost principles in draft documents heretofore prepared by Mr. Bordner and by the ASPR sub-committee will be reviewed in the above drafting.

d. This work to be undertaken concurrently with a sufficient interchange of ideas to incorporate all basic principles.

e. The above drafts will be submitted to the panel of Department of Defense and Service representatives for review and for the following decisions:

(1) Will ASPR include a Section or Sub-section on the reporting of cost data for fixed-price type contracts or will this material be included in a revised Audit Manual?

(2) Action to be taken on Joint Letter #12?

(3) What vehicle is to be used to furnish information to contractors?

F. W. HESSER
Rear Admiral SC USN
FOR

WARREN WEBSTER, JR.
Director of Procurement
and Production Policies

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

Supply and Logistics

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44 - Issues Raised in Section XV
Part I - Should costs of profit sharing plans be allowable to a limited extent as an item of contract costs?
Part II - Should costs of stock bonus plans be allowable?
Part III - Should costs of independent research and development be allowable?

Part I

1. Issue. Should costs of profit sharing plans be allowable to a limited extent as an item of contract costs?

2. Background. The Section XV Subcommittee, in considering the subject question, has been unable to reach complete agreement and presents the question to the ASPR Committee for a determination and statement of basic Department of Defense policy. Upon receipt of such a statement of policy the Subcommittee will prepare appropriate implementation.

This question has previously been submitted to the ASPR Committee but was not ruled upon. It was the ASPR Committee's opinion that comments from Technical Services, Bureaus, etc., might give sufficient guidance for a determination, but such has not been the case. In fact, the comments have been as sharply divided as the opinions of the Subcommittee members and, consequentl the question is again submitted to the ASPR Committee.

3. Employee Benefit Plans. The major types of employee benefit plans may be summarized as follows:

a. Pension Plans.

b. Deferred-Distribution Profit Sharing Plans.

c. Immediate Distribution Profit Sharing Plans.

4. Pension Plans. A recognized definition of a pension plan is contained in Internal Revenue Service Regulation 118, Section 39.165-1(a)(2) as follows:

"A pension plan within the meaning of Section 165(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Retirement 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 retirement 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 service, 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 will, for the purpose of Section 165(a), be considered a pension plan if under the plan either the benefits payable to the employee or the required contributions by the employer can be determined actuarially".

Under existing ASPR 15-601 contractors cost for this type of plan are allowable. The Subcommittee unanimously agrees that revision of Section XV should authorize the continuance of such allowability.

5. Deferred Distribution Profit Sharing Plan.

a. Definition and discussion. Also taken from Internal Revenue Service Regulation 118, Section 39.165-1(a)(2), immediately following the above, is the definition of a "profit-sharing plan":

"A profit-sharing plan is a plan established and maintained by an employer to provide for the participation in his profits, by his employees or their beneficiaries, based on a definite predetermined formula for determining the profits to be shared and a definite predetermined formula for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior concurrence of some event such as illness, disability, retirement, death, or severance of employment. A formula for determining the profits to be shared is definite, for example, if it provides for a contribution equal to (i) a specified percentage of the annual profits, (ii) a specified percentage of the annual profits in excess of the sum of dividend commitments plus a fixed amount with an overall limitation, or (iii) a specified percentage of the annual profits not to exceed a specified percentage of the salaries of the participants or their contributions, if any, to the fund. A formula for distributing the accumulated funds among the participants is definite, for example, if it provides for a distribution in proportion to the basic compensation for each participant."

Under a deferred distribution profit sharing plan approved by Internal Revenue Service, the employer may deduct such contributions from his taxable income and the employee pays income tax in the year in which benefits are actually received. The contributions, although prohibited from being actuarially determined, are under a fixed formula and payments are made to the

employees on the happening of specified events. A plan under which the employer has discretion in determining the amounts to be distributed will not be approved by Internal Revenue Service.

The income tax law limits the deductable contributions by the contractor to 15% of the compensation of the participating employees. When an employer has credit carry-overs representing unpaid contributions, he may, in some circumstances, deduct for tax purposes for the particular year up to 30% of the compensation of participants.

ASPR 15-601.2(f) provides that for plans based on profits and approved by Internal Revenue Service, the amount allowable for apportionment to contracts in any one year shall be the amount contributed to the trust(s) for that year, but not to exceed 15% of the total compensation otherwise paid or accrued in that year to the individuals covered under the plan.

b. Position for Allowance. Certain Subcommittee members believe that such costs should be allowable within the limits hereinafter mentioned.

1. Unlike a formal pension plan which provides for fixed contributions year-in and year-out, profits or no profits, a profit-sharing plan provides for contributions when a company's earnings, if any, warrant such contributions. The plans providing for these contributions are subject to review and approval by the Internal Revenue Service prior to acceptance by the Military Departments, and are hedged with restrictions and limitations. The contributions under such plans must be:

(i) Paid into a trust

(ii) Irrevocable

(iii) Subject to qualifications and limitations of the agreement and the plans setting up the trust

(iv) For the exclusive benefit of the employees and of their beneficiaries

(v) For the purpose of providing retirement income to their employees at a stated age, or at death or after termination of services or disability.

2. An issue here resolves itself around the term "profit-sharing". The proponents are of the view that although this is a part of the terminology used, the fact remains that the contributions under profit sharing plans are part of employee compensation similar to other fringe benefits. Almost 30% of the approximately 365 plans in the category of pension and profit-sharing retirement plans submitted to the Internal Revenue Service for the fiscal year ended 30 June 1953 were of a profit-sharing nature and the percentage has been steadily increasing. Not to recognize the fact that profit-sharing is becoming an integral part of industrial operations is to overlook an important phase of industrial costs of operations.

3. A contribution made pursuant to a profit-sharing plan is one which is measured or determined by the amount of a contractor's earnings. It is true that if there are no earnings, no contributions are made. However, deferred benefits inuring to employees under a profit-sharing plan are considered additional compensation and similar in principle to piece-rate compensation and bonuses paid to production workers.

4. It should be pointed out that the contributions are irrevocably made to a trust fund and employees participate in the benefits only in accordanc with the provisions of the plan. One of the several requirements (all of which must be satisfied prior to approval of a plan by the Internal Revenue Service)

is that the sole purpose of the trust is to provide benefits for the employees and their beneficiaries and that no part of the trust can revert to the employer.

5. A contribution under a profit-sharing plan constitutes additional compensation for personal services rendered by the covered employees and if reasonable in amount represents a necessary and ordinary business expense for tax purposes.

6. To the extent that a contractor provides for reasonable fringe benefits, such as retirement, by one method or another, whether as a cost before determination of profits (as in the case of contributions under a pension trust) or after determination of profits appears to be immaterial provided the cost is reasonable and is in accord with the concept of a cost of doing business and other factors to be considered in determining allowability of costs. The mechanics of the method of computing the cost should not be the controlling criteria as to its allowability. The broader question to be considered is whether it is a necessary and ordinary business expense, which from a competitive standpoint other contractors provide for by different methods and yardsticks.

c. Position for Disallowance. See paragraph 7.

6. Immediate-Distribution Profit Sharing Plan.

a. Definition. This type of employee benefit plan provides compensation additional to take home pay as a reward for better than average performance as measured by profits of the contractor. The plan is thus essentially a bonus plan dependent upon profits and the participating employees receive current benefits.

The coverage and extent of employee participation under the plan may be determined by a formal agreement between the employer and employee or may be entirely at the discretion of the employer.

On this type of plan the employee is subject to personal income tax and the employer's contributions are deductible from taxable income if the Internal Revenue Service Regulation as to reasonableness of total employee compensation is met.

b. Position for Allowance. Employer contribution to immediate distribution of profit sharing plan should be allowable cost if such contributions meet the following tests:

(1) Paid pursuant to an arms length agreement between the contractor and the employees before the services are rendered or pursuant to an established plan consistently followed by the contractor which constitutes, in effect, an implicit agreement on the part of the contractor.

(2) Reasonable in Amount. For the purpose of determination of reasonableness the employer contribution shall not exceed 15% of the total basic compensation paid or approved to the participating employees in that year under consideration.

(3) Paid for services actually rendered by employees.

(4) Available to all employees of the contractor or to all employees within a group or salary classification which is not unreasonably restricted.

(5) Allowable as an ordinary or necessary business expense for tax purposes.

(6) Total employee compensation, including such profit sharing distribution, is reasonable in amount for such services.

7. Position for Disallowance. Certain members believe that distribution of earnings to employees (contributions to profit sharing plans, deferred distribution or immediate distribution) and stock bonuses should not be recog-

nized as allowable costs.

a. The fixed fee negotiated is intended to represent the contractor's entire profit. To accept contributions to profit sharing plans as reimbursable costs is, in effect, giving the contractor an extra profit margin equal in amount to his contribution to the plan. The advantages gained in original negotiation of the fixed fee are thereby nullified.

b. It is reasonable to expect that the compensation and fringe benefits to be reimbursable as costs of Government contracts should be definite and constitute a firm rather than a contingent obligation. One of the reasons for using a Cost-type contract is to eliminate contingency factors from the price.

c. To encourage or support a type of retirement plan or compensation which is contingent upon a realization of sufficient profits to make a contribution to the plan does not appear to be a sound policy since the Government would be relieving some contractors of risks which others are willing to assume.

d. In a profit sharing plan the contractor purports to be sharing his profits with its employees. In actual practice under firm price commitments, the contractor would be sharing its earnings. However, when profit distributions are treated as costs in determining the final price, the contractor does not give up any profits. Furthermore, to the extent that profits under firm price commitments are higher than profits under cost type contracts, the contractor may in fact receive additional profits not anticipated in the negotiation of the fixed fee.

e. Payment by the Government to cover profits distributed to employees would constitute additional profit for distribution at the discretion of the board of directors.

f. Profits do not vary directly with individual human effort of the

rank and file worker. Appearing before the Senate investigating committee, H. Bordman Spalding, then Chairman of the Government Finance Committee of the National Association of Manufacturers, stated his belief in profit sharing for executives only: "I have a great deal of doubt and a great deal of reservation in regard to carrying it much below the executive and junior executive position in any company."[1/] Explaining that executives constitute a smaller group, easier to educate, more quickly stimulated by profit participation opportunities. James Gorton and his associates in an early study of profit sharing declared: "The effectiveness of profit sharing as an instrument for profit making is greatest among high officers and among small groups."[2/] C. Canby Balderston, Dean of the University of Pennsylvanis's Wharton School of Finance and Commerce, addressing a conference of the American Management Association, stated: "Applied to wage earners, profit sharing does not appear to induce greater output, quality or reduction of waste."[3/] The following are basic weaknesses in profit sharing as an incentive:

(1) The payment of the bonus is dependent on profits, which are often influenced by factors that cannot be controlled by employees in general. This may result in a poor profit and no bonus in a year when workers have done a good job or a good profit and bonus in a year when the converse is true.

(2) The bonus is usually paid annually, and this postponement of the payment of the rewards until the end of the year weakens its incentive value.[4/]

1./ "The Senate Looks at Profit Sharing", Congressional Digest, Jan.1939, p.30

2./ James Gorton and others, Profit Sharing and Stock Ownership for Employees, p. 200.

3./ C. Canby Balderston, "Administration of Supplementary Compensation Plan", Address, Conference on Personnel, American Management Association, Feb.17, 1948, A.M.A. Press Release, p. 1.

4./ L.P. Alford and H.Russell Beatty, Principles of Industrial Management,1951, p. 680.

g. With regard to stock bonus plans, it is felt that a stock bonus plan by itself does not actually and truly represent an incurred cost but usually results in a redistribution of the equity of all prior shareholders. The cost of this distribution of ownership is not a cost of production and therefore should not be allowed. There is no objection to employees obtaining a proprietary interest in the company, but let such interest take place by voluntary contributions on the part of the employees out of reasonable compensation paid, with arrangements for payroll deductions if more convenient.

Part II

Closely related to employee benefit plans outlined in Part I of this report is the question of allowability of cost of stock bonus plans.

The proponents for the allowability of the cost of stock bonus plans feel in general that the same principles govern as those applicable to the recognition of profit sharing plans. The position for disallowance is as stated in Paragraph 7 of Part I.

Part III

1. Issues. The Section XV Subcommittee due principally to the factors set forth in paragraph 4 below is unable to agree as to what extent if any costs of research and development should be allowable. The Subcommittee therefore seeks policy guidance from the ASPR Committee. In the event such costs should be allowable, then further instructions are requested on the extent of such allowance.

2. Present Section XV. ASPR 15-204(s) provides the following is allowable:

"Research and development specifically applicable to the supplies or services covered by the contract."

ASPR 15-205(j) provides the following is unallowable:

"General research, unless specifically provided for elsewhere in the contract."

ASPR 15-502(m) provides the following may require special consideration:

"Research programs of a general nature".

3. Definitions. In the proposed revision of Section XV, the following definitions have been agreed upon.

a. General research (also referred to as basic, fundamental, pure and blue-sky) is that research in which the motive is the increase in knowledge or the advancement of the arts or sciences, with no direction of its applicability to any product or product line. The cost of performance of this type of research is supported either by the contractor (independent general research) or is reimbursed by contract or grant (sponsored general research).

b. Related research and development (also referred to as applied, product and product line) is all research other than that included in (a) above. Generally, it consists of the application of known scientific principles, formulas or characteristics in the research for or the development of a product, or a product line. The cost of performance of this type of research is supported either by the contractor (independent related research) or is reimbursed by contract or grant (sponsored related research).

4. National Policy Re: General Research. The President in a press release dated 17 March 1954 stated that the 1955 F. Y. Budget included two billion dollars for R&D. He added, "This rapid expansion of Federal responsibility requires prudent administration.", and "I believe strongly that this Nation must extend its support of research in basic science." On the same date Executive Order 10521 was issued conferring certain duties upon the National Science Foundation. This Executive Order provides in part, "As now or hereafter

authorized or permitted by law, the Foundation shall be increasingly responsible for providing support by the Federal Government for general-purpose basic research through contracts and grants. The conduct and support by other Federal agencies of basic research in areas which are closely related to their missions is recognized as important and desirable, especially in response to current national needs, and shall continue."

5. It is the opinion of some members of the Subcommittee that a strict interpretation of the Executive Order and the expressions of the President in the press release provides that (i) the National Science Foundation has the sole responsibility for the sup ort of general research and (ii) the Defense Department should not contribute thru overhead allocations toward the cost of a Contractor's independent general research. Other members of the Committee are of the opinion that such an interpretation is too restrictive. It is their opinion that in the interest of National Defense the Defense Department must give financial support thru overhead allocations to a Contractor's independent research, both general and related.

The above raises several fundamental questions. (a) Is the sole support of independent general research the responsibility of the National Science Foundation? (b) Should Defense give support to independent general research through allocation of overhead? (c) May independent general research be considered as closely related to a defense mission and therefore be supported through overhead allocation?

6. With respect to the problem of independent related research, present Section XV limits reimbursement to such research specifically applicable to the supplies covered by the contract. One of the difficulties in this area is determining whether independent related research is "specifically applicable to the supplies". If the research is applicable and the program is a

good one, would not a R & D contract be more appropriate? Under present ASPR procedure, the Government may indirectly contribute to a contractor's independent related research. If such research is successful and results in an "item useful in National defense", the Government may again pay for the research through future procurement.

7. As a corollary aspect to the foregoing, to what extent if any, should production funds be used to support either general or related research?

H. H. GALLUP
Chairman
Section XV Subcommittee

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

Washington 25, D. C.

Supply & Logistics 17 September 1953

MEMORANDUM FOR THE CHAIRMAN, ASPR COMMITTEE

SUBJECT: Case 53-44 - Revision of Section XV - Contract Cost Principles

I. PROBLEM:

To amend the report of the Patents Subcommittee on the subject material in memorandum dated 16 September 1953, in view of action by the ASPR Committee at its 15 September 1953 meeting, rejecting the Subcommittee's proposal for a paragraph 9-107.6 dealing with the problem of allowance of costs for support of contractors' programs for both product research and improvement and for general research.

II. RECOMMENDATION:

Referring to Tab A to the memorandum dated 16 September 1953, delete proposed revision of paragraph 15-313.11(c) and substitute the following:

> "(c) See paragraph 9-107 for instructions as to patent rights to be obtained when research or development work is called for or required in the performance of a contract or when allowances are made for costs for product research or improvement."

III. DISCUSSION:

1. While the Patents Subcommittee report commenting on subject case is dated 16 September 1953, it had actually been completed and processed for reproduction on 14 September 1953. The report of 16 September 1953 was predicated on acceptance by the ASPR Committee of the proposal for a new paragraph 9-107.6 contained in Tab A to the Subcommittee's report on Case 52-77 - Revision of paragraph 9-107 - Second Proposed Revision of Section IX, contained in memorandum for the Chairman, ASPR Committee, dated 4 September 1953. When the last mentioned report was considered by the ASPR Committee at its meeting of 15 September 1953, paragraph 9-107.6 was rejected. It is therefore

necessary for the Patents Subcommittee to revise its proposal for paragraph 15-313.11(c) in its 16 September 1953 report to conform with the action by the ASPR Committee.

PATENTS SUBCOMMITTEE

BY:

George W. Seevers (Navy)

Jos. A. Hill, Capt. (Army)

Frank D. O'Connell (Air Force)

Ray M. Harris, Chairman (OSD)

are chargeable directly thereto. Major items of cost readily identifiable with the contract or with other work of the contractor should be charged directly thereto. This principle may often be applicable to such elements of expense as freight, travel, communications, engineering services, etc., as well as the normal items of materials and productive labor. However, when the contractor is engaged in mixed production, this principle must be applied consistently to the costing of both defense and non-defense products or services, in order to produce equitable results. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect expenses.

15-202.1 DIRECT MATERIALS. The cost of direct materials includes 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 furnishing such product. Costs of reasonable overruns, spoilage, and defective work may also be included (as to defective work, see paragraph 7-203.5(c)).

15-202.2 DIRECT LABOR. The cost of direct labor includes salaries and wages specifically identifiable with and properly chargeable directly to the performance of contract or other work of the contractor. Average rates may be used where it is demonstrated by the contractor that the results are equitable. Direct labor may also include other associated costs such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.3 OTHER DIRECT COSTS. Where other items of cost are charged directly to the contract consistent with paragraph 15-202 above, the contractor must demonstrate that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of like items applicable to other work of the contractor must be eliminated from indirect costs allocated to the contract.

15-203 INDIRECT COSTS.

(a) Indirect costs are expenses which are incurred for common or joint objectives, are accumulated for accounting purposes by departmental activity or other logical cost grouping and are charged to the contract and other work of the contractor by a process of allocation. Each element thereof is subject to the limitations of this part as to allowability.

(b) No specific rules can be stated as to the method of allocation of indirect costs because the actual condition in each instance must be taken into account in determining the most suitable method or methods. The objective should be the selection of a method or methods which will distribute the indirect costs in a fair and equitable manner. The method used in connection with Government contracts must, in order to be acceptable, conform with generally accepted accounting practices, be applied consistently, and produce equitable results. Any significant change, such as in the nature of the business, extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, or the products being produced, may require reconsideration of the methods previously in use to determine whether they continue to be equitable. Further discussion relative to allocation of the individual categories of indirect costs will be found in the subparagraphs below.

15-203.1 INDIRECT MANUFACTURING AND PRODUCTION EXPENSES. Indirect manufacturing and production expenses consist of costs which are incurred in the productive process as a whole and are not readily subject to treatment as direct costs in accordance with paragraph 15-202. Allocation of indirect manufacturing and production expenses on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable bases, in appropriate circumstances, include direct labor dollars (exclusive of overtime premium), units processed and prime costs of units processed. The contractor may departmentalize or establish cost centers in order to distribute equitably the

indirect costs. The factors to be considered in determining the extent of departmentalization or establishment of cost centers include variety of products, complexity of processes and relative labor and facility requirements for the various products.

15-203.2 INDIRECT ENGINEERING EXPENSES. Indirect engineering expenses include engineering supervision, engineering administrative expense, engineering general supplies, and other related expenses. These expenses arise out of engineering activities which 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 expenses should be allocated to the benefited activities, i.e., contract and other work of the contractor (including independent research projects) on the basis of direct engineering man-hours expended, direct engineering labor dollars (exclusive of overtime premium), or other equitable basis. Direct costs of engineering activities should be charged directly to the benefited activities, i.e., contract and other work of the contractor in accordance with paragraph 15-202.

15-203.3 SELLING AND DISTRIBUTION EXPENSES. The expenses in this group consist of items which represent the cost of marketing the contractor's products and include sales promotion, advertising, distribution costs and other related items. Generally, such expenses are not considered to be allowable as a charge to Government cost-reimbursement type contracts for the reason that marketing, in the ordinary commercial sense, is not necessary for doing business with the Government. However, dependent upon a reasonable demonstration of benefits to Government contracts and subject to the other provisions of this part, there may be an allocation to government work of those expenses in this category which consist of technical, consulting and such other beneficial services (including related supervision and clerical expenses) which are for purposes such as application and adaptation of the

contractor's products rather than pure selling. Such costs should first be allocated between the contractor's commercial line and its Government contracts. The amount allocated to the latter should then be charged to the individual contracts on any equitable basis. Because of the special problems that arise in this area, it is usually desirable for the contractor to identify in its records by means of sub-accounts or otherwise, the items of these expenses considered properly allocable to Government contracts.

15-203.4 GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses consist of costs incurred in the over-all management, supervision and conduct of the business. Any recognized method of allocating general and administrative expense is acceptable provided equitable results are thereby obtained. Some of the factors that should receive consideration in determining whether the results are equitable are (i) the cost pattern of the Government contracts (that is, the percentage of the total cost of the contract, exclusive of general and administrative expenses, represented by each of the several cost components thereof) in relation to the cost pattern for the plant or activity as a whole, and (ii) the ultimate objective of distribution of these expenses in approximate ratio to the general and administrative effort involved in the two categories of work. In addition, consideration should be given to any significant variations of inventories between accounting periods, variations in the ratio of contract inventory levels to all other inventory levels, and other relevant factors including those mentioned in para. 15-203(b).

15-203.5 BASE PERIOD FOR ALLOCATION OF INDIRECT EXPENSES. The base period for allocation of indirect expenses should approximate the period of contract performance or should be representative of that period. The base period should be sufficiently long to avoid inequities in the allocation of costs.

15-204 APPLICATIONS OF BASIC COST PRINCIPLES AND STANDARDS TO SELECTED ITEMS OF COST. This paragraph states, in some detail, applications of the basic cost principles and standards set forth in the preceding paragraphs of this part to certain selected

items of cost. The statements herein apply irrespective of whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost herein is not intended to imply that it is either allowable or unallowable. With respect to those items not specifically covered, as well as all the subparagraphs below, determination as to allowability will be made in the light of the basic principles and standards herein and, where appropriate, the treatment of similar or related items in this Part.

15-204.1 ADVERTISING. Advertising expenses include the costs of advertising media and corollary administrative expenses. Advertising media include magazines, newspapers, radio and television programs, direct mail, trade papers, outdoor advertising, dealer cards and window displays, conventions, and exhibits, free goods and samples, and sales literature.

a. The following advertising costs only are allowable:

(1) 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.

(2) Help wanted advertising, as set forth in paragraph 15-204.32.

15-204.2 BAD DEBTS. Bad debt expenses consist of losses (whether actual or estimated) arising from uncollectible customers' accounts and other claims, and include related collection expenses and related legal expenses. These costs are unallowable.

15-204.3 BIDDING EXPENSE. Bidding expenses are the costs of preparing bid estimates on potential contracts or projects, including the development of engineering and cost data necessary to support the contractor's price proposal or estimated cost of work performance. Bidding expenses of the current accounting period of both successful and unsuccessful bids normally will be treated as indirect expenses and allocated currently to all business of the contractor, in which event no

bidding expenses of past accounting periods will be allocable in the current period to the Government contract. However, the contractor's established practice may be to treat bidding expenses by some other recognized method. Regardless of the method used, the results obtained may be accepted only if found to be reasonable and equitable.

15-204.4 CAFETERIAS, DINING ROOMS, AND OTHER FOOD SERVICES. This class of expenses consists of cost, less revenue, of operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, or other types of services for contractors employees at the contractor's facilities. Profits accruing to the contractor from the operation of these services whether operated by the contractor or by a concessionaire, will be treated as a credit to costs of all production within the contractor's plant in which the services are furnished, except for services from which the profits are 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. Reasonable losses of operation from such services are allowable when it is the policy of the contractor to operate such services at no loss or profit; provided, however, that any gains or losses from these services must be appropriately allocated to all activities benefited including Government contracts. When it is the policy of the contractor to furnish such services at a loss, losses on such operation will not be allowed as a cost, unless authorized by special contract provision.

15-204.5 CIVIL DEFENSE. Civil defense costs are those incurred in the planning for and the protection of life and property against the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by local and state civil defense authorities. Examples of civil defense costs include cost in excess of normal plant protection expenses and may consist of first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions and other approved civil defense measures. Reasonable costs of 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. In the case of capital assets, acquired for civil defense purposes the costs thereof will be depreciated over a reasonable number of years in conformity with generally accepted accounting principles. Except as specifically provided in the contract, contributions to local/civil defense funds or projects not on the contractor's premises are unallowable.

15-204.6 COMPENSATION FOR PERSONAL SERVICES. (To be inserted later on this page and pages 1509, 1510 and 1511).

15-204.7 CONTINGENCIES. This type of charge results from the creation and maintenance of reserves to provide for an event whose occurrence cannot be foretold with certainty as to time, intensity or even an assurance of its happening. These costs are not allowable. (For self-insurance programs see paragraph 15-204.15).

15-204.8 CONTRIBUTIONS AND DONATIONS. 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.

15-204.9 DEPRECIATION.

a. Depreciation as described herein is a charge to current operations intended to distribute the cost of tangible capital assets, less estimated residual value, over their estimated useful life in a systematic and logical manner. It involves a process of allocation, not of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

b. Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, provided the amount thereof is based upon original acquisition cost. Depreciation will be accounted for by consistent application to the asset(s) concerned of any generally accepted accounting principles, including those recognized by Section 167 of the Internal Revenue Code of 1954, and should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation charged in any accounting period may vary with volume of production or use of multishift operations, provided the method

followed is consistent with basic objectives set forth in subparagraph a. above.

c. Charges for depreciation on idle or excess facilities will not be allowed except on such facilities as are reasonably necessary for standby purposes.

d. Unless otherwise provided in the contract, no use charge will be allowed for assets still in use which have been, in accordance with the contractor's consistent accounting practice, fully depreciated on the contractor's books of account.

e. Where the contractor has applied for, received, and accepted a determination of "true depreciation" from an Emergency Facilities Board covering an emergency facility acquired under a certificate of necessity, the amounts so determined for "true depreciation" over the emergency period (5 years) will be recognized in lieu of normal depreciation. After the expiration of the emergency period for the facility concerned where a determination of "true depreciation" has been made, the remaining undepreciated portion of the cost of such facility will be depreciated over its remaining useful life and will be the only amount recognized as allowable cost, subject to paragraph 15-204.12. The contractor may elect to use normal depreciation rather than the "true depreciation" as determined by the Emergency Facilities Board. However, the method chosen after such determination of "true depreciation" must be followed consistently throughout the life of the emergency facility.

15-204.10 EMPLOYEE MORALE, HEALTH AND WELFARE. Included in this category are expenses of health and welfare activities incurred for the improvement of working conditions and the improvement of employer-employee relations, employee morale, and employee performance. Examples of these activities are house publications, health or first-aid clinics, and employee counselling services. These costs are allowable when incurred in accordance with the contractor's established practice or custom in the industry or area and are reasonable and equitably allocated to all classes of work performed in the contractor's plant. Income generated from any of these

activities will be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

15-204.11 ENTERTAINMENT EXPENSE. This item includes the cost of amusement, diversion, social activities and incidental costs relating thereto, such as meals, lodging, rentals, transportation and gratuities. These costs are unallowable.

15-204.12 EXCESS FACILITIES. This item includes the cost of maintaining and housing idle and excess facilities, except those reasonably necessary for standby purposes. These costs are unallowable. The costs of additional plant capacity reserved for defense production shall be the subject of a separate contract.

15-204.13 FINES AND PENALTIES. Included in this item are those costs resulting from violations of, or failure of the contractor to comply with, local, state and Federal laws and regulations. These expenses are not allowable except when incurred as a result of compliance with specific provisions of the contract or instructions in writing from the contracting officer.

15-204.14 FRINGE BENEFITS. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries.

a. The determination as to the allowability of the cost of pension and retirement plans, profit sharing and other bonuses, and severance pay will be in accordance with sub-paragraphs 15-204.26, 15-204.6 and 15-204.37 respectively.

b. The cost of other fringe benefits such as pay for vacations, holidays, sick leave, military leave and employee insurance (but see subparagraph 204.15e) is allowable to the extent required by law, employer-employee agreement, or established policy of the contractor that constitutes, in effect, an implicit agreement on the contractor's part.

15-204.15 INSURANCE AND INDEMNIFICATION.

a. Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative, and

(2) any other insurance for which the contractor seeks reimbursement under the contract. The kinds of insurance ordinarily included in the first category are set out in ASPR 10-501.

b. Costs of Government required insurance are allowable within the limitations as to the extent of coverage and premium rates approved by the Government. Costs of other insurance, except that applicable to Government-owned property, are allowable provided (1) the insurance has been approved by the military department concerned or (2) in the absence of such approval requirement, the types of coverage, extent of coverage, and rates are reasonable under the circumstances. Costs allowed for use and occupancy insurance, however, will in principle be limited so as to exclude coverage of profit, interest, federal income taxes, and any other items of expense unallowable under this part.

c. The costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are not allowable except to the extent that the Government may have required the contractor to carry such insurance.

d. Provision for losses under a self insurance program are allowable provided the program has been approved by the Military Departments concerned. Actual losses sustained under such a self-insurance program are not allowable.

e. The costs of insurance on the lives of officers, partners or proprietors, are not allowable except where such insurance is part of an employee plan which is not unduly restricted.

f. Losses resulting from failure to insure (through self insurance or otherwise) are not allowable unless approved by the Department concerned.

g. Cost of indemnification will be allowable only to the extent expressly provided for in the contract.

15-204.16 INTEREST AND OTHER FINANCIAL EXPENSES. This item includes interest (however represented), bond discount and expenses, and the cost of financing and refinancing operations as well as legal and professional fees paid in connection

with the preparation of a prospectus, cost of preparation and issuance of stock rights and expenses related thereto. (See also 15-204.23). These costs are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in subparagraph 15-204.39.

15-204.17 LABOR RELATIONS. This item covers expenses incurred in maintaining satisfactory relations between the contractor and his employees. It includes the cost of shop stewards, labor management committees, employee publications and other related activities. Costs incurred for these purposes are allowable.

15-204.18 LOSSES ON OTHER CONTRACTS. This item covers any excess of costs over income under any and all other contracts, whether such other contracts are of a supply, research and development or other nature. Costs of this nature are not allowable as a cost of performance of the Government contract.

15-204.19 MAINTENANCE AND REPAIRS.

a. This item includes those costs necessary for the upkeep of property (including Government property unless otherwise provided for) which neither adds to the permanent value of the property nor appreciably prolongs its intended life but keeps it in an efficient operating condition. These costs are allowable. Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation will be allowable only on a depreciation basis. Cost of maintenance and repairs of excess facilities and of idle facilities (other than reasonable standby facilities) are not allowable.

b. Deferred maintenance is defined as maintenance and repairs which for some reason such as abnormal operating conditions or lack of funds, is delayed to a future period. The cost of maintenance and repairs which has been deferred from a period prior to the contract is not allowable unless specifically provided for in the contract. Likewise, the estimated cost of maintenance and repairs normally required but not accomplished during the period of the contract will not be allowed as a cost unless specifically provided for in the contract.

15-204.20 MANUFACTURING AND PRODUCTION ENGINEERING. Manufacturing and production engineering includes the cost of engineering activities in connection with (1) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement and (2) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production. These costs are allowable.

15-204.21 MATERIALS AND SUPPLIES.

a. This item includes the net costs of such items as raw materials, parts, sub-assemblies, components, and manufacturing supplies, whether purchased outside or manufactured by the contractor, and may include such collateral items as inbound transportation and intransit insurance. In computing materials costs consideration will be given to reasonable overruns, spoilage, or defective work (as to defective work, see paragraph 7-203.5(c)). These costs are allowable subject, however, to the provisions of subparagraphs b. through f. below.

b. Costs of materials and supplies shall be suitably adjusted for applicable portions of income and other credits. Such income and other credits include trade discounts, refunds, rebates and allowances, cash discounts available, credits for scrap and salvage and materials returned to vendors. Such discounts, rebates, allowances and credits, may be applied directly to the charges for materials involved or may be apportioned through credits to indirect costs. However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond his control, such lost discounts will be allowed.

c. When materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to the contract.

d. If materials are issued from stock, any generally recognized method of pricing such materials will be acceptable, provided the 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 and the Government may, by contract provision, agree upon the use of a method of pricing based upon the fair value of the materials as of the date of the contract, but not in excess of replacement cost on such date. Such agreement should include identification of the types or kinds of materials involved and should be made at the time the contract is entered into and provided for therein.

e. Reasonable charges arising from difference between periodic physical inventory quantities and related material control records will be included in arriving at the cost of materials, provided that such charges (1) do not include "write-downs" of values, and (2) relate to the period of performance of the contract. All credits arising from differences between periodic physical inventory quantities and related material control records shall be taken into account.

f. Ordinarily sales or transfers of materials, services and supplies between plants, divisions, or organizations, under a common control, shall be stated on the basis of cost to the transferor. 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, provided that the price charged to the contract does not exceed the lower of (1) the transferor's sales price to its most favored customer for the same item in like quantity, or (2) the prices of other suppliers for the same or substantially similar items.

15-204.22 ORGANIZATION EXPENSES. This item consists of expenditures in connection with organization or reorganization of a business. Examples of such costs are incorporation fee, attorneys fee, fees to promoters and organizers and costs of raising capital. These costs are unallowable. (See paragraph 15-204.16).

15-204.23 OTHER BUSINESS EXPENSES. Included in this item are such recurring expenses as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy

solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies and incidental costs of directors and committee meetings. The above and similar costs are allowable when allocated on an equitable basis to all classes of work.

15-204.24 OVERTIME, EXTRA PAY SHIFT AND MULTI-SHIFT PREMIUMS. This item consists of the premium portion of overtime and shift payments to employees. Such premiums on direct labor may be classified as either direct or indirect labor costs, but the amount of overtime premium should be separately identified. When direct labor cost is the base for distribution of overhead, overtime premiums shall not be included therein. Cost of overtime and shift premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government. Cost of overtime and shift premiums for indirect labor is allowable without prior approval, if reasonable, and the cost is allowable on a pro rata basis to commercial as well as government work. See ASPR 12-102 for further information concerning the policy regarding such authorization. The amount of overtime and shift premium cost charged on Government contracts shall be equitable in relation to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant and the factors which necessitate the incurrence of the cost.

15-204.25 PATENT EXPENSES. Included in this item are such expenses as amortization of the cost of purchased patents and all costs leading to the issuance of patents, as well as the cost of infringement investigation and litigation. Amortization of the cost of purchased patents applicable to contract products or processes is allowable. The cost of preparing disclosures and other reports as required by the contract and of preparing assignment and other papers in connection with the filing of a patent application by or for the Government, and any expenses incident to patents incurred upon the written authorization of the contracting officer, are allowable. All other patent expenses and charges for the use of

patents where the Government has a license or the right to free use thereof, are unallowable unless otherwise provided in the contract. The cost of research and development work leading to patents is treated in subparagraph 15-204.34.

15-204.26 PENSION PLANS.

a. A pension plan as used herein is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to his 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 will be considered a pension plan, if, under the plan, either the 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 be subject to paragraph 15-204.6e).

b. Pension plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the Military Department; however, approval of the plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such plan by the Military Department. Consideration of a plan and the method of determination of cost thereof will be the responsibility of the Department to which audit cognizance is assigned and the subsequent action taken by that Department will generally be accepted by the

other Departments. Where pension and retirement plans of non-profit or other tax exempt organizations are not required to be reviewed and approved by the Internal Revenue Service, it will be the responsibility of the Department to which audit cognizance is assigned to give consideration to the acceptability of such plans.

c. The costs of a pension plan approved by the Military Department concerned, to the extent such costs are claimed and deductible for income tax purposes (or are determined to be reasonable in the case of non-profit or tax exempt organizations), are allowable except as otherwise determined unallowable under this paragraph. Such costs may include excess contributions of previous years to the extent such contributions are claimed and allowed for tax purposes in the current taxable period. In cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract cost will be made for contributions disallowed for tax purposes which previously had been allocated to and allowed as contract costs.

d. In determining the net costs allocable to military contracts, consideration will be given to the possibility of future abnormal termination credits or gains and the effect such credits or gains would have upon current costs. These termination credits or gains will arise with respect to individuals for whom current costs are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits purchased or funded by current costs. When such credits or gains are foreseeable and their worth can be evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to the anticipated future credits or gains will be made. Such equitable adjustment can be accomplished either by discounting 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 discount for the abnormal termination credits or gains which are anticipated. However, most often such abnormal credits or gains, if foreseeable at all, are not susceptible of being evaluated at

the time of contracting because neither the timing nor the severity of the termination actions will be known. Under these circumstances, the Government's interest in such abnormal credits or gains will be preserved for retrospective evaluation and accounting. If a contractor has but one or relatively few Government contracts, an appropriate contractual provision may be used to preserve the Government's interest and provide for the retrospective accounting. In other cases, where a contractor is not limited to one or few Government contracts or there is reasonable probability he will receive follow-on contracts, a separate contractual "side" agreement will be negotiated having application to all pension costs allowed under contracts with the particular contractor and provide for an accounting of abnormal credits or gains, as that term is defined in the agreement, arising by reason of a cutback or cessation of Government contract work.

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

15-204.27 PLANT PROTECTION EXPENSES. This item includes the cost of wages, uniforms and equipment of personnel engaged in plant protection, supplies, depreciation on plant protection capital assets, and necessary expenses to comply with military security requirements. These costs are allowable.

15-204.28 PRECONTRACT COSTS. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs will not be allowed unless specifically set forth in the contract and may be limited to a period of time as well as to the type and amount of such costs.

15-204.29 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER.

a. This item includes the cost of professional services rendered by the members of the particular profession separately engaged. These costs generally

are allowable when reasonable in relation to the services rendered and are not contingent upon recovery of the costs from the Government.

b. Factors to be considered (among others) in determining the allowability of costs in a particular case are: (1) past pattern of such costs, particularly in the years prior to the award of Government contracts; (2) the impact of Government contracts on the contractor's business; (3) the nature and scope of managerial services expected of the contractor's own organization; and (4) whether or not the proportion of Government work to the contractor's total business is such as to influence the contractor in favor of incurring the cost, particularly where the services rendered are not of a continuing nature and have little relationship to work under Government contracts. Retainer fees to be allowable must be reasonably supported by evidence of services rendered.

c. The costs of legal, accounting and consulting services and related expenses incurred in connection with organization or reorganization, prosecution of patent infringement litigation (except as provided for in 15-204.25) defense of anti-trust suits, and the prosecution of claims against the Government are unallowable.

15-204.30 PROFITS AND LOSSES ON DISPOSITION OF PLANT, EQUIPMENT OR OTHER CAPITAL ASSETS. Included herein are gains or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments. Profits or losses on sale or exchange of capital assets, including investments, will be excluded in computing contract costs.

15-204.31 RECONVERSION EXPENSES. Reconversion expenses are those incurred in the restoration of the contractor's facilities to approximately 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 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.

15-204.32 RECRUITING EXPENSE. This item includes the costs of "help wanted" advertising and the operating costs of an employment office necessary to secure and maintain an adequate labor force. It further includes the costs of operating an educational and aptitude testing program, travel expenses of employees while engaged in recruiting personnel, and travel expenses of applicants for interviews for prospective employment. These costs are allowable. Where the contractor uses private employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are not allowable.

15-204.33 RENTALS OF PLANT AND EQUIPMENT. (Including sale and leaseback of facilities.) This item includes expenses for (1) use of land, buildings, and equipment or other personal property, and (2) rental expenses under sale and lease-back agreements incurred by contractors through sale of plant facilities to investment organizations (such as insurance companies) or to private investors and concurrently leasing back the same facilities.

a. Rentals of plant and equipment under (1) above are allowable if the rates are reasonable in light of the type, condition and value of the facilities leased, options available and other provisions of the rental agreement.

b. Rentals specified in sale and lease-back agreements under (2) above are allowable only to the extent that such rentals do not exceed normal costs (such as depreciation, taxes, insurance and maintenance expenses) which would have been incurred had the contractor retained legal title to the facilities.

15-204.34 RESEARCH AND DEVELOPMENT. Research and development expenses (sometimes referred to as general engineering expenses) for the purpose of contract costing are divided into two major categories, namely:

a. General research, also referred to as basic research, fundamental research, pure research and blue-sky research.

b. Related research or development, also referred to as applied research, product research and product line research.

(i) General research is that type of research which is directed towards increase of knowledge in science. It is research where the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. The allocable portion of 75% of the allowable costs of a contractor's independent general research (that which is not sponsored by a contract or grant or other arrangement) shall be allowed in all cost type contracts under the following conditions:

(a) The costs are equitably allocated to all work of the contractor other than its independent general and related research.

(b) The contractor agrees to divulge to the Government the purposes and results of such independent general research.

(ii) Related research is that type of research which is directed toward practical application of science, and "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 15-204.20). The costs of a contractor's independent related research and development (that which is not sponsored by a contract or grant or is not otherwise reimbursed to a contractor) may, if allocated on the basis of all production, be allowed as a cost under any cost type production contract if the research is related to the contract product or product line. No portion of such research will be allowable under cost-type research and development contracts.

c. Independent research projects will absorb their appropriate share of the indirect expenses of the department where the research work is performed.

d. Research and development costs, regardless of the nature, which were incurred in accounting periods prior to the award of a particular military contract, (including amounts capitalized and the cost of patents obtained) will not be

allocated to that contract unless allowable as pre-contract costs (Paragraph 15-204.28).

15-204.35 ROYALTY PAYMENTS. This item covers amounts paid or payable for the right to use patents. Where the use of such patent is necessary for the proper performance of the contract and where the Government does not already have a license or other right to use such patents, the royalties are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the contracting officer.

15-204.36 SERVICE AND INSTALLATION EXPENSES. This item includes the costs of servicing the product installation, and training personnel in the use, maintenance and operation of the product. Such costs are allowable.

15-204.37 SEVERANCE PAY. Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated.

The cost of severance pay is allowable only to the extent that, in each case, it is required by (1) law, (2) employer-employee agreements, (3) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (4) the circumstances of the particular employment.

For contract costing purposes severance pay is divided into two categories as follows:

a. Normal Turnover Severance Pay. The cost of severance payments is allowable and must be allocated to all classes of work being performed in the contractor's plant at the time of payment. However, 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.

b. Mass Severance Pay. The cost of abnormal or mass severance pay 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 entire period of employment with the contractor and equitably apportioning such cost to all business of the contractor performed during that period.

A reservation in the final release of claims (See ASPR 7-203.4) may be made in the case of completed cost-reimbursement type contracts when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

15-204.38 SPECIAL TOOLING. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or to the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. The cost of special tooling, when acquired for and its usefulness is limited to government contracts, is allowable and will be charged directly to the government contracts. When such special tooling is acquired it shall be subject to the provisions of the contract clause set forth in ASPR 13-503 entitled, "Government Property".

15-204.39 TAXES. Taxes are charges levied by a government unit. They do not include fines and penalties except as otherwise provided herein.

a. In general, taxes (including state and local income taxes) which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for (1) Federal income and excess profits taxes; (2) taxes in connection with financing, refinancing or refunding operations (see paragraph 15-204.16); (3) taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government; and (4) special assessments on land which represent capital improvements.

b. Taxes otherwise allowable under a. above, but which may be illegally or erroneously assessed may be allowed as a cost of work performed, provided that the contractor, prior to payment of such taxes, (1) promptly requests instructions from the contracting officer concerning such taxes; (2) agrees to comply with such instructions; and (3) if so directed by the contracting officer also agrees to take all necessary action in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refun of such taxes and any interest of penalties thereon. Interest and penalties incurr by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer, shall be allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs.

c. Any refund of taxes, penalties or interest thereon shall be credited to contract costs in the proportion in which contract costs absorbed the costs of taxes, interest or penalties. If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

15-204.40 TRADE, BUSINESS, TECHNICAL AND PROFESSIONAL ACTIVITIES.

a. Memberships. This item includes costs of membership in trade, business, technical and professional organizations and such costs are allowable.

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

c. Meetings and Conferences. Expenses representing the purchase of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such expenses is the dissemination of technical information or the stimulation of production, are allowable.

15-204.41 TRAINING EXPENSES.

a. This item includes the costs of preparing and maintaining a program of instruction designed to increase the over-all effectiveness of employees. Included are the costs of the director of training and staff, training materials and text books when the training program is controlled by the contractor, and tuition, fees, training materials and text books when the training is in educational institutions.

b. Such costs which are limited to on the job training are allowable when properly allocated.

c. Costs of training in educational institutions are not allowable, except to the extent specifically provided in the contract.

15-204.42 TRANSPORTATION EXPENSES. Transportation expenses include the cost of freight, express, cartage and postage relating either to goods purchased, in process, or delivered.

When such costs can readily be identified with the items involved, they may be direct costed or added to the cost of such items. (See paragraph 15-204.21) Where identification with the materials received cannot readily be made, inbound transportation expense may be charged to the appropriate indirect expense accounts, provided the contractor follows a consistent procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as direct charges.

15-204.43 TRAVEL EXPENSES. This includes costs of transportation, lodging, subsistence and incidental expenses incurred by contractor personnel in a travel status while on official company business.

a. Travel expenses incurred in the normal course of over-all administration of the business and applicable to the entire business are allowable when properly allocated.

b. Travel expenses directly attributable to contract performance may be charged to the contract in accordance with the principle of direct costing.

c. Subsistence and lodging including tips or similar incidental expenses may be reimbursed either on an actual or per diem basis. The basis selected should be consistently followed.

d. Entertainment expenses are not allowable.

e. Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the Contracting Officer.

TO: MR. ~~J. D. BLANCHARD~~ Thomas G. Cassidy

Subject: ASPR Case 53-44, Revision of Section XV
Contract Cost Principles

In connection with ASBCA case No. 16445, Appeal of Control Data Corporation, I would like copies of the following documents (in Case 53-44 file).

(a) Subcommittee Memorandum to the ASPR Committee dated November 1, 1955 including attached draft.

(b) Editing Subcommittee Report of March 9, 1956 including attached draft.

(c) American Institute of Accountants letter to Honorable Thomas P. Pike, dated 30 June 1955 including attached memo of Mr. M. E. Peloubet.

(d) Excerpt from Committee ~~meeting~~ minutes of 14 August 1957 which records the Committee closing of ASPR case 53-44.

At your preference the copies can be submitted to me or to the ASBCA (Case No. 16445).

OASD (I&L)
Executive Secretary
Armed Services Pro Reg Comm
Room 3D-780
Pentagon

DEC 3 1954

During the discussion of Revised Section XV, the question was raised as to the effect of the new revenue legislation on depreciation costing. There follows a staff proposal on the subject.

Depreciation Cost Interpretation

15-602 Depreciation.

15-602.1 Effective Date and Applicability. This cost interpretation pertains to paragraph 15-204(d) and applies to payments made for depreciation incurred under all existing and future contracts in which the contractor's taxable year ends after 31 December 1953.

15-602.2 Interpretation. Any of the depreciation methods set forth in and as limited by Section 167 of the Internal Revenue Code of 1954 shall be recognized for contract cost purposes; provided, that depreciation is recorded on that basis in the contractor's books of account.

5-3-44

To Industry → 11 April 1955

PROPOSED REVISION OF
ASPR SECTION XV
CONTRACT COST PRINCIPLES

The following letter and enclosure has been transmitted for comments to ten industrial associations representing a cross-section of Defense contractors.

The Department of Defense has had under development for some time through the Armed Services Procurement Regulation Committee, certain revisions to Section XV of the Regulation applicable to cost-reimbursement type contracts. Drafts of the proposed revision to Part 2 thereof are enclosed for your consideration and comments. Part 1 will contain only introductory rather than substantive material.

In the development of this draft serious effort has been made to amplify the treatment of certain items of cost in the present Section XV, to minimize the need for departmental implementation, and to include more equitable coverage of additional items of cost incurred by contractors. In this revision each item of cost contains a definition, a statement as to the extent of allowability, unallowability, and whether specific provisions must be made in the contract to make the item allowable.

We feel that this proposal has liberalized the treatment accorded certain controversial elements of cost and, in addition, has gone far in defining, delineating, and clarifying cost determinations under the Section in order to promote uniformity and minimize variations in its application. With respect to its application, or mis-application frequently complained of by industry, the recent issuance of Department of Defense Instruction No. 4105.11 specifically cancels an earlier Munitions Board Instruction permitting use of these Cost Principles as a "working guide" by Contracting Officers in the negotiation of prices under fixed price type contracts; this Instruction together with the statement of applicability presently contained in Part 1 of the Section should do much to satisfy the objections of mis-application.

It is requested that your comments or concurrence with respect to this proposed revision be forwarded to this office on or before 23 May 1955.

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 organizations having commercial type accounting systems. However, this part does not apply to contracts for facilities, construction and architect-engineer services related to construction.

15-201 BASIC PRINCIPLES AND STANDARDS.

a. Composition of Total Cost. The total cost of a cost-reimbursement type contract is the net sum of (i) the allowable direct costs, (ii) the properly allocable portion of allowable indirect costs and (iii) applicable income and other credits.

b. Factors Affecting Allowability of Costs. The factors to be considered in determining the allowability of costs include (i) reasonableness, (ii) application of generally accepted accounting principles and practices, (iii) exercise of good business judgment in incurrence of cost, (iv) significant deviations in the established practices of the contractor which substantially increase the contract costs, and (v) any limitations as to types or amounts of cost items set forth in this Part 2 of Section XV or otherwise included in the contract.

c. Credits. The applicable portion of income and other credits, rebates, allowances, and equivalent benefits accruing to the contractor and which are related to any allowed cost will be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

d. 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).

15-202 DIRECT COSTS. Subject to the provisions of paragraph 15-201, allowable direct costs are those items of cost, or aggregate thereof, which can be identified specifically with any objective, service, program or project under the contract and are chargeable directly thereto. Major items of cost readily identifiable with the contract or with other work of the contractor should be charged directly thereto. This principle may often be applicable to such elements of expense as freight, travel, communications, engineering services, etc., as well as the normal items of materials and productive labor. However, when the contractor is engaged in mixed production, this principle must be applied consistently to the costing of both defense and non-defense products or services, in order to produce equitable results. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect expenses.

15-202.1 DIRECT MATERIALS. The cost of direct materials includes the cost of items purchased, supplied, manufactured or fabricated, which enter directly into the end product or which are used or consumed directly in connection with furnishing such product.

15-202.2 DIRECT LABOR. The cost of direct labor includes salaried and wages specifically identifiable with and properly chargeable directly to the performance of contract or other work of the contractor. It may also include other associated costs such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.3 OTHER DIRECT COSTS. Where other items of cost are charged directly to the contract consistent with paragraph 15-202 above, the contractor must

demonstrate that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable to other work of the contractor must be eliminated from indirect costs allocated to the contract.

15-203 INDIRECT COSTS.

(a) Indirect costs are expenses which are incurred for common or joint objectives, are accumulated for accounting purposes by departmental activity or other logical cost grouping and are charged to the contract and other work of the contractor by a process of allocation. Each element thereof is subject to the limitations of this part as to allowability.

(b) No specific rules can be states as to the method of allocation of indirect costs because the actual condition in each instance must be taken into account in determining the most suitable method or mehtods. The objective should be the selection of a method or method which will distribute the indirect costs in a fair and equitable manner. The method used in connection with Government contracts must, in order to be acceptable, conform with generally accepted accounting practices, be applied consistently, and produce equitable results. Any significant change, such as in the nature of the business, extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, or the products being produced, may require reconsideration of the methods previously in use to determine whether they continue to be equitable. Further discussion relative to allocation of the individual categories of indirect costs will be found in the subparagraphs below.

15-203.1 INDIRECT MANUFACTURING AND PRODUCTION EXPENSES. Indirect manufacturing and production expenses consist of costs which are necessary to the productive process as a whole and are not readily subject to treatment as direct costs in accordance with paragraph 15-202. Allocation of indirect manufacturing and production expenses on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable bases, in appropriate circumstances, include direct labor dollars (exclusive of overtime premium), units processed and prime costs of units processed. In some instances, it may be necessary to departmentalize or establish cost centers in order to distribute equitably the indirect costs. The factors to be considered in determining the extent of departmentalization or establishment of cost centers include variety of products, complexity of processes and relative labor and facility requirements for the various products.

15-203.2 INDIRECT ENGINEERING EXPENSES. Indirect engineering expenses consist chiefly of engineering supervision, engineering administrative expense and engineering general supplies. These expenses arise out of engineering activities which 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 expenses should be allocated to the benefited activities, i.e., contract and other work of the contractor on the basis of direct engineering man-hours expended, direct engineering labor dollars (exclusive of overtime premium), or other equitable basis. Direct costs of engineering activities should be charged directly to the benefited activities, i.e., contract and other work of the contractor in accordance with paragrpah 15-202.

15-203.3 SELLING AND DISTRIBUTION EXPENSES. The expenses in this group consist of items which represent the cost of marketing the contractor's products and include sales promotion, advertising, distribution costs and other related items. Generally, such expenses are not considered to be allowable as a charge to Government cost-reimbursement type contracts for the reason that marketing, in the ordinary commercial sense, is not necessary for doing business with the Government. However, dependent upon a reasonable demonstration of benefits to Government contracts and subject to the other provisions of this part, there may be an allocation to government work of those expenses in this category which consist of technical, consulting and such other beneficial services (including related supervision and clerical expenses) which are for purposes such as application and adaptation of the contractor's products rather than pure selling. Such costs should first be allocated between the contractor's commercial line and its Government contracts. The amount allocated to the latter should then be charged to the individual contracts on any equitable basis. Because of the special problems that arise in this area, it is usually desirable for the contractor to identify in its records by means of sub-accounts or otherwise, the items of these expenses considered properly allocable to Government contracts.

15-203.4 GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses consist of costs incurred in the over-all management, supervision and conduct of the business. Any recognized method of allocating general and administrative expense is acceptable provided equitable results are thereby obtained. Some of the factors that should receive consideration in determining whether the results are equitable are (i) the cost pattern of the Government contracts (that is, the percentage of the total cost of the contract, exclusive of general and administrative expenses, represented by each of the several cost components thereof) in relation to the cost pattern for the plant or activity as a whole, and (ii) the ultimate objective of distribution of these expenses in approximate ratio to the general and administrative effort involved in the two categories

of work. In addition, consideration should be given to any significant variations of inventories between accounting periods, variations in the ratio of contract inventory levels to all other inventory levels, and any other relevant factors such as those mentioned in paragraph 15-203(b).

15-203.5 BASE PERIOD FOR ALLOCATION OF INDIRECT EXPENSES. The base period for allocation of indirect expenses should approximate the period of contract performance or should be representative of that period. The base period should be sufficiently long to avoid inequities in the allocation of costs.

15-204 APPLICATIONS OF BASIC COST PRINCIPLES AND STANDARDS TO SELECTED ITEMS OF COST. This paragraph states, in some detail, applications of the basic cost principles and standards set forth in the preceding paragraphs of this part to certain selected items of cost. The statements herein apply irrespective of whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost herein is not intended to imply that it is either allowable or unallowable. With respect to those items not specifically covered, determination as to allowability will be made in the light of the basic principles and standards and, where appropriate, the treatment of similar or related items in this Part. All of the subparagraphs below are subject to the basic principles and standards set out in paragraph 15-201.

15-204.1 ADVERTISING. Advertising expenses include the costs of advertising media and corollary administrative expenses. Advertising media include magazines, newspapers, radio and television programs, direct mail, trade papers, outdoor advertising, dealer cards and window displays, conventions, and exhibits, free goods and samples, and sales literature.

a. The following advertising costs only are allowable:

(1) Advertising in trade and technical journals, provided such advertising does not offer specific products or services

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.

(2) Help wanted advertising, as set forth in paragraph 15-204.33.

15-204.2 BAD DEBTS. Bad debt expenses consist of losses (whether actual or estimated) arising from uncollectible customers' accounts and other claims, and include collection expenses and related legal expenses. These costs are unallowable.

15-204.3 BIDDING EXPENSE. Bidding expenses are the costs of preparing bid estimates on potential contracts or projects, including the development of engineering and cost data necessary to support the contractor's price proposal or estimated cost of work performance. Bidding expenses of the current accounting period of both successful and unsuccessful bids normally will be treated as indirect expenses and allocated currently to all business of the contractor, in which event no bidding expenses of past accounting periods will be chargeable to the Government contract. However, the contractor's established practice may be to treat bidding expenses by some other recognized method. Regardless of the method used, the results obtained may be accepted only if found to be reasonable and equitable.

15-204.4 CAFETERIAS, DINING ROOMS, AND OTHER FOOD SERVICES. This class of expenses consists of cost, less revenue, of operating or furnishing facilities for cafeterias, dining rooms, sales stores, canteens, lunch wagons, vending machines, or other types of services for contractors employees at the contractor's facilities. Profits accruing to the contractor from the operation from these services whether operated by the contractor or by a concessionaire, will be treated as a credit to costs of all production within the contractor's

plant in which the services are furnished, except for services from which the profits are irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for the benefit of the employees at the bid location. Reasonable losses from operation from such services are allowable when it is determined that the contractor is intending to operate such services at no loss or profit. The gains or losses from these services must be appropriately allocated to all activities benefited including Government contracts. When such services are intentionally furnished at a loss to the contractor, losses on such operation will not be allowed as a cost, unless authorized by special contract provision.

15-204.5 CIVIL DEFENSE. Civil defense costs are those incurred in the planning for and the protection of life and property against the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by local and state civil defense authorities. Examples of civil defense costs include cost in excess of normal plant protection expenses and may consist of first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions and other approved civil defense measures. Reasonable costs of 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. In the case of capital assets, acquired for civil defense purposes the costs thereof will be depreciated over a reasonable number of years in conformity with generally accepted accounting principles. Except as specifically provided in the contract contributions to local civil defense funds or projects not on the contractor's premises are unallowable.

15-204.6 COMPENSATION FOR PERSONAL SERVICES.

a. This item includes salaries, wages, deferred compensation and fringe benefits for services rendered to the contractor by employees as well

as fees paid to directors and committee members. Subject to specific limitations set forth hereunder, such costs are allowable when the total compensation is reasonable in light of the services rendered.

b. Generally, the amount of compensation established by the contractor will be considered commensurate with the services rendered. However, compensation of individuals such as corporate officials, directors, executives, department heads, partners and sole proprietors may be subject to special consideration and limitation as to allowability for contract cost purposes where amounts appear excessive. Some situations which may give rise to excessive compensation are where (i) the individual or member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization; or (ii) ownership of the contractor is limited to a small cohesive group; or (iii) the volume of Government contracts when related to the contractor's total business is such as to influence the amount of compensation.

c. The cost of options to purchase stock of the contractor corporation granted to employees is not allowable as an item of cost.

d. Bonuses to employees, such as production incentives and suggestion or safety awards, represent a part of their total compensation and are allowable when appropriately allocated, if they are:

(1) Paid pursuant to an arms length agreement between the contractor and the employees before the services are rendered or pursuant to an established plan consistently followed by the contractor which constitutes, in effect an implicit agreement on the part of the contractor.

(2) Reasonable in amount.

(3) Paid for current services actually rendered by employees.

(4) Available to all employees of the contractor or to all employees within a group or salary classification which is not unreasonably

restricted.

(5) Allowable as an ordinary or necessary business expense for tax purposes.

(6) Not restricted to officer or other employee stockholders or are not distributed on the basis of stockholdings.

(7) Total employee compensation is reasonable in amount for such services.

e. Profit sharing plans.

(1) As used herein profit sharing is construed to be any plan (immediate or deferred-regardless of method of payment or participation) which includes, in whole or in part, a formal sharing of profits or is in any manner measured by dependent upon or contingent upon profit.

(2) Except as provided in (3) below, the cost of profit-sharing plans shall be allowable under the following conditions:

(i) Compensation payable under immediate distribution plans is allowable subject to the criteria set forth in subparagraph d. above and g. below.

(ii) Employer contributions under deferred distribution profit-sharing plans, to be allowable costs, must meet all pertinent conditions set forth under subparagraph d. above and g. below and, if subject to Internal Revenue Service consideration, must have their approval. The carry-over provisions of the regulations of Internal Revenue Service with respect to contributions under qualified deferred distribution profit-sharing plans shall not be recognized for Government contract cost determination purposes. Forfeitures of non-vested benefits under a profit-sharing plan will be treated in accordance with the principles stated in paragraph 15-204.27(f).

(3) Unless otherwise provided by special contract provision, the cost of profit-sharing plans shall not be allowable in the following situations:

(i) The business of the contractor at the time of entering into the contract is less than 75% with non-Governmental customers, taking into account the amount of the contract in question.

f. Stock bonus plans. Stock bonuses which are not disallowed by the provisions of subparagraph e. above are acceptable as a form of compensation, and the costs thereof are allowable subject to all conditions pertinent under sub-paragraph d. above and g. below and meet the following requirements:

(1) The valuation placed on the stock for the purpose of calculating such cost must be computed on a sound basis.

(2) In the case of unlisted stock having no current market, the contractor must demonstrate the values ascribed thereto are fair and reasonable.

(3) Bonuses paid in the form of previously unissued stock of an affiliate will not ordinarily be allowed unless it can be demonstrated that there exists a bona fide arms-length agreement and the values ascribed to such stock are fair and reasonable.

(4) Claims for accruals of compensation under a stock bonus arrangement prior to acquisition of stock by employees will not be allowable unless arrangements are made for appropriate credit adjustment of costs in the event such stock is not acquired by employees.

g. For the purpose of determination of reasonableness, the employer contribution under profit sharing plans and stock bonus plans shall not exceed, in the aggregate for each participating employee, 15% of the total basic compensation paid or accrued to such employees in the year under consideration.

h. The determination of allowability of the cost of pension and retirement plans, training expense, overtime, extra pay and multi-shift premiums and other fringe benefits will be in accordance with paragraphs 15-204.27, 15-204.43, 15-204.25, and 15-204.14 respectively. Any form of compensation to an employee not specifically mentioned in this part 2, in addition to those set forth in this paragraph, will be given consideration as a part of total compensation.

15-204.7 CONTINGENCIES. This type of charge results from the creation and maintenance of reserves to provide for an event whose occurrence cannot be foretold with certainty as to time, intensity or even an assurance of its happening. These costs are not allowable. (For self-insurance programs see paragraph 15-204.16).

15-204.8 CONTRIBUTIONS AND DONATIONS. 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.

15-204.9 DEPRECIATION.

a. Depreciation as described herein is a charge to current operations intended to distribute the cost of tangible capital assets, less estimated residual value, over their estimated useful life in a systematic and logical manner. It involves a process of allocation, not of valuation. Useful life has reference to the prospective period of economic usefulness in the particular

contractor's operations as distinguished from physical life.

b. Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, provided the amount thereof is based upon original acquisition cost. Depreciation will be accounted for by consistent application to the asset(s) concerned of any generally accepted accounting principles and should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation charged in any accounting period may vary with volume of production or use of multishift operations, provided the method followed is consistent with basic objectives set forth in subparagraph a. above.

c. Charges for depreciation on idle or excess facilities will not be allowed except on such facilities as are reasonably necessary for contract performance standby purposes.

d. Unless otherwise provided in the contract, no use charge will be allowed on assets still in use which have been, in accordance with the contractor's consistent accounting practice, fully depreciated on the contractor's books of account.

e. Where the contractor has applied for and received a determination of "true depreciation" from an Emergency Facilities Board covering emergency facilities acquired under certificates of necessity, the amounts so determined for "true depreciation" over the emergency period (5 years) will be recognized in lieu of normal depreciation. After the expiration of the emergency period for the facilities concerned where a determination of "true depreciation" has been made, the remaining undepreciated portion of the cost of such facility will be depreciated over its remaining useful life and will be the only amount recognized as allowable cost, subject to paragraph 15-204.12. The contractor may elect to use normal depreciation rather than the "true depreciation" as determined by the Emergency Facilities Board. However, the method chosen after such determination of "true depreciation" must be followed consistently throughout

the life of the emergency facilities.

15-204.10 EMPLOYEE MORALE, HEALTH AND WELFARE. Included in this category are expenses of health and welfare activities incurred for the improvement of working conditions and the improvement of employer-employee relations and employee performance. Examples of these activities are house publications, health or first-aid clinics, and employee counselling services. These costs are allowable when incurred in accordance with the contractor's established practice or custom in the industry or area and are reasonable and equitably allocated to all classes of work performed in the contractor's plant. Income generated from any of these activities will be credited to the costs thereof.

15-204.11 ENTERTAINMENT EXPENSE. This item includes the cost of amusement, diversion, social activities and incidental costs relating thereto, such as meals, lodging, rentals, transportation and gratuities. These costs are unallowable.

15-204.12 EXCESS FACILITIES. This item includes the cost of maintaining and housing idle and excess facilities, except those reasonably necessary for contract performance standby purposes. These costs are unallowable. The costs of additional plant capacity reserved for defense production shall be the subject of a separate contract.

15-204.13 FINES AND PENALTIES. Included in this item are those costs resulting from violations of, or failure of the contractor to comply with, local, state and Federal laws and regulations. These expenses are not allowable except when incurred as a result of compliance with specific provisions of the contract or instructions in writing from the contracting officer.

15-204.14 FRINGE BENEFITS. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries.

a. The determination as to the allowability of the cost of pension and retirement plans, profit sharing and other bonuses, and severance pay will be in accordance with sub-paragraphs 15-204.27, 15-204.6 and 15-204.38, respectively.

b. The cost of other fringe benefits such as pay for vacations, holidays, sick leave, military leave and employee insurance (but see sub-paragraph 204.16e) is allowable to the extent required by law, employer-employee agreement, or established policy of the contractor that constitutes, in effect, an implicit agreement on the contractor's part.

15-204.15 INITIAL PRODUCTION COSTS. Initial production costs, known also as "starting-load costs", are non-continuing costs that arise in early stages of production because of the contractor's lack of experience with particular materials, manufacturing processes or techniques involved. Such costs may consist of excessive material costs resulting from abnormal scrap losses, excessive direct labor costs and related overhead resulting from idle time due to testing and change in production methods, cost of training employees, and excessive defective work due to inexperienced labor.

While initial production costs are allowable, the contractor will be expected to work actively to minimize or eliminate them as rapidly as possible. In cases where these costs continue to an unwarranted extent after the contractor has been allowed reasonable time to learn to make the product efficiently, the excessive costs will be subject to disallowance.

15-204.16 INSURANCE AND INDEMNIFICATION

a. Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by

specific instruction of the contracting officer or his authorized representative, and (2) any other insurance for which the contractor seeks reimbursement under the contract. The kinds of insurance ordinarily included in the first category are set out in ASPR 10-501.

b. Costs of Government required insurance are allowable within the limitations as to the extent of coverage and premium rates approved by the Government. Costs of other insurance, except that applicable to Government-owned property, are allowable provided (1) the insurance has been approved by the military department concerned or (2) in the absence of such approval requirement, the types of coverage, extent of coverage, and rates are reasonable under the circumstances. Costs allowed for use and occupancy insurance, however, will in principle be limited so as to exclude coverage of profit, interest, federal income taxes, and any other items of expense unallowable under this part.

c. The costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are not allowable except to the extent that the Government may have required the contractor to carry such insurance.

d. The costs of a self insurance program are allowable provided the program has been approved by the Military Departments concerned. Actual losses sustained under such a self-insurance program are not allowable.

e. The costs of insurance on the lives of officers, partners or proprietors, are not allowable except where such insurance is part of an employee plan which is not unduly restricted.

f. Losses resulting from failure to insure (through self insurance or otherwise) against a contingent loss or damage, where a reasonably prudent

business organization would have insured against such loss or damage, are not allowable.

g. Cost of indemnification will be allowable only to the extent expressly provided for in the contract.

15-204.17 INTEREST AND OTHER FINANCIAL EXPENSES. This item includes interest paid or accrued (regardless of the nature of the obligation which gives rise to the interest cost), bond discount and expenses, and the cost of financing and refinancing operations as well as legal and professional fees paid in connection with the preparation of a prospectus, cost of preparation and issuance of stock rights and expenses related thereto. (See also 15-204.24). These costs are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in subparagraph 15-204.40.

15-204.18 LABOR RELATIONS. This item covers expenses incurred in maintaining satisfactory relations between the contractor and his employees. It includes the cost of shop stewards, labor management committees, employee publications and other related activities. Costs incurred for these purposes are allowable.

15-204.19 LOSSES ON OTHER CONTRACTS. This item covers any excess of costs over income under any and all other contracts, whether such other contracts are of a supply, research and development or other nature. Costs of this nature are not allowable as a cost of performance of the Government contract.

15-204.20 MAINTENANCE AND REPAIRS. (a) This item includes those costs necessary for the upkeep of property which neither adds to the permanent value of the property nor appreciably prolongs its intended life but keeps it in its efficient operating condition. These costs are allowable. Expenditures for plant and equipment which, according to generally accepted accounting

principles, should be capitalized and subjected to depreciation will be allowable only on a depreciation basis. Cost of maintenance and repairs of excess facilities and of idle facilities (other than reasonable standby facilities) are not allowable.

b. Deferred maintenance is defined as maintenance and repairs which for some reason such as abnormal operating conditions or lack of funds, is delayed to a future period. The cost of maintenance and repairs which has been deferred from a period prior to the contract is not allowable unless specifically provided for in the contract. Likewise, the estimated cost of maintenance and repairs normally required but not accomplished during the period of the contract will not be allowed as a cost unless specifically provided for in the contract.

15-204.21 MANUFACTURING AND PRODUCTION ENGINEERING. Manufacturing and production engineering includes the cost of engineering activities in connection with (1) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement and (2) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production. These costs are allowable. For purposes of distribution, such costs should ordinarily be divided into two categories: (i) those which directly benefit a contract, a project, or a product line and (ii) those expenses which are not subject to direct costing. Items in category (i) should be charged directly to the contract or project or allocated to the products in the product line. Costs in category (ii) should be allocated to all benefited work.

15-204.22 MATERIALS AND SUPPLIES.

a. This item includes the net costs of such items as raw materials, parts, sub-assemblies, components, and manufacturing supplies, whether purchased outside or manufactured by the contractor, and may include such collateral items as inbound transportation and intransit insurance. These costs are allowable subject, however, to the provisions of subparagraphs b through f below.

b. Costs of materials and supplies shall be suitably adjusted for applicable portions of income and other credits. Such income and other credits include trade discounts, refunds, rebates and allowances. Cash discounts available, and credits for scrap and salvage and materials returned to vendors. However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond his control, such lost discounts will be allowed.

c. When materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to the contract.

d. If materials are issued from stock, any generally recognized method of pricing such materials will be acceptable, provided the 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 and the Government may, by contract provision, agree upon the use of a method of pricing based upon the fair value of the materials as of the date of the contract, but not in excess of replacement cost on such date. Such agreement should

include identification of the types or kinds of materials involved and should be made at the time the contract is entered into and provided for therein.

e. Reasonable charges arising from difference between periodic physical inventory quantities and related material control records will be included in arriving at the cost of materials, provided that such charges (i) do not include "write-downs" of values, and (ii) relate to the period of performance of the contract. All credits arising from differences between periodic physical inventory quantities and related material control records shall be taken into account.

f. Ordinarily sales or transfers of materials and supplies between plants, divisions, or organizations, under a common control, shall be stated on the basis of cost to the transferor. 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, provided that the price charged to the contract does not exceed the lower of (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.

15-204.23 ORGANIZATION EXPENSES. This item consists of expenditures in connection with organization or reorganization of a business. Examples of such costs are incorporation fee, attorneys fee, fees to promoters and organizers and costs of raising capital. These costs are unallowable. (See paragraph 15-204.17).

15-204.24 OTHER BUSINESS EXPENSES. Included in this item are such recurring expenses as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of annual reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies and incidental costs of directors and committee meetings. The above and similar costs are allowable when incurred in reasonable amounts in accordance with the contractor's established practices and are allocated on an equitable basis to all classes of work.

15-204.25 OVERTIME, EXTRA PAY SHIFT AND MULTI SHIFT PREMIUMS. This item consists of the premium portion of overtime and shift payments to employees. Such premiums may be classified as either direct or indirect labor costs, but the amount of overtime premium should be separately identified. When direct labor cost is the base for distribution of overhead, overtime premiums shall not be included therein. Cost of overtime and shift premiums are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government. See ASPR 12-102 for further information concerning the policy regarding such authorization. The amount of overtime and shift premium cost charged on Government contracts shall be equitable in relation to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant and the factors which necessitate the incurrence of the cost.

15-204.26 PATENT EXPENSES. Included in this item are amortization of the cost of purchased patents and all costs leading to the issuance of patents, as well as the cost of infringement investigation and litigation. Amortization of the cost of purchased patents applicable to contract products or processes is allowable. The cost of preparing disclosures as required by the contract and

of preparing assignment and other papers in connection with the filing of a patent application for the Government, and any expenses incident to patents incurred upon the written authorization of the contracting officer, are allowable. All other patent expenses and charges for the use of patents where the Government has a license or the right to free use thereof, are unallowable. The cost of research and development work leading to patents is treated in subparagraph 15-204.35.

15-204.27 PENSION AND RETIREMENT PLANS.

a. A pension plan as used herein is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to his 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 service 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 will be considered a pension plan, if, under the plan, either the benefits payable to the employee or the required contributions by the contractor can be determined actuarially.

b. Pension and retirement plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the Military Department; however, approval of the plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such plan by the Military Department. Consideration of the plans will be the responsibility

of the Department to which audit cognizance is assigned and the subsequent action taken by that Department will generally be accepted by the other Departments. In cases where the Internal Revenue Service withdraws approval of a plan, amounts allocated to contract costs will be withdrawn accordingly. Where pension and retirement plans of non-profit or other tax-exempt organizations are not required to be reviewed and approved by the Internal Revenue Service, it will be the responsibility of the Department to which audit cognizance is assigned to give consideration to the acceptability of such plans.

c. The costs of acceptable pension and retirement plans, which are properly deductible from taxable income are allowable except as otherwise determined unallowable under this paragraph. The cost of retirement plans, which are based on profit sharing, shall be subject to paragraph 15-204.6e. Costs of acceptable pension and retirement plans established by nonprofit or other tax-exempt organizations are also allowable except as otherwise determined under this paragraph.

d. Pension and retirement costs constitute a part of the total compensation by a contractor to the individuals covered by the plan, and accordingly, are subject to the provisions of this section with respect to reasonableness of the total compensation paid to the individual for the services rendered. (See 15-204.6)

e. The amount of the contribution subject to allocation as a contract cost will be limited to the maximum amount required to fund an approved plan, or the amount actually contributed, during the taxable year, whichever is the lesser. The carryover provisions of the Internal Revenue Code with respect to contributions under pension and retirement plans shall not be recognized for the purpose of determining allowable pension and retirement costs under Government contracts.

f. Credits which arise under pension plans from various sources, such as dividends and cancellation of employee benefits which have not vested at the

time of termination of their employment, must be taken into account in an equitable manner in the determination of the allowable pension and retirement contribution. Special provision for these credits is usually necessary when the contractor's organization has substantially expanded for the performance of military contracts and there is a reasonable expectation that the employment of a large number of the additional employees will be terminated upon curtailment of military work. Under these circumstances, 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. There are two general methods which may be used, individually or in combination, in making such arrangements:

(1) A lump sum or percentage discount of current pension costs negotiated and agreed upon in advance. Determination of such allowance generally is not an actuarial problem involving a calculation based upon known factors, but rather is an attempt to reach a negotiated agreement as to various uncertain or variable factors in a complex situation.

(2) A retrospective determination at some time in the future when a more accurate estimate can be made by virtue of experience which may have developed. Until such determination, current costs, which should be net of current credits may be allowed provided an appropriate contractual agreement can be reached which reserves the Government's right to future credits.

g. The costs of lump sum purchases of annuities or of lump sum cash payments or periodic cash payments made to provide pension or retirement benefits for retiring or retired employees other than incurred under approved pension and retirement plans are allowable only to the extent specifically provided for in the contract.

15-204.28 PLANT PROTECTION EXPENSES. This item includes the cost of plant

protection measures such as wages of guards, equipment of guards (uniforms, firearms, etc.), and depreciation on plant protection capital assets. For the purpose of contract costing, these expenses are divided into two categories, namely, normal plant protection expenses and special plant protection expenses. Normal plant protection costs are allowable and are allocable to all work in the plant. Special plant protection costs, which term refers to an extension of the contractor's normal plant protection program are also allowable and allocable to specific Government contracts requiring special protection upon the specific direction and approval of the contracting officer.

15-204.29 PRECONTRACT COSTS. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs will not be allowed unless specifically set forth in the contract and may be limited to a period of time as well as to the type and amount of such costs.

15-204.30 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER.

a. This item includes the cost of professional services rendered by the members of the particular profession separately engaged. These costs generally are allowable when reasonable in relation to the services rendered and are not contingent upon recovery of the costs from the Government.

b. Factors to be considered (among others) in determining the allowability of costs in a particular case are: (i) 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 organization; and (iv) whether or not the proportion of Government work to the contractor's

total business is such as to influence the contractor in favor of incurring the cost, particularly where the services rendered are not of a continuing nature and have little relationship to work under Government contracts. Retainer fees to be allowable must be reasonably supported by evidence of services rendered.

c. The costs of legal, accounting and consulting services and related expenses incurred in connection with organization or reorganization, prosecution of patent infringement litigation (except as provided for in 15-204.26), defense of anti-trust suits, and the prosecution of claims against the Government are unallowable.

15-204.31 PROFITS AND LOSSES ON DISPOSITION OF PLANT, EQUIPMENT OR OTHER CAPITAL ASSETS. Included herein are gains or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments. Profits or losses on sale or exchange of capital assets, including investments, will be excluded in computing contract costs.

15-204.32 RECONVERSION EXPENSES. Reconversion expenses are those incurred in the restoration of the contractor's facilities to approximately 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 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.

15-204.33 RECRUITING EXPENSE. This item includes the costs of "help wanted" advertising and the operating costs of an employment office necessary to secure and maintain an adequate labor force. It further includes the costs of operating

an educational and aptitude testing program, travel expenses of employees while engaged in recruiting personnel, and travel expenses of applicants for interviews for prospective employment. These costs are allowable. Where the contractor uses private employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are not allowable.

15-204.34 RENTALS OF PLANT AND EQUIPMENT (Including sale and leaseback of facilities.)

This item includes expenses for (i) use of land, buildings, and equipment or other personal property, and (ii) rental expenses under sale and lease-back agreements incurred by contractors through sale of plant facilities to investment organizations (such as insurance companies) or to private investors and concurrently leasing back the same facilities.

a. Rentals of plant and equipment under (i) above are allowable if the rates are reasonable in light of the type, condition and value of the facilities leased, options available and other provisions of the rental agreement.

b. Rentals specified in sale and lease-back agreements under (ii) above are allowable only to the extent that such rentals do not exceed normal costs (such as depreciation, taxes, insurance and maintenance expenses) which would have been incurred had the contractor retained legal title to the facilities.

15-204.35 RESEARCH AND DEVELOPMENT. Research and development expenses (sometimes referred to as general engineering expenses) for the purpose of contract

costing are divided into two major categories, namely:

a. General research, also referred to as basic research, fundamental research, pure research and blue-sky research.

b. Related research or development, also referred to as applied research, product research and product line research.

(1) General research is that type of research which is directed towards increase of knowledge in science. It is research where the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. The costs of a contractor's independent general research (that which is not sponsored by a contract or grant or is not otherwise reimbursed to a contractor) shall be an allowable cost in all cost type contracts under the following conditions:

(i) The amount of such costs is reasonable.

(ii) The costs are equitably allocated to all work of the contractor other than its independent general and related research.

(iii) The contractor agrees to divulge to the Government the results of such independent general research.

(iv) The business of the contractor at the time of entering the contract is predominantly (75% or more) with non-Governmental customers. If less than 75% at the time of entering the contract, allowance may be authorized by special contract provision.

The above conditions will also apply in the negotiation of predetermined overhead rates.

(2) Related research is that type of research which is directed toward practical application of science, and "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 15-204.21). The costs of a contractor's independent related research (that which is not sponsored by a contract or grant or is not otherwise reimbursed to a contractor) may, if allocated on the basis of all production, be allowed as a cost under any cost type production contract if the research is related to the contract product or product line. No portion of such research will be allowable under cost-type research and development contracts.

c. Research and development costs, regardless of the nature, which were incurred in accounting periods prior to the award of a particular military contract, (including amounts capitalized and the cost of patents obtained) will not be allocated to that contract unless allowable as pre-contract costs (Paragraph 15-204.29).

15-204.36 ROYALTY PAYMENTS. This item covers amounts paid for the right to use patents. Where the use of such patent is necessary for the proper performance of the contract and where the Government does not already have a license or other right to use such patents, the royalties are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the contracting officer.

15-204.37 SERVICE AND WARRANTY EXPENSES. This item includes the costs of servicing the product installation, training personnel in the use, operation and maintenance of the product, correcting product defects, replacing defective parts, and other related operations or practices. Actual costs to be reimbursed to the contractor will be in accordance with the clause of the contract entitled "Inspection of Supplies and Correction of Defects", (See paragraph ASPR 7-203.5), or as otherwise provided in the contract.

15-204.38 SEVERANCE PAY. Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated.

The cost of severance pay is allowable only to the extent that, in each case, it is required by (i) law, (ii) employer-employee agreements, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) the circumstances of the particular employment.

For contract costing purposes severance pay is divided into two categories as follows:

a. Normal Turnover Severance Pay. The cost of severance payments is allowable and must be allocated to all classes of work being performed in the contractor's plant at the time of payment. However, where the contractor provides for accrual of pa 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.

b. Mass Severance Pay. The cost of abnormal or mass severance pay 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 entire period of employment with the contractor and equitably apportioning such cost to all business of the contractor performed during that period.

A reservation in the final release of claims (See ASPR 7-203.4) may be made in the case of completed cost-reimbursement type contracts when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

15-204.39 SPECIAL TOOLING. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or to the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. The cost of special tooling, when acquired for and its usefulness is limited to government contracts, is allowable and will be charged directly to the government contracts. When such special tooling is acquired it shall be subject to the provisions of the contract clause set forth in ASPR 13-503 entitled "Government Property".

15-204.40 TAXES. Taxes are charges levied by a government unit. They do not include fines and penalties except as otherwise provided herein.

a. In general, taxes (including state income taxes) which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except (i) for Federal income and excess profits taxes; (ii) taxes in connection with financing, refinancing or refunding operations (see paragraph 15-204.17); (iii) taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government; and (iv) special assessments on land which represent capital improvements.

b. Taxes otherwise allowable under a. above, but which may be illegally or erroneously assessed may be allowed as a cost of work performed, provided that the contractor, prior to payment of such taxes, (i) promptly requests instructions from the contracting officer concerning such taxes; (ii) agrees to comply with such instructions; and (iii) if so directed by the contracting officer also agrees to take all necessary action in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon. Interest and penalties incurred

by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer, shall be allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs.

c. Any refund of taxes, penalties or interest thereon shall be credited to contract costs in the proportion in which contract costs absorbed the costs of taxes, interest or penalties. If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

15-204.41 TRADE, BUSINESS, AND PROFESSIONAL ACTIVITIES.

a. Memberships. This item includes costs of membership in trade, business, and professional organizations and such costs are allowable.

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

c. Meetings and Conferences. Expenses representing the purchase of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrance of such expenses is the dissemination of technical information or the stimulation of production, are allowable.

15-204.42 TRAINING EXPENSES.

a. This item includes the costs of preparing and maintaining a program of instruction designed to increase the over-all effectiveness of employees. Included are the costs of the director of training and staff, training materials

and text books when the training program is controlled by the contractor, and tuition, fees, training materials and text books when the training is in educational institutions.

b. Such costs which are limited to on the job training are allowable when properly allocated.

c. Costs of training in educational institutions are not allowable, except to the extent specifically provided in the contract.

15-204.43 TRANSPORTATION EXPENSES. Transportation expenses include the cost of freight, express, cartage and postage relating either to goods purchased, in process, or delivered.

When such costs can readily be identified with the items involved they may be direct costed or added to the cost of such material. (See paragraph 15-204.22). Where identification with the materials received cannot readily be made, inbound transportation expense may be charged to the appropriate indirect expense accounts, provided the contractor follows a consistent procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as direct charges.

15-204.44. TRAVEL EXPENSES. This includes costs of transportation, lodging, subsistence and incidental expenses incurred by contractor personnel in a travel status while on official company business.

a. Travel expenses incurred in the normal course of overall administration of the business and applicable to the entire business are allowable when properly allocated.

b. Travel expenses directly attributable to contract performance may be charged to the contract in accordance with the principle of direct costing.

c. Subsistence and lodging including tips or similar incidental expenses may be reimbursed either on an actual or per diem basis. The basis selected should be consistently followed.

d. Costs of premium transportation may be allowed when it is shown to be necessary to performance of the contract.

e. Entertainment expenses are not allowable.

f. Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the Contracting Officer.

5 March 1956

AFMPP-PR-2

MEMORANDUM FOR ASPR EDITING AND SECTION XV PART 2 SUBCOMMITTEES

SUBJECT: Editing Subcommittee's Change to Paragraphs 15-204.21(f) and 15-204.34(b)(ii) Section XV Part 2 Cost Principles

1. The Air Force Procurement member of the Contract Cost Principles Subcommittee having given further consideration to the Editing Subcommittee's changes to (i) the material and supply paragraph relating to interdivisional transfer of such items and (ii) the paragraph on related research, finds he cannot agree to the changes considered by Section XV and Editing Subcommittees on 2 March 1956.

2. Consider first the edited changes to interdivisional transfer language, namely, the insertion of the words "or the prices of other suppliers for the same or substantially similar items, whichever is lower."

Reasons advanced for this addition were somewhat as follows:

a. "While it may not be likely to ordinarily occur, it is conceivable that a company might transfer goods from one division to another for use on a government contract at a 'price' based on existing market conditions which would be below the original cost to the transferor. Without this language the Government would be obligated to pay the transferor's cost, although the company might be willing to make the transfer at a price below cost".

Comment: Such a situation could only occur where such materials were in stock. The chances that this situation is ever likely to occur so that the contract costs would be affected in any material amount is so remote as to be beyond such serious consideration as to change the paragraph on interdivisional transfers. Companies just don't go about carrying large obsolete or non-usable materials in stock.

b. "This language would cover a situation where a contractor elects to manufacture in one of his other divisions an item which is not normally manufactured by that division, but which is regularly manufactured by another 'outside' company; and in such situation the change in the paragraph would limit the contractor's reimbursement for such item to the lower of his manufacturing cost or the price he would have paid had the item been bought from the normal outside manufacturer".

Comment: Again, this is a situation that is "conceivable" but its actual occurrence is so remote that it need not and should not be covered in the language relating to inter-

divisional transfers. Such language can only lead to confusion among auditors, contracting officers and contractors as to how and when it applies. This type of situation can best be handled by the contracting officer in his approval authority over subcontracts.

3. The change to the paragraph covering related research which would allocate to the contract the cost of its related research is, likewise, not agreed to.

4. The Contract Cost Principle Subcommittee, acting on instructions from the ASPR Committee, provided in its revision to the cost principles that related research related to the contract product line should be allocated to all production work of the contractor. This was based on the ASPR Committee's decision that a little more liberal treatment should be taken on accepting related research cost than the present existing ASPR 15-204(s) provides, which is: "Research and development specifically applicable to the supplies or services covered by the contract."

5. The Air Force Procurement member feels that there should be no change in the allocation to all production work of related research related to the contract product line.

PAUL M. SOUTHWELL

OGC/GWM:lwt March 9, 1956

MEMORANDUM FOR THE ASPR COMMITTEE

Subj: ASPR Case 53-44, Revision of Section XV, Contract Cost Principles

1. In accordance with the request of the ASPR Committee (Minutes of Meeting of 28 February 1956, Item 12), the Editing Subcommittee met on March 2, 5, and 6, jointly with the Section XV Subcommittee and itself met in a further meeting on March 7, 1956.

2. The joint subcommittees discussed each of the areas referred to in paragraph 1 of the Editing Subcommittee report of February 27, 1956, and recommendations with respect to each area are set forth below under A, B, and C. The edited material prepared by the Editing Subcommittee as a result of such discussions is contained in the appropriately numbered paragraphs of the attached TAB B. The bracketed references are to paragraphs in the Section XV Subcommittee draft as submitted for editing.

A. Material and Supply Costs - ASPR 15-204.2(n)(6) [15-204.21f]

The Problem:

In regard to transfers between divisions or organizations under common control of items not regularly manufactured and sold through commercial channels, the Editing Committee recommended that subparagraph 6 include the following words before the proviso:

> "or the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is lowest."

Joint Recommendation:

Do not include the words:

> "or the cost to the transferor".

Include the words:

> "or the prices of other suppliers for the same or substantially similar items, whichever is lower,"

B. Research and Development Costs - ASPR 15-204.2(v)(3) /15-204.34(ii)/

The Problem:

The Editing Subcommittee recommended that, in subparagraph 3, the term "product line" be clarified and that consideration be given to whether the proposed allocation of the costs of related research to "all production work of the contractor" would create an inequity since such costs would be allowable only to the extent the research was related to the "contract product or product line."

Joint Recommendation I:

Change the term "contract product or product line" to "contract product line." This was recognized as a temporary expedient which would probably have the effect of limiting the term "product line" so that it would not be construed as having the broadest possible application, i.e., all products sold by the contractor. There was general agreement that such a broad application was not intended and would be undesirable. However, a protracted discussion did not produce any general consensus of opinion on what area the term was intended to cover or what coverage would be desirable. The problem requires further study.

Joint Recommendation II:

The words "if allocated to all production work of the contractor" should be deleted to avoid an inequity and the following words should be added to the proviso before the period:

> "and the costs are allocated to all production work of the contractor on the contract product line."

C. Pension Plans - ASPR 15-204.2(q) /ASPR 15-204.26/

I. The Substantive Issue Problem.

In regard to the issue relating to reversionary credits arising out of future abnormal terminations (discussed in paragraph 3.C.1. of the report of February 27, 1956), the Section XV Subcommittee was in agreement that its draft as submitted for editing was not intended to provide for retrospective accounting in addition to a discount of current costs or realistic recognition in the actuarial calculation of current costs in order to give effect to the anticipated future credits or gains arising out of "abnormal" terminations. Accordingly, it was

4. The Editing Subcommittee submits herewith an edited draft of Part 2, Section XV, in accordance with the assignment of the ASPR Committee (see Minutes of Meeting of 13 December 1955, Item 4). This draft has the concurrence of the Editing Subcommittee with the reservation that it is anticipated that several points will require brief discussion when the matter is considered by the ASPR Committee.

5. The Editing Committee invites attention of the ASPR Committee to paragraphs 4 and 5 of its report of February 27, 1956, as matters for its further consideration. In connection with the matter of "side" agreements referred to in paragraph 4 of said report, members of the Section XV Subcommittee have furnished information to the joint Subcommittees to the effect that this matter was the subject of a policy determination by the Procurement Secretaries in the early part of 1955.

Editing Subcommittee:

GEORGE W. MARKEY, JR.
Navy Member
Chairman

CHARLES W. WILKINSON
Lt. Colonel, SS JAG
Army Member

JOHN W. PERRY
Air Force Member

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J. O. Hunnicutt, Jr., Major, DCSLOG
T. P. Partyka, AAA
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For the above reason the joint subcommittees requested the technical assistance of the Internal Revenue Service. The Chairman of the Editing Subcommittee made arrangements to contact W. G. Shreve, Acting Head, Pension Trust Section, Internal Revenue Service, and he in turn arranged for Mr. J. F. Heathcote, Technical Assistant, to attend the joint meeting of March 6, 1956, and advise the subcommittees in their consideration of the problem. This assistance has been invaluable and is gratefully acknowledged; without it, the joint subcommittees would have been required to spend a much longer time at this task.

From information furnished as a result of the above contacts, it appears that the problem starts with the inferences that can be drawn from the present ASPR 15-601.2(b) that certain pension plans must be submitted for prior approval by the Internal Revenue Service but that plans of tax-exempt organizations are not subject to any approval. Actually, no pension plans are necessarily required to be approved at all although the plans of tax-exempt organizations as well as those of organizations subject to taxation are subject to approval at some time. In the case of the latter, the review would most usually come about as a result of the employer's deduction for tax purposes of its contributions to a pension plan and would occur at the time of auditing income tax returns within three years after filing. However, this does not always occur. In the case of tax-exempt organizations, the chief effect of approval or disapproval is on the tax liability of the employee beneficiary; this may vary depending on whether the plan is "qualified" or not. To clarify this question, plans of tax-exempt organizations are often submitted for approval in advance. If not so submitted, the matter of tax liability does not usually come under scrutiny until the employee beneficiary begins receiving benefits.

Following extensive discussion, the joint subcommittees agreed in principle on a draft dealing with this problem. An edited version of this material is set forth in TAB B, as subparagraphs (2) and (3)(i) through (iii) of proposed ASPR 15-204.2(q).

3. Except for the single dissent mentioned above with respect to paragraph 2.C.1., the recommendations set forth in the foregoing paragraph have had the concurrence of the Editing Subcommittee and the Section XV Subcommittee. Subsequent to action by the joint subcommittees on the problems discussed in paragraphs 2.A. and 2.B., Mr. Paul Southwell, Air Force procurement member of the Section XV Subcommittee, submitted the memorandum attached as TAB A. Owing to the limited time for submitting this report, it has not been possible to have the members of the joint subcommittees give advance consideration to this report or the edited draft of the paragraph covering the ~~cases~~ costs of Pension Plans (Proposed ASPR 15-204.2(q), TAB B attached).

decided to treat subparagraphs (3)(iii)(A) and (3)(iii)(B) of proposed ASPR 15-204.2(q) in the disjunctive rather than the conjunction by deleting the "and" and retaining the "or" between them.

It appeared that some of the original concern of the Army and Air Force members to the disjunctive treatment was associated with the matter of credits or gains arising out of "normal" employee turnover which the Section XV Subcommittee had not intended to include under the paragraph in question. To clarify this point, a specific reference to credits or gains arising out of "normal employee turnover" is made in the redraft of subparagraph (3)(iii)(A) (appearing as (3)(iv)(A) in TAB B.

To satisfy another concern of the Army and Air Force members of the Editing Subcommittee, this provision also provides that, where future credits for abnormal terminations are accounted for by a discount of, or an actuarial recognition in, current costs, the appropriate adjustment "shall be reflected in the contract, in an amendment thereto, or some other writing binding on the Government and the contractor." In regard to the words "some other writing binding on the Government and the contractor", the Editing Subcommittee does not intend that a formal agreement must be entered into or that any action by a Contracting Officer is necessarily required. It is merely intended to require that the Departmental activity authorized to determine costs and incidental credits reach a definitive written understanding with the contractor, by exchange of memoranda, correspondence, or otherwise, which will not leave the question whether the credits have been received by the Government, open to speculation, conjecture, or surmise.

The joint subcommittees agreed in principle (Mr. Cox, one of three Air Force representatives, being the sole dissenter) on treating this problem in the manner set forth in TAB B as proposed ASPR 15-204.2(q)(3)(iv) which is an edited version subsequently prepared by the Editing Subcommittee.

II. The Problem of Consistency, with Part 6, Section XV

Following submission of the report of February 27, 1956, the Army member of the Editing Subcommittee contacted the Internal Revenue Service and learned that the present Part 6, Section XV, as well as the draft submitted for editing were open to misinterpretation with respect to the matter of approval of pension plans by Internal Revenue Service.

OGC/GWM:lwt March 9, 1956

Part 2 -- Supply Contracts, and Service and Research and Development Contracts with Organizations Having Commercial Type Accounting Systems

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 the procurement of supplies, services, and research and development work. However, this Part does not apply to contracts for services or research and development work with contractors or subcontractors which do not have commercial type accounting systems, or for facilities, construction, or architect-engineer services related to construction.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (i) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

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

15-201.3 Credits. The applicable income, rebates, allowances, and other credits received by or accruing to the contractor which are related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

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 (ASPR 7-203.7).

15-202 Direct Costs.

15-202.1 General. Direct costs are those items of cost which can be specifically identified with any objective, service, program, or project of the contractor and are chargeable directly thereto. Allowability of direct costs shall be determined pursuant to ASPR 15-201.2. Major items of cost such as freight, travel, communications, engineering services, etc., as well as the costs of materials and productive labor, should be charged directly to (i) a contract, or (ii) other work of the contractor, with which they are readily

identifiable. When the contractor is engaged in both defense and non-defense production or services, this principle must be applied consistently to both. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect costs.

15-202.2 Direct Material Costs. Direct material costs include the cost of all purchased items and items manufactured independently of a contract, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract. Direct material costs of reasonable overruns, spoilage, and defective work may also be included; but, as to defective work, see paragraph (c) of the inspection clause in ASPR 7-203.5.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically indentifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable. Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

15-203 Indirect Costs.

15-203.1 General. (a) Indirect costs are those items of cost which cannot be specifically identified with any one objective, service, program or project of the contractor. Indirect costs are accumulated for accounting purposes by logical cost groupings and are charged to all work of the contractor by a process of allocation . Each element of indirect cost is subject to the limitations of this Part as to allowability.

(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, be applied

consistently, and produce equitable results. Any significant change in the nature of the business, the extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, the contractor's products, or other factors may require reconsideration of the method previously used. Individual elements of indirect cost are discussed in ASPR 15-203.2 through 15-203.5.

(c) The base period for allocation of indirect costs shall be representative of the period of contract performance and shall be sufficiently long to avoid inequities in the allocation of costs, but in no event longer than the contractor's fiscal year.

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 and which cannot be specifically identified with any one objective, service, program, or project in accordance with ASPR 15-202. 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 overtime premium), units processed, and prime costs of units processed. The contractor may departmentalize or establish cost centers, in order to allocate the indirect costs equitably. Factors to be considered in determining the propriety of 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. Indirect engineering costs include costs of engineering supervision, engineering administration, and engineering supplies, and other related costs, which cannot be specifically identified with any one objective service, program, or project in accordance with ASPR 15-202. These costs arise out of engineering activities such as 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(v)(4)) on the basis of direct engineering man-hours expended, direct engineering labor dollars (exclusive of overtime, extra-pay shift, and multi-shift premium), or some other equitable basis.

15-203.4 Selling and Distribution Costs. Selling and distribution costs arise through marketing the contractor's products and include sales promotion, advertising, and distribution costs, and other related costs. Generally, such

costs are not considered to be 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.

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. Any recognized method of allocating general and administrative costs is acceptable if equitable results are thereby obtained. Factors to be considered in determining whether the results are equitable include:

(i) the ratio of each of the several cost components to the total cost of the contract, exclusive of general and administrative costs, compared to the corresponding ratios for the contractor's entire business;

(ii) the ultimate objective of distributing general and administrative costs consistently with the general and administrative effort involved in each element of the contractor's business;

(iii) any significant variations of inventories between accounting periods;

(iv) variations in the ratio of the contract inventory levels to all other inventory levels; and

(v) other relevant factors including those mentioned in ASPR 15-203.1(b).

15-204 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below, and apply whether the particular item of cost is treated by the contractor as direct cost or as indirect

cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

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. Only 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 (t) below.

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

(c) Cafeteria, Dining Room, and Other 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 to costs of all production within the contractor's plant in which the services are furnished. Reasonable losses of operation from such services are allowable when it is the policy of the contractor to operate such services at no loss or profit; provided, however, that any gains or losses from these services must be appropriately allocated to all activities benefited, including Government contracts. 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.

(d) Civil Defense Costs. Civil defense costs are those incurred in the planning for, and the protection of life and property against, the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by State and local civil defense authorities. 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 over a reasonable number of years in conformity with generally accepted accounting principles. Except as specifically provided for in the contract, contributions to local civil defense funds or projects not on the contractor's premises are unallowable.

(e) Compensation for Personal Services. (Reserved)

(f) Contributions and Donations. Reasonable contributions and donations to established nonprofit charitable, scientific, and educational organizations are allowable if they are deductible for Federal income tax purposes; provided that such deductibility does not in itself justify allowance as a contract cost. The reasonableness 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. Allowable contributions and donations shall be allocated to all work of the contractor.

(g) Depreciation.

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

(2) Depreciation on a contractor's plant, equipment, and other capital facilities is an allowable element of contract cost; provided that the amount thereof is based upon original acquisition cost. Depreciation shall be accounted for by consistent application to the assets concerned of any generally accepted accounting principles, including those recognized by Section 167 of the Internal Revenue Code of 1954, and should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives set forth in (1) above, vary with volume of production or use of multi-shift operations.

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

(4) Where the contractor has applied for, received, and accepted a determination of "true depreciation" from an Emergency Facilities Board covering an emergency facility acquired under a certificate of necessity, the amount so determined for "true depreciation" over the emergency period (5 years) shall be recognized in lieu of normal depreciation. The contractor may elect to use normal depreciation rather than "true depreciation" as determined by the Emergency Facilities Board; however, the method chosen after such determination of "true depreciation" must be followed consistently throughout the life of the emergency facility. The undepreciated cost of the emergency facility remaining after the expiration of the emergency period shall be depreciated over its remaining useful life and shall be the only amount recognized as allowable cost (but see paragraph 15-204.3(d). The remaining undepreciated cost shall not include any amount of unrecovered "true depreciation" (or normal depreciation if the contractor has elected not to use "true depreciation") allowable during the emergency period.

(5) Unless otherwise provided for in the contract, no use charge shall be allowed for assets still in use which, in accordance with the contractor's consistent accounting practice, have or should have been fully depreciated on the contractor's books.

(h) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(i) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor which constitutes, in effect, an implied agreement on the contractor's part (but see (e) above, and (j)(3)(v), (q) and (y) below.)

(j) Insurance and Indemnification.

(1) Insurance and indemnification include (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative (see ASPR 10-501 for kinds of insurance ordinarily required), (ii) any other insurance for which the contractor seeks reimbursement under the contract, and (iii) liabilities to third persons not compensated by insurance or otherwise.

(2) Costs of insurance required or approved, and maintained pursuant to the clause in ASPR 7-203.22 are allowable.

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

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

(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 unallowable except to the extent that the Government shall have approved or required such insurance or reserve;

(iv) costs of a reserve for a self-insurance program are unallowable unless the program has been approved by the military department concerned; and

(v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(4) The Government is only obligated to indemnify the contractor to the extent expressly provided in the contract (for example, see ASPR 7-203.22). Therefore, except as otherwise expressly provided in the contract, actual losses not reimbursed by insurance (through an approved self-insurance program or otherwise) are unallowable.

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

(l) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable. Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis. Costs of maintenance and repair of excess facilities and of idle facilities (other than reasonable standby facilities) are unallowable.

(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 shall not be allowed as a cost unless specifically provided for in the contract.

(m) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

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

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

of simplifying production;

are allowable.

(n) Material and Supply Costs.

(1) The net costs of such items as raw material, parts, sub-assemblies components, and manufacturing supplies, whether purchased or manufactured by the contractor, and such collateral items as inbound transportation and in-transit insurance, are allowable, subject, however, to (2) through (6) below. In computing costs of material, consideration will be given to reasonable over-runs, spoilage, or defective work (as to defective work, see paragraph (c) of the inspection clause in ASPR 7-203.5).

(2) Costs of material and supplies 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 and supplies returned to vendors. Such income and other credits shall either be credited directly to cost of the material or supplies 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 shall 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.

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

(6) Costs of material, services, or supplies, sold or transferred between plants, divisions, or organizations, under common control, shall be allowable only to the extent of the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is lower; 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 either (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.

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees may be classified as either direct or indirect labor costs, but the amount of such premiums shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government (see ASPR 12-102 for further information concerning the policy regarding such authorization). When direct labor cost is the base for distribution of overhead, the premium portion of overtime payments shall not be included in that base. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work. When such premium costs are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs.

(p) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. 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 by the Government, are allowable. Costs of research and development work are treated in (v) below. (See also (w) below.)

(q) Pension Plans.

(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, either the 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 (q).)

(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 plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P.L. 591, 83rd Cong., 2d 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 are allowable subject to the following conditions:

(i) such costs shall meet the requirements of ASPR 15-201.2;

(ii) such costs, including excess contributions (see Section 404(a)(1)(D) of the Internal Revenue Code of 1954), are allowable only to the extent —

(A) such costs are claimed and deductible for Federal income tax purposes in the current taxable period; or

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

4. The Editing Subcommittee submits herewith an edited draft of Part 2, Section XV, in accordance with the assignment of the ASPR Committee (see Minutes of Meeting of 13 December 1955, Item 4). This draft has the concurrence of the Editing Subcommittee with the reservation that it is anticipated that several points will require brief discussion when the matter is considered by the ASPR Committee.

5. The Editing Committee invites attention of the ASPR Committee to paragraphs 4 and 5 of its report of February 27, 1956, as matters for its further consideration. In connection with the matter of "side" agreements referred to in paragraph 4 of said report, members of the Section XV Subcommittee have furnished information to the joint Subcommittees to the effect that this matter was the subject of a policy determination by the Procurement Secretaries in the early part of 1955.

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For the above reason the joint subcommittees requested the technical assistance of the Internal Revenue Service. The Chairman of the Editing Subcommittee made arrangements to contact W. G. Shreve, Acting Head, Pension Trust Section, Internal Revenue Service, and he in turn arranged for Mr. J. F. Heathcote, Technical Assistant, to attend the joint meeting of March 6, 1956, and advise the subcommittees in their consideration of the problem. This assistance has been invaluable and is gratefully acknowledged; without it, the joint subcommittees would have been required to spend a much longer time at this task.

From information furnished as a result of the above contacts, it appears that the problem starts with the inferences that can be drawn from the present ASPR 15-601.2(b) that certain pension plans must be submitted for prior approval by the Internal Revenue Service but that plans of tax-exempt organizations are not subject to any approval. Actually, no pension plans are necessarily required to be approved at all although the plans of tax-exempt organizations as well as those of organizations subject to taxation are subject to approval at some time. In the case of the latter, the review would most usually come about as a result of the employer's deduction for tax purposes of its contributions to a pension plan and would occur at the time of auditing income tax returns within three years after filing. However, this does not always occur. In the case of tax-exempt organizations, the chief effect of approval or disapproval is on the tax liability of the employee beneficiary; this may vary depending on whether the plan is "qualified" or not. To clarify this question, plans of tax-exempt organizations are often submitted for approval in advance. If not so submitted, the matter of tax liability does not usually come under scrutiny until the employee beneficiary begins receiving benefits.

Following extensive discussion, the joint subcommittees agreed in principle on a draft dealing with this problem. An edited version of this material is set forth in TAB B, as subparagraphs (2) and (3)(i) through (iii) of proposed ASPR 15-204.2(q).

3. Except for the single dissent mentioned above with respect to paragraph 2.C.1., the recommendations set forth in the foregoing paragraph have had the concurrence of the Editing Subcommittee and the Section XV Subcommittee. Subsequent to action by the joint subcommittees on the problems discussed in paragraphs 2.A. and 2.B., Mr. Paul Southwell, Air Force procurement member of the Section XV Subcommittee, submitted the memorandum attached as TAB A. Owing to the limited time for submitting this report, it has not been possible to have the members of the joint subcommittees give advance consideration to this report or the edited draft of the paragraph covering the ~~cases~~ costs of Pension Plans (Proposed ASPR 15-204.2(q), TAB B attached).

decided to treat subparagraphs (3)(iii)(A) and (3)(iii)(B) of proposed ASPR 15-204.2(q) in the disjunctive rather than the conjunction by deleting the "and" and retaining the "or" between them.

It appeared that some of the original concern of the Army and Air Force members to the disjunctive treatment was associated with the matter of credits or gains arising out of "normal" employee turnover which the Section XV Subcommittee had not intended to include under the paragraph in question. To clarify this point, a specific reference to credits or gains arising out of "normal employee turnover" is made in the redraft of subparagraph (3)(iii)(A) (appearing as (3)(iv)(A) in TAB B.

To satisfy another concern of the Army and Air Force members of the Editing Subcommittee, this provision also provides that, where future credits for abnormal terminations are accounted for by a discount of, or an actuarial recognition in, current costs, the appropriate adjustment "shall be reflected in the contract, in an amendment thereto, or some other writing binding on the Government and the contractor." In regard to the words "some other writing binding on the Government and the contractor", the Editing Subcommittee does not intend that a formal agreement must be entered into or that any action by a Contracting Officer is necessarily required. It is merely intended to require that the Departmental activity authorized to determine costs and incidental credits reach a definitive written understanding with the contractor, by exchange of memoranda, correspondence, or otherwise, which will not leave the question whether the credits have been received by the Government, open to speculation, conjecture, or surmise.

The joint subcommittees agreed in principle (Mr. Cox, one of three Air Force representatives, being the sole dissenter) on treating this problem in the manner set forth in TAB B as proposed ASPR 15-204.2(q)(3)(iv) which is an edited version subsequently prepared by the Editing Subcommittee.

II. The Problem of Consistency, with Part 6, Section XV

Following submission of the report of February 27, 1956, the Army member of the Editing Subcommittee contacted the Internal Revenue Service and learned that the present Part 6, Section XV, as well as the draft submitted for editing were open to misinterpretation with respect to the matter of approval of pension plans by Internal Revenue Service.

OGC/GWM:lwt March 9, 1956

Part 2 -- Supply Contracts, and Service and Research and Development Contracts with Organizations Having Commercial Type Accounting Systems

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 the procurement of supplies, services, and research and development work. However, this Part does not apply to contracts for services or research and development work with contractors or subcontractors which do not have commercial type accounting systems, or for facilities, construction, or architect-engineer services related to construction.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (i) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

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

15-201.3 Credits. The applicable income, rebates, allowances, and other credits received by or accruing to the contractor which are related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

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 (ASPR 7-203.7).

15-202 Direct Costs.

15-202.1 General. Direct costs are those items of cost which can be specifically identified with any objective, service, program, or project of the contractor and are chargeable directly thereto. Allowability of direct costs shall be determined pursuant to ASPR 15-201.2. Major items of cost such as freight, travel, communications, engineering services, etc., as well as the costs of materials and productive labor, should be charged directly to (i) a contract, or (ii) other work of the contractor, with which they are readily

identifiable. When the contractor is engaged in both defense and non-defense production or services, this principle must be applied consistently to both. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect costs.

15-202.2 Direct Material Costs. Direct material costs include the cost of all purchased items and items manufactured independently of a contract, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract. Direct material costs of reasonable overruns, spoilage, and defective work may also be included; but, as to defective work, see paragraph (c) of the inspection clause in ASPR 7-203.5.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically indentifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable. Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

15-203 Indirect Costs.

15-203.1 General. (a) Indirect costs are those items of cost which cannot be specifically identified with any one objective, service, program or project of the contractor. Indirect costs are accumulated for accounting purposes by logical cost groupings and are charged to all work of the contractor by a process of allocation . Each element of indirect cost is subject to the limitations of this Part as to allowability.

(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, be applied

consistently, and produce equitable results. Any significant change in the nature of the business, the extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, the contractor's products, or other factors may require reconsideration of the method previously used. Individual elements of indirect cost are discussed in ASPR 15-203.2 through 15-203.5.

(c) The base period for allocation of indirect costs shall be representative of the period of contract performance and shall be sufficiently long to avoid inequities in the allocation of costs, but in no event longer than the contractor's fiscal year.

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 and which cannot be specifically identified with any one objective, service, program, or project in accordance with ASPR 15-202. 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 overtime premium), units processed, and prime costs of units processed. The contractor may departmentalize or establish cost centers, in order to allocate the indirect costs equitably. Factors to be considered in determining the propriety of 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. Indirect engineering costs include costs of engineering supervision, engineering administration, and engineering supplies, and other related costs, which cannot be specifically identified with any one objective service, program, or project in accordance with ASPR 15-202. These costs arise out of engineering activities such as 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(v)(4)) on the basis of direct engineering man-hours expended, direct engineering labor dollars (exclusive of overtime, extra-pay shift, and multi-shift premium), or some other equitable basis.

15-203.4 Selling and Distribution Costs. Selling and distribution costs arise through marketing the contractor's products and include sales promotion, advertising, and distribution costs, and other related costs. Generally, such

costs are not considered to be 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.

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. Any recognized method of allocating general and administrative costs is acceptable if equitable results are thereby obtained. Factors to be considered in determining whether the results are equitable include:

(i) the ratio of each of the several cost components to the total cost of the contract, exclusive of general and administrative costs, compared to the corresponding ratios for the contractor's entire business;

(ii) the ultimate objective of distributing general and administrative costs consistently with the general and administrative effort involved in each element of the contractor's business;

(iii) any significant variations of inventories between accounting periods;

(iv) variations in the ratio of the contract inventory levels to all other inventory levels; and

(v) other relevant factors including those mentioned in ASPR 15-203.1(b).

15-204 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below, and apply whether the particular item of cost is treated by the contractor as direct cost or as indirect

cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

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. Only 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 (t) below.

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

(c) Cafeteria, Dining Room, and Other 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 to costs of all production within the contractor's plant in which the services are furnished. Reasonable losses of operation from such services are allowable when it is the policy of the contractor to operate such services at no loss or profit; provided, however, that any gains or losses from these services must be appropriately allocated to all activities benefited, including Government contracts. 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.

(d) Civil Defense Costs. Civil defense costs are those incurred in the planning for, and the protection of life and property against, the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by State and local civil defense authorities. 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 over a reasonable number of years in conformity with generally accepted accounting principles. Except as specifically provided for in the contract, contributions to local civil defense funds or projects not on the contractor's premises are unallowable.

(e) Compensation for Personal Services. (Reserved)

(f) Contributions and Donations. Reasonable contributions and donations to established nonprofit charitable, scientific, and educational organizations are allowable if they are deductible for Federal income tax purposes; provided that such deductibility does not in itself justify allowance as a contract cost. The reasonableness 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. Allowable contributions and donations shall be allocated to all work of the contractor.

(g) Depreciation.

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

(2) Depreciation on a contractor's plant, equipment, and other capital facilities is an allowable element of contract cost; provided that the amount thereof is based upon original acquisition cost. Depreciation shall be accounted for by consistent application to the assets concerned of any generally accepted accounting principles, including those recognized by Section 167 of the Internal Revenue Code of 1954, and should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives set forth in (1) above, vary with volume of production or use of multi-shift operations.

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

(4) Where the contractor has applied for, received, and accepted a determination of "true depreciation" from an Emergency Facilities Board covering an emergency facility acquired under a certificate of necessity, the amount so determined for "true depreciation" over the emergency period (5 years) shall be recognized in lieu of normal depreciation. The contractor may elect to use normal depreciation rather than "true depreciation" as determined by the Emergency Facilities Board; however, the method chosen after such determination of "true depreciation" must be followed consistently throughout the life of the emergency facility. The undepreciated cost of the emergency facility remaining after the expiration of the emergency period shall be depreciated over its remaining useful life and shall be the only amount recognized as allowable cost (but see paragraph 15-204.3(d). The remaining undepreciated cost shall not include any amount of unrecovered "true depreciation" (or normal depreciation if the contractor has elected not to use "true depreciation") allowable during the emergency period.

(5) Unless otherwise provided for in the contract, no use charge shall be allowed for assets still in use which, in accordance with the contractor's consistent accounting practice, have or should have been fully depreciated on the contractor's books.

(h) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(i) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor which constitutes, in effect, an implied agreement on the contractor's part (but see (e) above, and (j)(3)(v), (q) and (y) below.)

(j) Insurance and Indemnification.

(1) Insurance and indemnification include (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative (see ASPR 10-501 for kinds of insurance ordinarily required), (ii) any other insurance for which the contractor seeks reimbursement under the contract, and (iii) liabilities to third persons not compensated by insurance or otherwise.

(2) Costs of insurance required or approved, and maintained pursuant to the clause in ASPR 7-203.22 are allowable.

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

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

(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 unallowable except to the extent that the Government shall have approved or required such insurance or reserve;

(iv) costs of a reserve for a self-insurance program are unallowable unless the program has been approved by the military department concerned; and

(v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(4) The Government is only obligated to indemnify the contractor to the extent expressly provided in the contract (for example, see ASPR 7-203.22). Therefore, except as otherwise expressly provided in the contract, actual losses not reimbursed by insurance (through an approved self-insurance program or otherwise) are unallowable.

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

(l) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable. Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis. Costs of maintenance and repair of excess facilities and of idle facilities (other than reasonable standby facilities) are unallowable.

(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 shall not be allowed as a cost unless specifically provided for in the contract.

(m) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

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

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

of simplifying production;

are allowable.

(n) Material and Supply Costs.

(1) The net costs of such items as raw material, parts, sub-assemblies components, and manufacturing supplies, whether purchased or manufactured by the contractor, and such collateral items as inbound transportation and in-transit insurance, are allowable, subject, however, to (2) through (6) below. In computing costs of material, consideration will be given to reasonable over-runs, spoilage, or defective work (as to defective work, see paragraph (c) of the inspection clause in ASPR 7-203.5).

(2) Costs of material and supplies 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 and supplies returned to vendors. Such income and other credits shall either be credited directly to cost of the material or supplies 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 shall 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.

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

(6) Costs of material, services, or supplies, sold or transferred between plants, divisions, or organizations, under common control, shall be allowable only to the extent of the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is lower; 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 either (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.

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees may be classified as either direct or indirect labor costs, but the amount of such premiums shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government (see ASPR 12-102 for further information concerning the policy regarding such authorization). When direct labor cost is the base for distribution of overhead, the premium portion of overtime payments shall not be included in that base. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work. When such premium costs are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs.

(p) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. 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 by the Government, are allowable. Costs of research and development work are treated in (v) below. (See also (w) below.)

(q) Pension Plans.

(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, either the 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 (q).)

(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 plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P.L. 591, 83rd Cong., 2d 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 are allowable subject to the following conditions:

(i) such costs shall meet the requirements of ASPR 15-201.2;

(ii) such costs, including excess contributions (see Section 404(a)(1)(D) of the Internal Revenue Code of 1954), are allowable only to the extent —

(A) such costs are claimed and deductible for Federal income tax purposes in the current taxable period; or

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

(iii) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall be made for contributions which previously have been allocated to and allowed as contract costs and which are —

(A) disallowed for tax purposes; or

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

(iv) in determining the net 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 —

(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 adjustment shall be reflected in the contract, in an amendment thereto, or some other writing binding on the Government and the contractor; or

(B) when such abnormal termination credits or gains, whether or not foreseeable, cannot be currently evaluated with reasonable accuracy, or have not been the subject of adjustment under (A) above, pension plan costs incurred under the contract shall be subject to

(iii) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall be made for contributions which previously have been allocated to and allowed as contract costs and which are —

(A) disallowed for tax purposes; or

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

(iv) in determining the net 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 —

(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 adjustment shall be reflected in the contract, in an amendment thereto, or some other writing binding on the Government and the contractor; or

(B) when such abnormal termination credits or gains, whether or not foreseeable, cannot be currently evaluated with reasonable accuracy, or have not been the subject of adjustment under (A) above, pension plan costs incurred under the contract shall be subject to

4. The Editing Subcommittee submits herewith an edited draft of Part 2, Section XV, in accordance with the assignment of the ASPR Committee (see Minutes of Meeting of 13 December 1955, Item 4). This draft has the concurrence of the Editing Subcommittee with the reservation that it is anticipated that several points will require brief discussion when the matter is considered by the ASPR Committee.

5. The Editing Committee invites attention of the ASPR Committee to paragraphs 4 and 5 of its report of February 27, 1956, as matters for its further consideration. In connection with the matter of "side" agreements referred to in paragraph 4 of said report, members of the Section XV Subcommittee have furnished information to the joint Subcommittees to the effect that this matter was the subject of a policy determination by the Procurement Secretaries in the early part of 1955.

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CHARLES W. WILKINSON
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Arthur Cox, AMC, Dayton

For the above reason the joint subcommittees requested the technical assistance of the Internal Revenue Service. The Chairman of the Editing Subcommittee made arrangements to contact W. G. Shreve, Acting Head, Pension Trust Section, Internal Revenue Service, and he in turn arranged for Mr. J. F. Heathcote, Technical Assistant, to attend the joint meeting of March 6, 1956, and advise the subcommittees in their consideration of the problem. This assistance has been invaluable and is gratefully acknowledged; without it, the joint subcommittees would have been required to spend a much longer time at this task.

From information furnished as a result of the above contacts, it appears that the problem starts with the inferences that can be drawn from the present ASPR 15-601.2(b) that certain pension plans must be submitted for prior approval by the Internal Revenue Service but that plans of tax-exempt organizations are not subject to any approval. Actually, no pension plans are necessarily required to be approved at all although the plans of tax-exempt organizations as well as those of organizations subject to taxation are subject to approval at some time. In the case of the latter, the review would most usually come about as a result of the employer's deduction for tax purposes of its contributions to a pension plan and would occur at the time of auditing income tax returns within three years after filing. However, this does not always occur. In the case of tax-exempt organizations, the chief effect of approval or disapproval is on the tax liability of the employee beneficiary; this may vary depending on whether the plan is "qualified" or not. To clarify this question, plans of tax-exempt organizations are often submitted for approval in advance. If not so submitted, the matter of tax liability does not usually come under scrutiny until the employee beneficiary begins receiving benefits.

Following extensive discussion, the joint subcommittees agreed in principle on a draft dealing with this problem. An edited version of this material is set forth in TAB B, as subparagraphs (2) and (3)(i) through (iii) of proposed ASPR 15-204.2(q).

3. Except for the single dissent mentioned above with respect to paragraph 2.C.1., the recommendations set forth in the foregoing paragraph have had the concurrence of the Editing Subcommittee and the Section XV Subcommittee. Subsequent to action by the joint subcommittees on the problems discussed in paragraphs 2.A. and 2.B., Mr. Paul Southwell, Air Force procurement member of the Section XV Subcommittee, submitted the memorandum attached as TAB A. Owing to the limited time for submitting this report, it has not been possible to have the members of the joint subcommittees give advance consideration to this report or the edited draft of the paragraph covering the ~~cases~~ costs of Pension Plans (Proposed ASPR 15-204.2(q), TAB B attached).

decided to treat subparagraphs (3)(iii)(A) and (3)(iii)(B) of proposed ASPR 15-204.2(q) in the disjunctive rather than the conjunction by deleting the "and" and retaining the "or" between them.

It appeared that some of the original concern of the Army and Air Force members to the disjunctive treatment was associated with the matter of credits or gains arising out of "normal" employee turnover which the Section XV Subcommittee had not intended to include under the paragraph in question. To clarify this point, a specific reference to credits or gains arising out of "normal employee turnover" is made in the redraft of subparagraph (3)(iii)(A) (appearing as (3)(iv)(A) in TAB B.

To satisfy another concern of the Army and Air Force members of the Editing Subcommittee, this provision also provides that, where future credits for abnormal terminations are accounted for by a discount of, or an actuarial recognition in, current costs, the appropriate adjustment "shall be reflected in the contract, in an amendment thereto, or some other writing binding on the Government and the contractor." In regard to the words "some other writing binding on the Government and the contractor", the Editing Subcommittee does not intend that a formal agreement must be entered into or that any action by a Contracting Officer is necessarily required. It is merely intended to require that the Departmental activity authorized to determine costs and incidental credits reach a definitive written understanding with the contractor, by exchange of memoranda, correspondence, or otherwise, which will not leave the question whether the credits have been received by the Government, open to speculation, conjecture, or surmise.

The joint subcommittees agreed in principle (Mr. Cox, one of three Air Force representatives, being the sole dissenter) on treating this problem in the manner set forth in TAB B as proposed ASPR 15-204.2(q)(3)(iv) which is an edited version subsequently prepared by the Editing Subcommittee.

II. The Problem of Consistency, with Part 6, Section XV

Following submission of the report of February 27, 1956, the Army member of the Editing Subcommittee contacted the Internal Revenue Service and learned that the present Part 6, Section XV, as well as the draft submitted for editing were open to misinterpretation with respect to the matter of approval of pension plans by Internal Revenue Service.

OGC/GWM:lwt March 9, 1956

Part 2 -- Supply Contracts, and Service and Research and Development Contracts with Organizations Having Commercial Type Accounting Systems

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 the procurement of supplies, services, and research and development work. However, this Part does not apply to contracts for services or research and development work with contractors or subcontractors which do not have commercial type accounting systems, or for facilities, construction, or architect-engineer services related to construction.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (i) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

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

15-201.3 Credits. The applicable income, rebates, allowances, and other credits received by or accruing to the contractor which are related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

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 (ASPR 7-203.7).

15-202 Direct Costs.

15-202.1 General. Direct costs are those items of cost which can be specifically identified with any objective, service, program, or project of the contractor and are chargeable directly thereto. Allowability of direct costs shall be determined pursuant to ASPR 15-201.2. Major items of cost such as freight, travel, communications, engineering services, etc., as well as the costs of materials and productive labor, should be charged directly to (i) a contract, or (ii) other work of the contractor, with which they are readily

identifiable. When the contractor is engaged in both defense and non-defense production or services, this principle must be applied consistently to both. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect costs.

15-202.2 Direct Material Costs. Direct material costs include the cost of all purchased items and items manufactured independently of a contract, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract. Direct material costs of reasonable overruns, spoilage, and defective work may also be included; but, as to defective work, see paragraph (c) of the inspection clause in ASPR 7-203.5.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically indentifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable. Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

15-203 Indirect Costs.

15-203.1 General. (a) Indirect costs are those items of cost which cannot be specifically identified with any one objective, service, program or project of the contractor. Indirect costs are accumulated for accounting purposes by logical cost groupings and are charged to all work of the contractor by a process of allocation . Each element of indirect cost is subject to the limitations of this Part as to allowability.

(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, be applied

consistently, and produce equitable results. Any significant change in the nature of the business, the extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, the contractor's products, or other factors may require reconsideration of the method previously used. Individual elements of indirect cost are discussed in ASPR 15-203.2 through 15-203.5.

(c) The base period for allocation of indirect costs shall be representative of the period of contract performance and shall be sufficiently long to avoid inequities in the allocation of costs, but in no event longer than the contractor's fiscal year.

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 and which cannot be specifically identified with any one objective, service, program, or project in accordance with ASPR 15-202. 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 overtime premium), units processed, and prime costs of units processed. The contractor may departmentalize or establish cost centers, in order to allocate the indirect costs equitably. Factors to be considered in determining the propriety of 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. Indirect engineering costs include costs of engineering supervision, engineering administration, and engineering supplies, and other related costs, which cannot be specifically identified with any one objective service, program, or project in accordance with ASPR 15-202. These costs arise out of engineering activities such as 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(v)(4)) on the basis of direct engineering man-hours expended, direct engineering labor dollars (exclusive of overtime, extra-pay shift, and multi-shift premium), or some other equitable basis.

15-203.4 Selling and Distribution Costs. Selling and distribution costs arise through marketing the contractor's products and include sales promotion, advertising, and distribution costs, and other related costs. Generally, such

costs are not considered to be 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.

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. Any recognized method of allocating general and administrative costs is acceptable if equitable results are thereby obtained. Factors to be considered in determining whether the results are equitable include:

(i) the ratio of each of the several cost components to the total cost of the contract, exclusive of general and administrative costs, compared to the corresponding ratios for the contractor's entire business;

(ii) the ultimate objective of distributing general and administrative costs consistently with the general and administrative effort involved in each element of the contractor's business;

(iii) any significant variations of inventories between accounting periods;

(iv) variations in the ratio of the contract inventory levels to all other inventory levels; and

(v) other relevant factors including those mentioned in ASPR 15-203.1(b).

15-204 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below, and apply whether the particular item of cost is treated by the contractor as direct cost or as indirect

cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

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. Only 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 (t) below.

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

(c) Cafeteria, Dining Room, and Other 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 to costs of all production within the contractor's plant in which the services are furnished. Reasonable losses of operation from such services are allowable when it is the policy of the contractor to operate such services at no loss or profit; provided, however, that any gains or losses from these services must be appropriately allocated to all activities benefited, including Government contracts. 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.

(d) Civil Defense Costs. Civil defense costs are those incurred in the planning for, and the protection of life and property against, the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by State and local civil defense authorities. 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 over a reasonable number of years in conformity with generally accepted accounting principles. Except as specifically provided for in the contract, contributions to local civil defense funds or projects not on the contractor's premises are unallowable.

(e) Compensation for Personal Services. (Reserved)

(f) Contributions and Donations. Reasonable contributions and donations to established nonprofit charitable, scientific, and educational organizations are allowable if they are deductible for Federal income tax purposes; provided that such deductibility does not in itself justify allowance as a contract cost. The reasonableness 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. Allowable contributions and donations shall be allocated to all work of the contractor.

(g) Depreciation.

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

(2) Depreciation on a contractor's plant, equipment, and other capital facilities is an allowable element of contract cost; provided that the amount thereof is based upon original acquisition cost. Depreciation shall be accounted for by consistent application to the assets concerned of any generally accepted accounting principles, including those recognized by Section 167 of the Internal Revenue Code of 1954, and should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives set forth in (1) above, vary with volume of production or use of multi-shift operations.

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

(4) Where the contractor has applied for, received, and accepted a determination of "true depreciation" from an Emergency Facilities Board covering an emergency facility acquired under a certificate of necessity, the amount so determined for "true depreciation" over the emergency period (5 years) shall be recognized in lieu of normal depreciation. The contractor may elect to use normal depreciation rather than "true depreciation" as determined by the Emergency Facilities Board; however, the method chosen after such determination of "true depreciation" must be followed consistently throughout the life of the emergency facility. The undepreciated cost of the emergency facility remaining after the expiration of the emergency period shall be depreciated over its remaining useful life and shall be the only amount recognized as allowable cost (but see paragraph 15-204.3(d). The remaining undepreciated cost shall not include any amount of unrecovered "true depreciation" (or normal depreciation if the contractor has elected not to use "true depreciation") allowable during the emergency period.

(5) Unless otherwise provided for in the contract, no use charge shall be allowed for assets still in use which, in accordance with the contractor's consistent accounting practice, have or should have been fully depreciated on the contractor's books.

(h) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(i) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor which constitutes, in effect, an implied agreement on the contractor's part (but see (e) above, and (j)(3)(v), (q) and (y) below.)

(j) Insurance and Indemnification.

(1) Insurance and indemnification include (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative (see ASPR 10-501 for kinds of insurance ordinarily required), (ii) any other insurance for which the contractor seeks reimbursement under the contract, and (iii) liabilities to third persons not compensated by insurance or otherwise.

(2) Costs of insurance required or approved, and maintained pursuant to the clause in ASPR 7-203.22 are allowable.

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

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

(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 unallowable except to the extent that the Government shall have approved or required such insurance or reserve;

(iv) costs of a reserve for a self-insurance program are unallowable unless the program has been approved by the military department concerned; and

(v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(4) The Government is only obligated to indemnify the contractor to the extent expressly provided in the contract (for example, see ASPR 7-203.22). Therefore, except as otherwise expressly provided in the contract, actual losses not reimbursed by insurance (through an approved self-insurance program or otherwise) are unallowable.

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

(l) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable. Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis. Costs of maintenance and repair of excess facilities and of idle facilities (other than reasonable standby facilities) are unallowable.

(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 shall not be allowed as a cost unless specifically provided for in the contract.

(m) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

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

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

of simplifying production;

are allowable.

(n) Material and Supply Costs.

(1) The net costs of such items as raw material, parts, sub-assemblies components, and manufacturing supplies, whether purchased or manufactured by the contractor, and such collateral items as inbound transportation and in-transit insurance, are allowable, subject, however, to (2) through (6) below. In computing costs of material, consideration will be given to reasonable over-runs, spoilage, or defective work (as to defective work, see paragraph (c) of the inspection clause in ASPR 7-203.5).

(2) Costs of material and supplies 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 and supplies returned to vendors. Such income and other credits shall either be credited directly to cost of the material or supplies 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 shall 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.

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

(6) Costs of material, services, or supplies, sold or transferred between plants, divisions, or organizations, under common control, shall be allowable only to the extent of the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is lower; 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 either (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.

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees may be classified as either direct or indirect labor costs, but the amount of such premiums shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government (see ASPR 12-102 for further information concerning the policy regarding such authorization). When direct labor cost is the base for distribution of overhead, the premium portion of overtime payments shall not be included in that base. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work. When such premium costs are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs.

(p) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. 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 by the Government, are allowable. Costs of research and development work are treated in (v) below. (See also (w) below.)

(q) Pension Plans.

(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, either the 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 (q).)

(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 plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P.L. 591, 83rd Cong., 2d 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 are allowable subject to the following conditions:

(i) such costs shall meet the requirements of ASPR 15-201.2;

(ii) such costs, including excess contributions (see Section 404(a)(1)(D) of the Internal Revenue Code of 1954), are allowable only to the extent —

(A) such costs are claimed and deductible for Federal income tax purposes in the current taxable period; or

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

(iii) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall be made for contributions which previously have been allocated to and allowed as contract costs and which are —

(A) disallowed for tax purposes; or

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

(iv) in determining the net 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 —

(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 adjustment shall be reflected in the contract, in an amendment thereto, or some other writing binding on the Government and the contractor; or

(B) when such abnormal termination credits or gains, whether or not foreseeable, cannot be currently evaluated with reasonable accuracy, or have not been the subject of adjustment under (A) above, pension plan costs incurred under the contract shall be subject to

(iii) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall be made for contributions which previously have been allocated to and allowed as contract costs and which are —

(A) disallowed for tax purposes; or

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

(iv) in determining the net 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 —

(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 adjustment shall be reflected in the contract, in an amendment thereto, or some other writing binding on the Government and the contractor; or

(B) when such abnormal termination credits or gains, whether or not foreseeable, cannot be currently evaluated with reasonable accuracy, or 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 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.

(r) Plant Protection Costs. Costs of wages, uniforms, and equipment of personnel engaged in plant protection; supplies; depreciation on plant protection capital assets; and necessary expenses to comply with military security requirements are allowable.

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

(1) Costs of professional services rendered by the members of a particular profession separately engaged by the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(f)).

(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 organization; and

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

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

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

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

(u) 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 the type, condition, and value of the facilities leased, options available, and other provisions of the rental agreement.

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

by the lessor, which would have been incurred had the contractor retained legal title to the facilities.

(v) Research and Development Costs.

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

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable to the extent specifically provided in the contract. Generally, the contractor shall be required to disclose to the Government the purposes and results of such independent general research. In specifically providing for such costs, factors to be considered include:

(i) scope, nature, and quality of the contractor's independent general research program;

(ii) capability of the contractor in the particular research field;

(iii) benefits which may accrue to the Government;

(iv) comparison of size and cost of contractor's previous years' independent research programs; and

(v) proportion of Government business to contractor's total business.

(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 ASPR 15-204.2(m)). 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 is related to the contract product

line and the costs are allocated to all production work of the contractor on the contract product line. Such research 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 research 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 allowable as precontract costs (see ASPR 15-204.3(i)).

(w) Royalties and Other Costs for Use of Patents. 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 are unallowable unless expressly set forth in the contract.

(x) Service and Installation Costs. Costs of servicing the product installation, and training Government personnel in the use, maintenance, and operation of the product are allowable.

(y) Severance Pay.

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

(2) For contract costing purposes, severance pay is divided into two categories as follows:

(i) Costs of normal turnover severance payments shall be allocated to all classes of work being performed in the contractor's plant at the time of payment; however, 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

(ii) costs of abnormal or mass severance pay actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of employment with the contractor and equitably allocated to all business of the contractor performed during that period. A reservation in the final release of claims (see ASPR 7-203.4) may be made in case of completed cost-reimbursement type contracts when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

(z) Special Tooling Costs. The term special tooling means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling, acquired for the performance of Government contracts, are allowable and shall be charged directly to such contracts.

(aa) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(f));

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

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

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

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

(ii) agrees to comply with such instructions; and

(iii) agrees to take all necessary action directed by the contracting officer in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon.

Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are allowable. Reasonable costs of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest, or penalties for the benefit of the Government are also allowable.

(3) Any refund of taxes, interest, or penalties, and any payment to the contractor of interest thereon, attributable to taxes, interest, or penalties which were allowed as contract costs, shall be credited or paid to the Government in the manner directed by the Government.

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

(1) Memberships. Costs of membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(cc) Training Costs. Costs of preparing and maintaining a program of instruction designed to increase the overall effectiveness of employees, including costs of the director of training and staff, training materials, and text

books, and tuition and fees when the training is conducted by educational institutions, are allowable when limited to on the job training and when properly allocated. Costs of training in educational institutions are unallowable, except to the extent specifically provided in the contract.

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

(ee) Travel Costs.

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

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

(3) Travel costs directly attributable to contract performance may be charged directly to the contract.

(4) 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.

(5) Entertainment costs are unallowable.

(6) Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the contracting officer.

(ff) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and

forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

(i) ASPR 15-204.3(e);

(ii) ASPR 15-204.3(i); and

(iii) ASPR 15-204.3(k).

15-204.3 Unallowable Costs.

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

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs see ASPR 204.2(j).)

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

(d) Excess Facility Costs. Costs of maintaining and housing idle and excess facilities, except those reasonably necessary for standby purposes, are unallowable. The costs of excess plant capacity reserved for defense mobilization production shall be the subject of a separate contract.

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

(f) Interest and Other financial Costs. Interest (however represented), bond discounts and costs, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of a prospectus,

costs of preparation and issuance of stock rights, and costs related thereto are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in ASPR 15-204.2(aa) (but see ASPR 15-204.2 (ff)).

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

(h) Organization Costs. Expenditures in connection with organization or reorganization of a business, such as incorporation fees, attorneys fees, accountants fees, fees to promoters and organizers, and costs of raising capital, are unallowable (see (f) above).

(i) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract. (See ASPR 15-1xx.)

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments, shall be excluded in computing contract costs.

(k) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately 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 unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(l) General.

(1) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

(i) ASPR 15-204.2(g)(3);
(ii) ASPR 15-204.2(l)(1), last sentence;
(iii) ASPR 15-204.2(s)(3), first sentence;

(iv) ASPR 15-204.2(t), last sentence;
(v) ASPR 15-204.2(w); first proviso;
(vi) ASPR 15-204.2(aa)(1)(i) through (iv); and
(vii) ASPR 15-204.2(ee)(5)

(2) Certain other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

(i) ASPR 15-204.2(c), last sentence;
(ii) ASPR 15-204.2(d), last sentence;
(iii) ASPR 15-204.2(g)(5);
(iv) ASPR 15-204.2(j)(3)(iii) and (iv), and (4);
(v) ASPR 15-204.2(l)(2);
(vi) ASPR 15-204.2(o), second sentence;
(vii) ASPR 15-204.2(p), second sentence;
(viii) ASPR 15-204.2(s)(3), last sentence;
(ix) ASPR 15-204.2(u)(2);
(x) ASPR 15-204.2(w);
(xi) ASPR 15-204.2(aa)(2);
(xii) ASPR 15-204.2(cc), last sentence; and
(xiii) ASPR 15-204.2(ee)(6)

4. The Editing Subcommittee submits herewith an edited draft of Part 2, Section XV, in accordance with the assignment of the ASPR Committee (see Minutes of Meeting of 13 December 1955, Item 4). This draft has the concurrence of the Editing Subcommittee with the reservation that it is anticipated that several points will require brief discussion when the matter is considered by the ASPR Committee.

5. The Editing Committee invites attention of the ASPR Committee to paragraphs 4 and 5 of its report of February 27, 1956, as matters for its further consideration. In connection with the matter of "side" agreements referred to in paragraph 4 of said report, members of the Section XV Subcommittee have furnished information to the joint Subcommittees to the effect that this matter was the subject of a policy determination by the Procurement Secretaries in the early part of 1955.

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Chairman

CHARLES W. WILKINSON
Lt. Colonel, SS JAG
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For the above reason the joint subcommittees requested the technical assistance of the Internal Revenue Service. The Chairman of the Editing Subcommittee made arrangements to contact W. G. Shreve, Acting Head, Pension Trust Section, Internal Revenue Service, and he in turn arranged for Mr. J. F. Heathcote, Technical Assistant, to attend the joint meeting of March 6, 1956, and advise the subcommittees in their consideration of the problem. This assistance has been invaluable and is gratefully acknowledged; without it, the joint subcommittees would have been required to spend a much longer time at this task.

From information furnished as a result of the above contacts, it appears that the problem starts with the inferences that can be drawn from the present ASPR 15-601.2(b) that certain pension plans must be submitted for prior approval by the Internal Revenue Service but that plans of tax-exempt organizations are not subject to any approval. Actually, no pension plans are necessarily required to be approved at all although the plans of tax-exempt organizations as well as those of organizations subject to taxation are subject to approval at some time. In the case of the latter, the review would most usually come about as a result of the employer's deduction for tax purposes of its contributions to a pension plan and would occur at the time of auditing income tax returns within three years after filing. However, this does not always occur. In the case of tax-exempt organizations, the chief effect of approval or disapproval is on the tax liability of the employee beneficiary; this may vary depending on whether the plan is "qualified" or not. To clarify this question, plans of tax-exempt organizations are often submitted for approval in advance. If not so submitted, the matter of tax liability does not usually come under scrutiny until the employee beneficiary begins receiving benefits.

Following extensive discussion, the joint subcommittees agreed in principle on a draft dealing with this problem. An edited version of this material is set forth in TAB B, as subparagraphs (2) and (3)(i) through (iii) of proposed ASPR 15-204.2(q).

3. Except for the single dissent mentioned above with respect to paragraph 2.C.1., the recommendations set forth in the foregoing paragraph have had the concurrence of the Editing Subcommittee and the Section XV Subcommittee. Subsequent to action by the joint subcommittees on the problems discussed in paragraphs 2.A. and 2.B., Mr. Paul Southwell, Air Force procurement member of the Section XV Subcommittee, submitted the memorandum attached as TAB A. Owing to the limited time for submitting this report, it has not been possible to have the members of the joint subcommittees give advance consideration to this report or the edited draft of the paragraph covering the ~~cases~~ costs of Pension Plans (Proposed ASPR 15-204.2(q), TAB B attached).

decided to treat subparagraphs (3)(iii)(A) and (3)(iii)(B) of proposed ASPR 15-204.2(q) in the disjunctive rather than the conjunction by deleting the "and" and retaining the "or" between them.

It appeared that some of the original concern of the Army and Air Force members to the disjunctive treatment was associated with the matter of credits or gains arising out of "normal" employee turnover which the Section XV Subcommittee had not intended to include under the paragraph in question. To clarify this point, a specific reference to credits or gains arising out of "normal employee turnover" is made in the redraft of subparagraph (3)(iii)(A) (appearing as (3)(iv)(A) in TAB B.

To satisfy another concern of the Army and Air Force members of the Editing Subcommittee, this provision also provides that, where future credits for abnormal terminations are accounted for by a discount of, or an actuarial recognition in, current costs, the appropriate adjustment "shall be reflected in the contract, in an amendment thereto, or some other writing binding on the Government and the contractor." In regard to the words "some other writing binding on the Government and the contractor", the Editing Subcommittee does not intend that a formal agreement must be entered into or that any action by a Contracting Officer is necessarily required. It is merely intended to require that the Departmental activity authorized to determine costs and incidental credits reach a definitive written understanding with the contractor, by exchange of memoranda, correspondence, or otherwise, which will not leave the question whether the credits have been received by the Government, open to speculation, conjecture, or surmise.

The joint subcommittees agreed in principle (Mr. Cox, one of three Air Force representatives, being the sole dissenter) on treating this problem in the manner set forth in TAB B as proposed ASPR 15-204.2(q)(3)(iv) which is an edited version subsequently prepared by the Editing Subcommittee.

II. The Problem of Consistency, with Part 6, Section XV

Following submission of the report of February 27, 1956, the Army member of the Editing Subcommittee contacted the Internal Revenue Service and learned that the present Part 6, Section XV, as well as the draft submitted for editing were open to misinterpretation with respect to the matter of approval of pension plans by Internal Revenue Service.

OGC/GWM:lwt March 9, 1956

Part 2 -- Supply Contracts, and Service and Research and Development Contracts with Organizations Having Commercial Type Accounting Systems

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 the procurement of supplies, services, and research and development work. However, this Part does not apply to contracts for services or research and development work with contractors or subcontractors which do not have commercial type accounting systems, or for facilities, construction, or architect-engineer services related to construction.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (i) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

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

15-201.3 Credits. The applicable income, rebates, allowances, and other credits received by or accruing to the contractor which are related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

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 (ASPR 7-203.7).

15-202 Direct Costs.

15-202.1 General. Direct costs are those items of cost which can be specifically identified with any objective, service, program, or project of the contractor and are chargeable directly thereto. Allowability of direct costs shall be determined pursuant to ASPR 15-201.2. Major items of cost such as freight, travel, communications, engineering services, etc., as well as the costs of materials and productive labor, should be charged directly to (i) a contract, or (ii) other work of the contractor, with which they are readily

identifiable. When the contractor is engaged in both defense and non-defense production or services, this principle must be applied consistently to both. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect costs.

15-202.2 Direct Material Costs. Direct material costs include the cost of all purchased items and items manufactured independently of a contract, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract. Direct material costs of reasonable overruns, spoilage, and defective work may also be included; but, as to defective work, see paragraph (c) of the inspection clause in ASPR 7-203.5.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically indentifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable. Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

15-203 Indirect Costs.

15-203.1 General. (a) Indirect costs are those items of cost which cannot be specifically identified with any one objective, service, program or project of the contractor. Indirect costs are accumulated for accounting purposes by logical cost groupings and are charged to all work of the contractor by a process of allocation . Each element of indirect cost is subject to the limitations of this Part as to allowability.

(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, be applied

consistently, and produce equitable results. Any significant change in the nature of the business, the extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, the contractor's products, or other factors may require reconsideration of the method previously used. Individual elements of indirect cost are discussed in ASPR 15-203.2 through 15-203.5.

(c) The base period for allocation of indirect costs shall be representative of the period of contract performance and shall be sufficiently long to avoid inequities in the allocation of costs, but in no event longer than the contractor's fiscal year.

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 and which cannot be specifically identified with any one objective, service, program, or project in accordance with ASPR 15-202. 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 overtime premium), units processed, and prime costs of units processed. The contractor may departmentalize or establish cost centers, in order to allocate the indirect costs equitably. Factors to be considered in determining the propriety of 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. Indirect engineering costs include costs of engineering supervision, engineering administration, and engineering supplies, and other related costs, which cannot be specifically identified with any one objective service, program, or project in accordance with ASPR 15-202. These costs arise out of engineering activities such as 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(v)(4)) on the basis of direct engineering man-hours expended, direct engineering labor dollars (exclusive of overtime, extra-pay shift, and multi-shift premium), or some other equitable basis.

15-203.4 Selling and Distribution Costs. Selling and distribution costs arise through marketing the contractor's products and include sales promotion, advertising, and distribution costs, and other related costs. Generally, such

costs are not considered to be 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.

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. Any recognized method of allocating general and administrative costs is acceptable if equitable results are thereby obtained. Factors to be considered in determining whether the results are equitable include:

(i) the ratio of each of the several cost components to the total cost of the contract, exclusive of general and administrative costs, compared to the corresponding ratios for the contractor's entire business;

(ii) the ultimate objective of distributing general and administrative costs consistently with the general and administrative effort involved in each element of the contractor's business;

(iii) any significant variations of inventories between accounting periods;

(iv) variations in the ratio of the contract inventory levels to all other inventory levels; and

(v) other relevant factors including those mentioned in ASPR 15-203.1(b).

15-204 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below, and apply whether the particular item of cost is treated by the contractor as direct cost or as indirect

cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

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. Only 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 (t) below.

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

(c) Cafeteria, Dining Room, and Other 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 to costs of all production within the contractor's plant in which the services are furnished. Reasonable losses of operation from such services are allowable when it is the policy of the contractor to operate such services at no loss or profit; provided, however, that any gains or losses from these services must be appropriately allocated to all activities benefited, including Government contracts. 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.

(d) Civil Defense Costs. Civil defense costs are those incurred in the planning for, and the protection of life and property against, the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by State and local civil defense authorities. 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 over a reasonable number of years in conformity with generally accepted accounting principles. Except as specifically provided for in the contract, contributions to local civil defense funds or projects not on the contractor's premises are unallowable.

(e) Compensation for Personal Services. (Reserved)

(f) Contributions and Donations. Reasonable contributions and donations to established nonprofit charitable, scientific, and educational organizations are allowable if they are deductible for Federal income tax purposes; provided that such deductibility does not in itself justify allowance as a contract cost. The reasonableness 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. Allowable contributions and donations shall be allocated to all work of the contractor.

(g) Depreciation.

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

(2) Depreciation on a contractor's plant, equipment, and other capital facilities is an allowable element of contract cost; provided that the amount thereof is based upon original acquisition cost. Depreciation shall be accounted for by consistent application to the assets concerned of any generally accepted accounting principles, including those recognized by Section 167 of the Internal Revenue Code of 1954, and should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives set forth in (1) above, vary with volume of production or use of multi-shift operations.

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

(4) Where the contractor has applied for, received, and accepted a determination of "true depreciation" from an Emergency Facilities Board covering an emergency facility acquired under a certificate of necessity, the amount so determined for "true depreciation" over the emergency period (5 years) shall be recognized in lieu of normal depreciation. The contractor may elect to use normal depreciation rather than "true depreciation" as determined by the Emergency Facilities Board; however, the method chosen after such determination of "true depreciation" must be followed consistently throughout the life of the emergency facility. The undepreciated cost of the emergency facility remaining after the expiration of the emergency period shall be depreciated over its remaining useful life and shall be the only amount recognized as allowable cost (but see paragraph 15-204.3(d). The remaining undepreciated cost shall not include any amount of unrecovered "true depreciation" (or normal depreciation if the contractor has elected not to use "true depreciation") allowable during the emergency period.

(5) Unless otherwise provided for in the contract, no use charge shall be allowed for assets still in use which, in accordance with the contractor's consistent accounting practice, have or should have been fully depreciated on the contractor's books.

(h) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(i) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor which constitutes, in effect, an implied agreement on the contractor's part (but see (e) above, and (j)(3)(v), (q) and (y) below.)

(j) Insurance and Indemnification.

(1) Insurance and indemnification include (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative (see ASPR 10-501 for kinds of insurance ordinarily required), (ii) any other insurance for which the contractor seeks reimbursement under the contract, and (iii) liabilities to third persons not compensated by insurance or otherwise.

(2) Costs of insurance required or approved, and maintained pursuant to the clause in ASPR 7-203.22 are allowable.

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

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

(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 unallowable except to the extent that the Government shall have approved or required such insurance or reserve;

(iv) costs of a reserve for a self-insurance program are unallowable unless the program has been approved by the military department concerned; and

(v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(4) The Government is only obligated to indemnify the contractor to the extent expressly provided in the contract (for example, see ASPR 7-203.22). Therefore, except as otherwise expressly provided in the contract, actual losses not reimbursed by insurance (through an approved self-insurance program or otherwise) are unallowable.

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

(l) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable. Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis. Costs of maintenance and repair of excess facilities and of idle facilities (other than reasonable standby facilities) are unallowable.

(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 shall not be allowed as a cost unless specifically provided for in the contract.

(m) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

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

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

of simplifying production;

are allowable.

(n) Material and Supply Costs.

(1) The net costs of such items as raw material, parts, sub-assemblies components, and manufacturing supplies, whether purchased or manufactured by the contractor, and such collateral items as inbound transportation and in-transit insurance, are allowable, subject, however, to (2) through (6) below. In computing costs of material, consideration will be given to reasonable over-runs, spoilage, or defective work (as to defective work, see paragraph (c) of the inspection clause in ASPR 7-203.5).

(2) Costs of material and supplies 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 and supplies returned to vendors. Such income and other credits shall either be credited directly to cost of the material or supplies 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 shall 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.

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

(6) Costs of material, services, or supplies, sold or transferred between plants, divisions, or organizations, under common control, shall be allowable only to the extent of the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is lower; 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 either (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.

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees may be classified as either direct or indirect labor costs, but the amount of such premiums shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government (see ASPR 12-102 for further information concerning the policy regarding such authorization). When direct labor cost is the base for distribution of overhead, the premium portion of overtime payments shall not be included in that base. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work. When such premium costs are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs.

(p) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. 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 by the Government, are allowable. Costs of research and development work are treated in (v) below. (See also (w) below.)

(q) Pension Plans.

(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, either the 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 (q).)

(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 plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P.L. 591, 83rd Cong., 2d 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 are allowable subject to the following conditions:

(i) such costs shall meet the requirements of ASPR 15-201.2;

(ii) such costs, including excess contributions (see Section 404(a)(1)(D) of the Internal Revenue Code of 1954), are allowable only to the extent —

(A) such costs are claimed and deductible for Federal income tax purposes in the current taxable period; or

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

(iii) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall be made for contributions which previously have been allocated to and allowed as contract costs and which are —

(A) disallowed for tax purposes; or

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

(iv) in determining the net 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 —

(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 adjustment shall be reflected in the contract, in an amendment thereto, or some other writing binding on the Government and the contractor; or

(B) when such abnormal termination credits or gains, whether or not foreseeable, cannot be currently evaluated with reasonable accuracy, or have not been the subject of adjustment under (A) above, pension plan costs incurred under the contract shall be subject to

(iii) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall be made for contributions which previously have been allocated to and allowed as contract costs and which are —

(A) disallowed for tax purposes; or

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

(iv) in determining the net 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 —

(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 adjustment shall be reflected in the contract, in an amendment thereto, or some other writing binding on the Government and the contractor; or

(B) when such abnormal termination credits or gains, whether or not foreseeable, cannot be currently evaluated with reasonable accuracy, or 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 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.

(r) Plant Protection Costs. Costs of wages, uniforms, and equipment of personnel engaged in plant protection; supplies; depreciation on plant protection capital assets; and necessary expenses to comply with military security requirements are allowable.

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

(1) Costs of professional services rendered by the members of a particular profession separately engaged by the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(f)).

(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 organization; and

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

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

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

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

(u) 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 the type, condition, and value of the facilities leased, options available, and other provisions of the rental agreement.

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

by the lessor, which would have been incurred had the contractor retained legal title to the facilities.

(v) Research and Development Costs.

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

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable to the extent specifically provided in the contract. Generally, the contractor shall be required to disclose to the Government the purposes and results of such independent general research. In specifically providing for such costs, factors to be considered include:

(i) scope, nature, and quality of the contractor's independent general research program;

(ii) capability of the contractor in the particular research field;

(iii) benefits which may accrue to the Government;

(iv) comparison of size and cost of contractor's previous years' independent research programs; and

(v) proportion of Government business to contractor's total business.

(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 ASPR 15-204.2(m)). 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 is related to the contract product

line and the costs are allocated to all production work of the contractor on the contract product line. Such research 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 research 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 allowable as precontract costs (see ASPR 15-204.3(i)).

(w) Royalties and Other Costs for Use of Patents. 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 are unallowable unless expressly set forth in the contract.

(x) Service and Installation Costs. Costs of servicing the product installation, and training Government personnel in the use, maintenance, and operation of the product are allowable.

(y) Severance Pay.

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

(2) For contract costing purposes, severance pay is divided into two categories as follows:

(i) Costs of normal turnover severance payments shall be allocated to all classes of work being performed in the contractor's plant at the time of payment; however, 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

(ii) costs of abnormal or mass severance pay actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of employment with the contractor and equitably allocated to all business of the contractor performed during that period. A reservation in the final release of claims (see ASPR 7-203.4) may be made in case of completed cost-reimbursement type contracts when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

(z) Special Tooling Costs. The term special tooling means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling, acquired for the performance of Government contracts, are allowable and shall be charged directly to such contracts.

(aa) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(f));

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

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

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

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

(ii) agrees to comply with such instructions; and

(iii) agrees to take all necessary action directed by the contracting officer in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon.

Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are allowable. Reasonable costs of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest, or penalties for the benefit of the Government are also allowable.

(3) Any refund of taxes, interest, or penalties, and any payment to the contractor of interest thereon, attributable to taxes, interest, or penalties which were allowed as contract costs, shall be credited or paid to the Government in the manner directed by the Government.

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

(1) Memberships. Costs of membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(cc) Training Costs. Costs of preparing and maintaining a program of instruction designed to increase the overall effectiveness of employees, including costs of the director of training and staff, training materials, and text

books, and tuition and fees when the training is conducted by educational institutions, are allowable when limited to on the job training and when properly allocated. Costs of training in educational institutions are unallowable, except to the extent specifically provided in the contract.

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

(ee) Travel Costs.

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

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

(3) Travel costs directly attributable to contract performance may be charged directly to the contract.

(4) 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.

(5) Entertainment costs are unallowable.

(6) Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the contracting officer.

(ff) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and

forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

(i) ASPR 15-204.3(e);

(ii) ASPR 15-204.3(i); and

(iii) ASPR 15-204.3(k).

15-204.3 Unallowable Costs.

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

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs see ASPR 204.2(j).)

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

(d) Excess Facility Costs. Costs of maintaining and housing idle and excess facilities, except those reasonably necessary for standby purposes, are unallowable. The costs of excess plant capacity reserved for defense mobilization production shall be the subject of a separate contract.

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

(f) Interest and Other financial Costs. Interest (however represented), bond discounts and costs, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of a prospectus,

costs of preparation and issuance of stock rights, and costs related thereto are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in ASPR 15-204.2(aa) (but see ASPR 15-204.2 (ff)).

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

(h) Organization Costs. Expenditures in connection with organization or reorganization of a business, such as incorporation fees, attorneys fees, accountants fees, fees to promoters and organizers, and costs of raising capital, are unallowable (see (f) above).

(i) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract. (See ASPR 15-1xx.)

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments, shall be excluded in computing contract costs.

(k) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately 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 unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(l) General.

(1) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

(i) ASPR 15-204.2(g)(3);
(ii) ASPR 15-204.2(l)(1), last sentence;
(iii) ASPR 15-204.2(s)(3), first sentence;

(iv) ASPR 15-204.2(t), last sentence;
(v) ASPR 15-204.2(w); first proviso;
(vi) ASPR 15-204.2(aa)(1)(i) through (iv); and
(vii) ASPR 15-204.2(ee)(5)

(2) Certain other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

(i) ASPR 15-204.2(c), last sentence;
(ii) ASPR 15-204.2(d), last sentence;
(iii) ASPR 15-204.2(g)(5);
(iv) ASPR 15-204.2(j)(3)(iii) and (iv), and (4);
(v) ASPR 15-204.2(l)(2);
(vi) ASPR 15-204.2(o), second sentence;
(vii) ASPR 15-204.2(p), second sentence;
(viii) ASPR 15-204.2(s)(3), last sentence;
(ix) ASPR 15-204.2(u)(2);
(x) ASPR 15-204.2(w);
(xi) ASPR 15-204.2(aa)(2);
(xii) ASPR 15-204.2(cc), last sentence; and
(xiii) ASPR 15-204.2(ee)(6)

53-44
Folder #2

Department of Defense Instruction

SUBJECT: Depreciation Methods Approved for Purposes of Contract Costing

I. PURPOSE

The purpose of this instruction is to establish uniform policy guidance with regard to the acceptance in contract costing of the provisions of Section 167(b) of the Internal Revenue Code of 1954.

II. APPLICABILITY

The policy set forth below is applicable to the determination of depreciation allowances for periods subsequent to 31 December 1953.

III. POLICY

The policy of the Department of Defense shall be to accept for contract costing purposes the use of any of the depreciation methods set forth in Section 167(b) as limited by Section 167(c) of the Internal Revenue Code of 1954, subject to meeting the test of reasonableness. Meeting this test may depend, in appropriate circumstances, upon whether: (1) the method used in the particular case has been accepted for tax purposes; and (2) the costing of defense contracts is on a basis consistent with the costing of the contractor's nondefense work.

IV. EFFECTIVE DATE

This instruction is effective from the date of its issuance.

V. IMPLEMENTATION

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

Assistant Secretary of Defense
(Comptroller)

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

Supply & Logistics

April 3, 1956

MEMORANDUM FOR THE ASPR COMMITTEE

SUBJECT: Case 53-44, Section XV, Part 2
Profit Sharing
Contributions and Donations
General Research Costs

On 3/2/56, the Section XV Committee considered the attached memorandum for the record concerning the three specific areas mentioned in the above subject.

With respect to paragraphs 1 and 2 of the attachment concerning profit sharing, before taking any action the Subcommittee requests specific guidance of the ASPR Committee. However, as to paragraphs 1, 2a and 2b, it was noted that if these principles are approved, they should merely be referred to the Editing Committee. As to paragraph 2c, the general feeling of the Subcommittee was that no further paragraphs should be added to Compensation since "reasonableness" could be relied upon.

As to paragraph 3a concerning Contributions and Donations, the Subcommittee has no objections to the text.

Regarding paragraph 3b covering General Research, the Subcommittee prefers the treatment accorded in the edited draft dated 3/29/56, as modified by the Subcommittee report thereon.

H. H. GALLUP

Attachment

ATTACHMENT

3/30/56

MEMORANDUM FOR THE RECORD

SUBJECT: Profit Sharing Plans, Contributions and Donations, and General Research Costs.

1. At a meeting held 3/30/56 in the Office of the Assistant Secretary of Defense (S&L), it was determined that the proposed revision of Section XV ASPR on the subject of Compensation specifically include the following first paragraph:

> "Compensation is allowable. (The term "compensation" includes all amounts paid or set aside, such as pension, retirement, and deferred compensation benefits in accordance with paragraph _____, 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)".

2. In connection with the above, it was also determined that:

   a. The revision of Section XV on profit sharing will include the existing ASPR coverage of the subject to the maximum practicable extent, i.e., no specific use shall be made to such terms as "immediate distribution profit sharing plans", "deferred distribution profit sharing plans", or "profit sharing plans".

   b. The title "Pension and Retirement Benefits" be expanded to read "Pension, Retirement, and Deferred Compensation Benefits" and that the concept of 15-601.2(f) be retained therein with the minimum possible changes in language.

   c. In addition to the language quoted in paragraph 2 above, the subject of Compensation may include additional paragraphs.

3. It was determined that ASPR coverage on Contributions and Donations, and General Research be as follows:

   a. "Contributions and donations are unallowable".

   b. "Costs of research programs of a general nature are allowable only to the extent expressly provided for in the contract."

OFFI OF THE ASSISTANT SECRETARY OF ENSE
Washington 25, D. C.

July 30, 1956

MEMORANDUM FOR THE ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Part 2, Section XV, Contract Cost Principles

In accordance with Item 7 of the ASPR Committee Minutes of 7/3/56, your Subcommittee considered the report of the Tax Subcommittee, dated 21 June 1956, as well as the three specific questions of the ASPR Committee set forth in the Minutes referred to above. With respect to the Tax Subcommittee report, the following comments are provided:

1. The ASPR Committee rejected the suggestion that the clause include a reference to taxes of "foreign" governments in subparagraph (1) of the clause.

2. The suggested change in subparagraph (2) of the clause is rejected. Your Subcommittee believes that this subparagraph as originally written adequately covers the problem. With respect to allowance of "interest and penalties incurred ....in the absence of instructions from the Contracting Officer, if incurred without the fault or negligence of the contractor", a government administrative burden is added to determine fault or negligence on the part of the contractor in each case and the situation can be avoided by the contractor paying the tax under protest.

3. The suggested addition of a sentence to subparagraph (3) is concurred in. As to the three questions raised by the ASPR Committee, the following answers are set forth:

A. Under subparagraph (1) of the clause will Defense reimburse a contractor for taxes "accrued"?

Answer: Yes, provided accrual is adjusted to actual taxes paid. However, to clarify the point beyond question, your Subcommittee proposes that in subparagraph (1) of the clause the phrase "in accordance with generally accepted accounting principles" be deleted since it is merely repetitive of an over-all requirement set forth in paragraph 15-201.2 and that the following clarification be substituted "and adjusted to amounts actually paid".

B. Is the statement contained in subparagraph (a)(ii) sound?

Answer: Your Subcommittee is unable to find any errors or weaknesses in this subparagraph.

C. Should the new sentence added to subparagraph (3) be a proviso sentence?

Answer: Yes.

For reference there is attached a copy of para. 15-204.2(y) as now recommended by your Subcommittee.

1 Incl.

H. H. GALLUP

(y) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(g));

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

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

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

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

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

Reasonable costs of any such proceeding instituted by the contractor at the direction of the contracting officer are allowable. Interest and penalties

incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are also allowable.

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

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

20 April 1956

MEMORANDUM FOR THE ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Section XV, Part 1

It is recommended that, when Part 2 is revised, the following changes be made simultaneously in Part 1:

1. 15-001. Delete entire paragraph.

2. 15-101. In line 5, delete "predetermined" and substitute "negotiated".

3. 15-102. Delete the last sentence and substitute the following:

"The cost principles outlined in Part 2, Part 3, or Part 4 of this section (whichever is applicable) shall be made a part of every contract of the type referred to in paragraph 15-101 executed as of a date on or after _____ 1956, with respect to Part 2, and as of a date on or after 1 March 1949 with respect to Part 3 and Part 4, except that (i) any such contract may exclude any item of allowable cost set forth in Part 2, Part 3, or Part 4, and (ii) any such contract containing Part 3 or Part 4 may, to the extent necessary in a particular case, expressly provide for the allowability of any of the kinds of costs referred to in Part 5 of this section unless any such cost is expressly excluded under Part 3 or Part 4 (whichever is applicable)."

4. 15-103. Add the following new paragraph:

"15-103 Negotiation of Special Items.

(a) Precontract Costs. When special provisions, providing for reimbursement for precontract costs, are included in a contract in accordance with ASPR 15-204.3( ) and ASPR 15-502(a), such costs shall be limited to a period of time as well as to type and amount of such costs.

(b) General Research Costs. In determining whether a special provision shall be included in the contract providing for reimbursement of general research costs in accordance with ASPR 15-204.2( ) and ASPR 15-502(m), factors to be considered include:

(i) scope, nature, and quality of the contractor's independent general research program;
(ii) capability of the contractor in the particular research field;
(iii) benefits which may accrue to the Government;
(iv) comparison of size and cost of contractor's previous years' independent research programs; and
(v) proportion of Government business to contractor's total business."

W. K. GHORMLEY
Brigadier General, USA

4. The Editing Subcommittee submits herewith an edited draft of Part 2, Section XV, in accordance with the assignment of the ASPR Committee (see Minutes of Meeting of 13 December 1955, Item 4). This draft has the concurrence of the Editing Subcommittee with the reservation that it is anticipated that several points will require brief discussion when the matter is considered by the ASPR Committee.

5. The Editing Committee invites attention of the ASPR Committee to paragraphs 4 and 5 of its report of February 27, 1956, as matters for its further consideration. In connection with the matter of "side" agreements referred to in paragraph 4 of said report, members of the Section XV Subcommittee have furnished information to the joint Subcommittees to the effect that this matter was the subject of a policy determination by the Procurement Secretaries in the early part of 1955.

Editing Subcommittee:

GEORGE W. MARKEY, JR.
Navy Member
Chairman

CHARLES W. WILKINSON
Lt. Colonel, SS JAG
Army Member

JOHN W. PERRY
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Joseph L. Kiraly, CIS

Air Force

Paul M. Southwell, AFMPP
George A. Rudigier, AFAUD
Arthur Cox, AMC, Dayton

For the above reason the joint subcommittees requested the technical assistance of the Internal Revenue Service. The Chairman of the Editing Subcommittee made arrangements to contact W. G. Shreve, Acting Head, Pension Trust Section, Internal Revenue Service, and he in turn arranged for Mr. J. F. Heathcote, Technical Assistant, to attend the joint meeting of March 6, 1956, and advise the subcommittees in their consideration of the problem. This assistance has been invaluable and is gratefully acknowledged; without it, the joint subcommittees would have been required to spend a much longer time at this task.

From information furnished as a result of the above contacts, it appears that the problem starts with the inferences that can be drawn from the present ASPR 15-601.2(b) that certain pension plans must be submitted for prior approval by the Internal Revenue Service but that plans of tax-exempt organizations are not subject to any approval. Actually, no pension plans are necessarily required to be approved at all although the plans of tax-exempt organizations as well as those of organizations subject to taxation are subject to approval at some time. In the case of the latter, the review would most usually come about as a result of the employer's deduction for tax purposes of its contributions to a pension plan and would occur at the time of auditing income tax returns within three years after filing. However, this does not always occur. In the case of tax-exempt organizations, the chief effect of approval or disapproval is on the tax liability of the employee beneficiary; this may vary depending on whether the plan is "qualified" or not. To clarify this question, plans of tax-exempt organizations are often submitted for approval in advance. If not so submitted, the matter of tax liability does not usually come under scrutiny until the employee beneficiary begins receiving benefits.

Following extensive discussion, the joint subcommittees agreed in principle on a draft dealing with this problem. An edited version of this material is set forth in TAB B, as subparagraphs (2) and (3)(i) through (iii) of proposed ASPR 15-204.2(q).

3. Except for the single dissent mentioned above with respect to paragraph 2.C.1., the recommendations set forth in the foregoing paragraph have had the concurrence of the Editing Subcommittee and the Section XV Subcommittee. Subsequent to action by the joint subcommittees on the problems discussed in paragraphs 2.A. and 2.B., Mr. Paul Southwell, Air Force procurement member of the Section XV Subcommittee, submitted the memorandum attached as TAB A. Owing to the limited time for submitting this report, it has not been possible to have the members of the joint subcommittees give advance consideration to this report or the edited draft of the paragraph covering the ~~cases~~ costs of Pension Plans (Proposed ASPR 15-204.2(q), TAB B attached).

decided to treat subparagraphs (3)(iii)(A) and (3)(iii)(B) of proposed ASPR 15-204.2(q) in the disjunctive rather than the conjunction by deleting the "and" and retaining the "or" between them.

It appeared that some of the original concern of the Army and Air Force members to the disjunctive treatment was associated with the matter of credits or gains arising out of "normal" employee turnover which the Section XV Subcommittee had not intended to include under the paragraph in question. To clarify this point, a specific reference to credits or gains arising out of "normal employee turnover" is made in the redraft of subparagraph (3)(iii)(A) (appearing as (3)(iv)(A) in TAB B.

To satisfy another concern of the Army and Air Force members of the Editing Subcommittee, this provision also provides that, where future credits for abnormal terminations are accounted for by a discount of, or an actuarial recognition in, current costs, the appropriate adjustment "shall be reflected in the contract, in an amendment thereto, or some other writing binding on the Government and the contractor." In regard to the words "some other writing binding on the Government and the contractor", the Editing Subcommittee does not intend that a formal agreement must be entered into or that any action by a Contracting Officer is necessarily required. It is merely intended to require that the Departmental activity authorized to determine costs and incidental credits reach a definitive written understanding with the contractor, by exchange of memoranda, correspondence, or otherwise, which will not leave the question whether the credits have been received by the Government, open to speculation, conjecture, or surmise.

The joint subcommittees agreed in principle (Mr. Cox, one of three Air Force representatives, being the sole dissenter) on treating this problem in the manner set forth in TAB B as proposed ASPR 15-204.2(q)(3)(iv) which is an edited version subsequently prepared by the Editing Subcommittee.

II. The Problem of Consistency, with Part 6, Section XV

Following submission of the report of February 27, 1956, the Army member of the Editing Subcommittee contacted the Internal Revenue Service and learned that the present Part 6, Section XV, as well as the draft submitted for editing were open to misinterpretation with respect to the matter of approval of pension plans by Internal Revenue Service.

OGC/GWM:lwt March 9, 1956

Part 2 -- Supply Contracts, and Service and Research and Development Contracts with Organizations Having Commercial Type Accounting Systems

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 the procurement of supplies, services, and research and development work. However, this Part does not apply to contracts for services or research and development work with contractors or subcontractors which do not have commercial type accounting systems, or for facilities, construction, or architect-engineer services related to construction.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (i) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

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

15-201.3 Credits. The applicable income, rebates, allowances, and other credits received by or accruing to the contractor which are related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

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 (ASPR 7-203.7).

15-202 Direct Costs.

15-202.1 General. Direct costs are those items of cost which can be specifically identified with any objective, service, program, or project of the contractor and are chargeable directly thereto. Allowability of direct costs shall be determined pursuant to ASPR 15-201.2. Major items of cost such as freight, travel, communications, engineering services, etc., as well as the costs of materials and productive labor, should be charged directly to (i) a contract, or (ii) other work of the contractor, with which they are readily

identifiable. When the contractor is engaged in both defense and non-defense production or services, this principle must be applied consistently to both. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect costs.

15-202.2 Direct Material Costs. Direct material costs include the cost of all purchased items and items manufactured independently of a contract, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract. Direct material costs of reasonable overruns, spoilage, and defective work may also be included; but, as to defective work, see paragraph (c) of the inspection clause in ASPR 7-203.5.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically indentifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable. Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

15-203 Indirect Costs.

15-203.1 General. (a) Indirect costs are those items of cost which cannot be specifically identified with any one objective, service, program or project of the contractor. Indirect costs are accumulated for accounting purposes by logical cost groupings and are charged to all work of the contractor by a process of allocation . Each element of indirect cost is subject to the limitations of this Part as to allowability.

(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, be applied

consistently, and produce equitable results. Any significant change in the nature of the business, the extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, the contractor's products, or other factors may require reconsideration of the method previously used. Individual elements of indirect cost are discussed in ASPR 15-203.2 through 15-203.5.

(c) The base period for allocation of indirect costs shall be representative of the period of contract performance and shall be sufficiently long to avoid inequities in the allocation of costs, but in no event longer than the contractor's fiscal year.

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 and which cannot be specifically identified with any one objective, service, program, or project in accordance with ASPR 15-202. 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 overtime premium), units processed, and prime costs of units processed. The contractor may departmentalize or establish cost centers, in order to allocate the indirect costs equitably. Factors to be considered in determining the propriety of 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. Indirect engineering costs include costs of engineering supervision, engineering administration, and engineering supplies, and other related costs, which cannot be specifically identified with any one objective service, program, or project in accordance with ASPR 15-202. These costs arise out of engineering activities such as 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(v)(4)) on the basis of direct engineering man-hours expended, direct engineering labor dollars (exclusive of overtime, extra-pay shift, and multi-shift premium), or some other equitable basis.

15-203.4 Selling and Distribution Costs. Selling and distribution costs arise through marketing the contractor's products and include sales promotion, advertising, and distribution costs, and other related costs. Generally, such

costs are not considered to be 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.

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. Any recognized method of allocating general and administrative costs is acceptable if equitable results are thereby obtained. Factors to be considered in determining whether the results are equitable include:

(i) the ratio of each of the several cost components to the total cost of the contract, exclusive of general and administrative costs, compared to the corresponding ratios for the contractor's entire business;

(ii) the ultimate objective of distributing general and administrative costs consistently with the general and administrative effort involved in each element of the contractor's business;

(iii) any significant variations of inventories between accounting periods;

(iv) variations in the ratio of the contract inventory levels to all other inventory levels; and

(v) other relevant factors including those mentioned in ASPR 15-203.1(b).

15-204 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below, and apply whether the particular item of cost is treated by the contractor as direct cost or as indirect

cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

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. Only 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 (t) below.

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

(c) Cafeteria, Dining Room, and Other 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 to costs of all production within the contractor's plant in which the services are furnished. Reasonable losses of operation from such services are allowable when it is the policy of the contractor to operate such services at no loss or profit; provided, however, that any gains or losses from these services must be appropriately allocated to all activities benefited, including Government contracts. 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.

(d) Civil Defense Costs. Civil defense costs are those incurred in the planning for, and the protection of life and property against, the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by State and local civil defense authorities. 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 over a reasonable number of years in conformity with generally accepted accounting principles. Except as specifically provided for in the contract, contributions to local civil defense funds or projects not on the contractor's premises are unallowable.

(e) Compensation for Personal Services. (Reserved)

(f) Contributions and Donations. Reasonable contributions and donations to established nonprofit charitable, scientific, and educational organizations are allowable if they are deductible for Federal income tax purposes; provided that such deductibility does not in itself justify allowance as a contract cost. The reasonableness 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. Allowable contributions and donations shall be allocated to all work of the contractor.

(g) Depreciation.

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

(2) Depreciation on a contractor's plant, equipment, and other capital facilities is an allowable element of contract cost; provided that the amount thereof is based upon original acquisition cost. Depreciation shall be accounted for by consistent application to the assets concerned of any generally accepted accounting principles, including those recognized by Section 167 of the Internal Revenue Code of 1954, and should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives set forth in (1) above, vary with volume of production or use of multi-shift operations.

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

(4) Where the contractor has applied for, received, and accepted a determination of "true depreciation" from an Emergency Facilities Board covering an emergency facility acquired under a certificate of necessity, the amount so determined for "true depreciation" over the emergency period (5 years) shall be recognized in lieu of normal depreciation. The contractor may elect to use normal depreciation rather than "true depreciation" as determined by the Emergency Facilities Board; however, the method chosen after such determination of "true depreciation" must be followed consistently throughout the life of the emergency facility. The undepreciated cost of the emergency facility remaining after the expiration of the emergency period shall be depreciated over its remaining useful life and shall be the only amount recognized as allowable cost (but see paragraph 15-204.3(d). The remaining undepreciated cost shall not include any amount of unrecovered "true depreciation" (or normal depreciation if the contractor has elected not to use "true depreciation") allowable during the emergency period.

(5) Unless otherwise provided for in the contract, no use charge shall be allowed for assets still in use which, in accordance with the contractor's consistent accounting practice, have or should have been fully depreciated on the contractor's books.

(h) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(i) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor which constitutes, in effect, an implied agreement on the contractor's part (but see (e) above, and (j)(3)(v), (q) and (y) below.)

(j) Insurance and Indemnification.

(1) Insurance and indemnification include (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative (see ASPR 10-501 for kinds of insurance ordinarily required), (ii) any other insurance for which the contractor seeks reimbursement under the contract, and (iii) liabilities to third persons not compensated by insurance or otherwise.

(2) Costs of insurance required or approved, and maintained pursuant to the clause in ASPR 7-203.22 are allowable.

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

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

(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 unallowable except to the extent that the Government shall have approved or required such insurance or reserve;

(iv) costs of a reserve for a self-insurance program are unallowable unless the program has been approved by the military department concerned; and

(v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(4) The Government is only obligated to indemnify the contractor to the extent expressly provided in the contract (for example, see ASPR 7-203.22). Therefore, except as otherwise expressly provided in the contract, actual losses not reimbursed by insurance (through an approved self-insurance program or otherwise) are unallowable.

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

(l) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable. Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis. Costs of maintenance and repair of excess facilities and of idle facilities (other than reasonable standby facilities) are unallowable.

(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 shall not be allowed as a cost unless specifically provided for in the contract.

(m) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

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

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

of simplifying production;

are allowable.

(n) Material and Supply Costs.

(1) The net costs of such items as raw material, parts, sub-assemblies components, and manufacturing supplies, whether purchased or manufactured by the contractor, and such collateral items as inbound transportation and in-transit insurance, are allowable, subject, however, to (2) through (6) below. In computing costs of material, consideration will be given to reasonable over-runs, spoilage, or defective work (as to defective work, see paragraph (c) of the inspection clause in ASPR 7-203.5).

(2) Costs of material and supplies 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 and supplies returned to vendors. Such income and other credits shall either be credited directly to cost of the material or supplies 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 shall 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.

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

(6) Costs of material, services, or supplies, sold or transferred between plants, divisions, or organizations, under common control, shall be allowable only to the extent of the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is lower; 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 either (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.

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees may be classified as either direct or indirect labor costs, but the amount of such premiums shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government (see ASPR 12-102 for further information concerning the policy regarding such authorization). When direct labor cost is the base for distribution of overhead, the premium portion of overtime payments shall not be included in that base. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work. When such premium costs are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs.

(p) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. 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 by the Government, are allowable. Costs of research and development work are treated in (v) below. (See also (w) below.)

(q) Pension Plans.

(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, either the 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 (q).)

(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 plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P.L. 591, 83rd Cong., 2d 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 are allowable subject to the following conditions:

(i) such costs shall meet the requirements of ASPR 15-201.2;

(ii) such costs, including excess contributions (see Section 404(a)(1)(D) of the Internal Revenue Code of 1954), are allowable only to the extent —

(A) such costs are claimed and deductible for Federal income tax purposes in the current taxable period; or

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

(iii) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall be made for contributions which previously have been allocated to and allowed as contract costs and which are —

(A) disallowed for tax purposes; or

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

(iv) in determining the net 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 —

(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 adjustment shall be reflected in the contract, in an amendment thereto, or some other writing binding on the Government and the contractor; or

(B) when such abnormal termination credits or gains, whether or not foreseeable, cannot be currently evaluated with reasonable accuracy, or have not been the subject of adjustment under (A) above, pension plan costs incurred under the contract shall be subject to

(iii) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall be made for contributions which previously have been allocated to and allowed as contract costs and which are —

(A) disallowed for tax purposes; or

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

(iv) in determining the net 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 —

(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 adjustment shall be reflected in the contract, in an amendment thereto, or some other writing binding on the Government and the contractor; or

(B) when such abnormal termination credits or gains, whether or not foreseeable, cannot be currently evaluated with reasonable accuracy, or 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 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.

(r) Plant Protection Costs. Costs of wages, uniforms, and equipment of personnel engaged in plant protection; supplies; depreciation on plant protection capital assets; and necessary expenses to comply with military security requirements are allowable.

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

(1) Costs of professional services rendered by the members of a particular profession separately engaged by the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(f)).

(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 organization; and

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

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

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

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

(u) 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 the type, condition, and value of the facilities leased, options available, and other provisions of the rental agreement.

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

by the lessor, which would have been incurred had the contractor retained legal title to the facilities.

(v) Research and Development Costs.

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

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable to the extent specifically provided in the contract. Generally, the contractor shall be required to disclose to the Government the purposes and results of such independent general research. In specifically providing for such costs, factors to be considered include:

(i) scope, nature, and quality of the contractor's independent general research program;

(ii) capability of the contractor in the particular research field;

(iii) benefits which may accrue to the Government;

(iv) comparison of size and cost of contractor's previous years' independent research programs; and

(v) proportion of Government business to contractor's total business.

(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 ASPR 15-204.2(m)). 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 is related to the contract product

line and the costs are allocated to all production work of the contractor on the contract product line. Such research 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 research 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 allowable as precontract costs (see ASPR 15-204.3(i)).

(w) Royalties and Other Costs for Use of Patents. 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 are unallowable unless expressly set forth in the contract.

(x) Service and Installation Costs. Costs of servicing the product installation, and training Government personnel in the use, maintenance, and operation of the product are allowable.

(y) Severance Pay.

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

(2) For contract costing purposes, severance pay is divided into two categories as follows:

(i) Costs of normal turnover severance payments shall be allocated to all classes of work being performed in the contractor's plant at the time of payment; however, 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

(ii) costs of abnormal or mass severance pay actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of employment with the contractor and equitably allocated to all business of the contractor performed during that period. A reservation in the final release of claims (see ASPR 7-203.4) may be made in case of completed cost-reimbursement type contracts when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

(z) Special Tooling Costs. The term special tooling means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling, acquired for the performance of Government contracts, are allowable and shall be charged directly to such contracts.

(aa) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(f));

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

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

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

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

(ii) agrees to comply with such instructions; and

(iii) agrees to take all necessary action directed by the contracting officer in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon.

Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are allowable. Reasonable costs of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest, or penalties for the benefit of the Government are also allowable.

(3) Any refund of taxes, interest, or penalties, and any payment to the contractor of interest thereon, attributable to taxes, interest, or penalties which were allowed as contract costs, shall be credited or paid to the Government in the manner directed by the Government.

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

(1) Memberships. Costs of membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(cc) Training Costs. Costs of preparing and maintaining a program of instruction designed to increase the overall effectiveness of employees, including costs of the director of training and staff, training materials, and text

books, and tuition and fees when the training is conducted by educational institutions, are allowable when limited to on the job training and when properly allocated. Costs of training in educational institutions are unallowable, except to the extent specifically provided in the contract.

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

(ee) Travel Costs.

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

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

(3) Travel costs directly attributable to contract performance may be charged directly to the contract.

(4) 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.

(5) Entertainment costs are unallowable.

(6) Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the contracting officer.

(ff) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and

forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

(i) ASPR 15-204.3(e);

(ii) ASPR 15-204.3(i); and

(iii) ASPR 15-204.3(k).

15-204.3 Unallowable Costs.

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

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs see ASPR 204.2(j).)

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

(d) Excess Facility Costs. Costs of maintaining and housing idle and excess facilities, except those reasonably necessary for standby purposes, are unallowable. The costs of excess plant capacity reserved for defense mobilization production shall be the subject of a separate contract.

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

(f) Interest and Other financial Costs. Interest (however represented), bond discounts and costs, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of a prospectus,

costs of preparation and issuance of stock rights, and costs related thereto are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in ASPR 15-204.2(aa) (but see ASPR 15-204.2 (ff)).

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

(h) Organization Costs. Expenditures in connection with organization or reorganization of a business, such as incorporation fees, attorneys fees, accountants fees, fees to promoters and organizers, and costs of raising capital, are unallowable (see (f) above).

(i) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract. (See ASPR 15-1xx.)

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments, shall be excluded in computing contract costs.

(k) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately 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 unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(l) General.

(1) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

(i) ASPR 15-204.2(g)(3);
(ii) ASPR 15-204.2(l)(1), last sentence;
(iii) ASPR 15-204.2(s)(3), first sentence;

(iv) ASPR 15-204.2(t), last sentence;
(v) ASPR 15-204.2(w); first proviso;
(vi) ASPR 15-204.2(aa)(1)(i) through (iv); and
(vii) ASPR 15-204.2(ee)(5)

(2) Certain other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

(i) ASPR 15-204.2(c), last sentence;
(ii) ASPR 15-204.2(d), last sentence;
(iii) ASPR 15-204.2(g)(5);
(iv) ASPR 15-204.2(j)(3)(iii) and (iv), and (4);
(v) ASPR 15-204.2(l)(2);
(vi) ASPR 15-204.2(o), second sentence;
(vii) ASPR 15-204.2(p), second sentence;
(viii) ASPR 15-204.2(s)(3), last sentence;
(ix) ASPR 15-204.2(u)(2);
(x) ASPR 15-204.2(w);
(xi) ASPR 15-204.2(aa)(2);
(xii) ASPR 15-204.2(cc), last sentence; and
(xiii) ASPR 15-204.2(ee)(6)

53-44
Folder #2

Department of Defense Instruction

SUBJECT: Depreciation Methods Approved for Purposes of Contract Costing

I. PURPOSE

The purpose of this instruction is to establish uniform policy guidance with regard to the acceptance in contract costing of the provisions of Section 167(b) of the Internal Revenue Code of 1954.

II. APPLICABILITY

The policy set forth below is applicable to the determination of depreciation allowances for periods subsequent to 31 December 1953.

III. POLICY

The policy of the Department of Defense shall be to accept for contract costing purposes the use of any of the depreciation methods set forth in Section 167(b) as limited by Section 167(c) of the Internal Revenue Code of 1954, subject to meeting the test of reasonableness. Meeting this test may depend, in appropriate circumstances, upon whether: (1) the method used in the particular case has been accepted for tax purposes; and (2) the costing of defense contracts is on a basis consistent with the costing of the contractor's nondefense work.

IV. EFFECTIVE DATE

This instruction is effective from the date of its issuance.

V. IMPLEMENTATION

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

Assistant Secretary of Defense
(Comptroller)

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

Supply & Logistics

April 3, 1956

MEMORANDUM FOR THE ASPR COMMITTEE

SUBJECT: Case 53-44, Section XV, Part 2
Profit Sharing
Contributions and Donations
General Research Costs

On 3/2/56, the Section XV Committee considered the attached memorandum for the record concerning the three specific areas mentioned in the above subject.

With respect to paragraphs 1 and 2 of the attachment concerning profit sharing, before taking any action the Subcommittee requests specific guidance of the ASPR Committee. However, as to paragraphs 1, 2a and 2b, it was noted that if these principles are approved, they should merely be referred to the Editing Committee. As to paragraph 2c, the general feeling of the Subcommittee was that no further paragraphs should be added to Compensation since "reasonableness" could be relied upon.

As to paragraph 3a concerning Contributions and Donations, the Subcommittee has no objections to the text.

Regarding paragraph 3b covering General Research, the Subcommittee prefers the treatment accorded in the edited draft dated 3/29/56, as modified by the Subcommittee report thereon.

H. H. GALLUP

Attachment

ATTACHMENT

3/30/56

MEMORANDUM FOR THE RECORD

SUBJECT: Profit Sharing Plans, Contributions and Donations, and General Research Costs.

1. At a meeting held 3/30/56 in the Office of the Assistant Secretary of Defense (S&L), it was determined that the proposed revision of Section XV ASPR on the subject of Compensation specifically include the following first paragraph:

> "Compensation is allowable. (The term "compensation" includes all amounts paid or set aside, such as pension, retirement, and deferred compensation benefits in accordance with paragraph _____, 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)".

2. In connection with the above, it was also determined that:

   a. The revision of Section XV on profit sharing will include the existing ASPR coverage of the subject to the maximum practicable extent, i.e., no specific use shall be made to such terms as "immediate distribution profit sharing plans", "deferred distribution profit sharing plans", or "profit sharing plans".

   b. The title "Pension and Retirement Benefits" be expanded to read "Pension, Retirement, and Deferred Compensation Benefits" and that the concept of 15-601.2(f) be retained therein with the minimum possible changes in language.

   c. In addition to the language quoted in paragraph 2 above, the subject of Compensation may include additional paragraphs.

3. It was determined that ASPR coverage on Contributions and Donations, and General Research be as follows:

   a. "Contributions and donations are unallowable".

   b. "Costs of research programs of a general nature are allowable only to the extent expressly provided for in the contract."

OFFI OF THE ASSISTANT SECRETARY OF ENSE
Washington 25, D. C.

July 30, 1956

MEMORANDUM FOR THE ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Part 2, Section XV, Contract Cost Principles

In accordance with Item 7 of the ASPR Committee Minutes of 7/3/56, your Subcommittee considered the report of the Tax Subcommittee, dated 21 June 1956, as well as the three specific questions of the ASPR Committee set forth in the Minutes referred to above. With respect to the Tax Subcommittee report, the following comments are provided:

1. The ASPR Committee rejected the suggestion that the clause include a reference to taxes of "foreign" governments in subparagraph (1) of the clause.

2. The suggested change in subparagraph (2) of the clause is rejected. Your Subcommittee believes that this subparagraph as originally written adequately covers the problem. With respect to allowance of "interest and penalties incurred ....in the absence of instructions from the Contracting Officer, if incurred without the fault or negligence of the contractor", a government administrative burden is added to determine fault or negligence on the part of the contractor in each case and the situation can be avoided by the contractor paying the tax under protest.

3. The suggested addition of a sentence to subparagraph (3) is concurred in. As to the three questions raised by the ASPR Committee, the following answers are set forth:

A. Under subparagraph (1) of the clause will Defense reimburse a contractor for taxes "accrued"?

Answer: Yes, provided accrual is adjusted to actual taxes paid. However, to clarify the point beyond question, your Subcommittee proposes that in subparagraph (1) of the clause the phrase "in accordance with generally accepted accounting principles" be deleted since it is merely repetitive of an over-all requirement set forth in paragraph 15-201.2 and that the following clarification be substituted "and adjusted to amounts actually paid".

B. Is the statement contained in subparagraph (a)(ii) sound?

Answer: Your Subcommittee is unable to find any errors or weaknesses in this subparagraph.

C. Should the new sentence added to subparagraph (3) be a proviso sentence?

Answer: Yes.

For reference there is attached a copy of para. 15-204.2(y) as now recommended by your Subcommittee.

1 Incl.

H. H. GALLUP

(y) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(g));

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

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

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

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

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

Reasonable costs of any such proceeding instituted by the contractor at the direction of the contracting officer are allowable. Interest and penalties

incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are also allowable.

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

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

20 April 1956

MEMORANDUM FOR THE ASPR COMMITTEE

SUBJECT: Case 53-44, Revision of Section XV, Part 1

It is recommended that, when Part 2 is revised, the following changes be made simultaneously in Part 1:

1. 15-001. Delete entire paragraph.

2. 15-101. In line 5, delete "predetermined" and substitute "negotiated".

3. 15-102. Delete the last sentence and substitute the following:

"The cost principles outlined in Part 2, Part 3, or Part 4 of this section (whichever is applicable) shall be made a part of every contract of the type referred to in paragraph 15-101 executed as of a date on or after _____ 1956, with respect to Part 2, and as of a date on or after 1 March 1949 with respect to Part 3 and Part 4, except that (i) any such contract may exclude any item of allowable cost set forth in Part 2, Part 3, or Part 4, and (ii) any such contract containing Part 3 or Part 4 may, to the extent necessary in a particular case, expressly provide for the allowability of any of the kinds of costs referred to in Part 5 of this section unless any such cost is expressly excluded under Part 3 or Part 4 (whichever is applicable)."

4. 15-103. Add the following new paragraph:

"15-103 Negotiation of Special Items.

(a) Precontract Costs. When special provisions, providing for reimbursement for precontract costs, are included in a contract in accordance with ASPR 15-204.3( ) and ASPR 15-502(a), such costs shall be limited to a period of time as well as to type and amount of such costs.

(b) General Research Costs. In determining whether a special provision shall be included in the contract providing for reimbursement of general research costs in accordance with ASPR 15-204.2( ) and ASPR 15-502(m), factors to be considered include:

(i) scope, nature, and quality of the contractor's independent general research program;
(ii) capability of the contractor in the particular research field;
(iii) benefits which may accrue to the Government;
(iv) comparison of size and cost of contractor's previous years' independent research programs; and
(v) proportion of Government business to contractor's total business."

W. K. GHORMLEY
Brigadier General, USA

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 organizations having commercial type accounting systems. However, this part does not apply to contracts for facilities, construction and architect-engineer services related to construction.

15-201 BASIC PRINCIPLES AND STANDARDS.

a. Composition of Total Cost. The total cost of a cost-reimbursement type contract is the net sum of (i) the allowable direct costs, (ii) the properly allocable portion of allowable indirect costs and (iii) applicable income and other credits.

b. Factors Affecting Allowability of Costs. The factors to be considered in determining the allowability of costs include (i) reasonableness, (ii) application of generally accepted accounting principles and practices, (iii) exercise of good business judgment in incurrence of cost, (iv) significant deviations in the established practices of the contractor which substantially increase the contract costs, and (v) any limitations as to types or amounts of cost items set forth in this Part 2 of Section XV or otherwise included in the contract.

c. Credits. The applicable portion of income and other credits, rebates, allowances, and equivalent benefits accruing to the contractor and which are related to any allowed cost will be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

d. 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).

15-202 DIRECT COSTS. Subject to the provisions of paragraph 15-201, allowable direct costs are those items of cost, or aggregate thereof, which can be identified specifically with any objective, service, program or project under the contract and are chargeable directly thereto. Major items of cost readily identifiable with the contract or with other work of the contractor should be charged directly thereto. This principle may often be applicable to such elements of expense as freight, travel, communications, engineering services, etc., as well as the normal items of materials and productive labor. However, when the contractor is engaged in mixed production, this principle must be applied consistently to the costing of both defense and non-defense products or services, in order to produce equitable results. When the accounting expense of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect expenses.

15-202.1 DIRECT MATERIALS. The cost of direct materials includes the cost of items purchased, supplied, manufactured or fabricated, which enter directly into the end product or which are used or consumed directly in connection with furnishing such product.

15-202.2 DIRECT LABOR. The cost of direct labor includes salaries and wages specifically identifiable with and properly chargeable directly to the performance of the contract or other work of the contractor. It may also include other associated costs such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.3 OTHER DIRECT COSTS. Where other items of cost are charged directly to the contract consistent with paragraph 15-202 above, the contractor must

demonstrate that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable to other work of the contractor must be eliminated from indirect costs allocated to the contract.

15-203 INDIRECT COSTS.

(a) Indirect costs are expenses which are incurred for common or joint objectives, are accumulated for accounting purposes by departmental activity or other logical cost grouping and are charged to the contract and other work of the contractor by a process of allocation. Each element thereof is subject to the limitations of this part as to allowability.

(b) No specific rules can be stated as to the method of allocation of indirect costs because the actual condition in each instance must be taken into account in determining the most suitable method or methods. The objective should be the selection of a method or methods which will distribute the indirect costs in a fair and equitable manner. The method used in connection with Government contracts must, in order to be acceptable, conform with generally accepted accounting practices, be applied consistently, and produce equitable results. Any significant change, such as in the nature of the business, extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, or the products being produced, may require reconsideration of the methods previously in use to determine whether they continue to be equitable. Further discussion relative to allocation of the individual categories of indirect costs will be found in the subparagraphs below.

15-203.1 INDIRECT MANUFACTURING AND PRODUCTION EXPENSES. Indirect manufacturing and production expenses consist of costs which are necessary to the productive process as a whole and are not readily subject to treatment as direct costs in accordance with paragraph 15-202. Allocation of indirect manufacturing and production expenses on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable bases, in appropriate circumstances, include direct labor dollars (exclusive of overtime premium), units processed and prime costs of units processed. In some instances, it may be necessary to departmentalize or establish cost centers in order to distribute equitably the indirect costs. The factors to be considered in determining the extent of departmentalization or establishment of cost centers include variety of products, complexity of processes and relative labor and facility requirements for the various products.

15-203.2 INDIRECT ENGINEERING EXPENSES. Indirect engineering expenses consist chiefly of engineering supervision, engineering administrative expense and general supplies. These expenses arise out of engineering activities which 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 expenses should be allocated to the benefited activities, i.e., the contract and other work of the contractor on the basis of direct engineering man-hours expended, direct engineering labor dollars (exclusive of overtime premium), or other equitable basis. NOTE: Direct costs of engineering activities should be charged directly to the benefited activities, i.e., the contract and other work of the contractor in accordance with paragraph 15-202.

15-203.3 SELLING AND DISTRIBUTION EXPENSES. The expenses in this group consist of items which represent the cost of marketing the contractor's products and include sales promotion, advertising, distribution costs and other related items. Generally, such expenses are not considered to be allocable to Government cost-reimbursement type contracts for the reason that marketing, in the ordinary commercial sense, is not necessary for doing business with the Government. However, dependent upon a demonstration of benefits to Government contracts, these costs should first be allocated between the contractor's commercial line and its Government contracts. The amount allocated to the latter should then be charged to the individual contracts on any recognized basis. Because of the special problems that arise in this area, it is usually desirable for the contractor to identify in its records by means of subaccounts or otherwise, the items of these expenses considered properly allocable to Government contracts.

15-203.4 GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses consist of costs incurred in the over-all management, supervision and conduct of the business. Any recognized method of allocating general and administrative expense is acceptable provided equitable results are thereby obtained. Some of the factors that should receive consideration in determining whether the results are equitable are (i) the cost pattern of the Government contracts (that is, the percentage of the total cost of the contract, exclusive of general and administrative expenses, represented by each of the several cost components thereof) in relation to the cost pattern for the plant or activity as a whole, and (ii) the ultimate objective of distribution of these expenses in approximate ratio to the general and administrative effort involved in the two categories of work. In addition,

consideration should be given to any significant variations of inventories between accounting periods, variations in the ratio of contract inventory levels to all other inventory levels, and any other relevant factors such as those mentioned in paragraph 15-203(b).

15-203.5 BASE PERIOD FOR ALLOCATION OF INDIRECT EXPENSES. The base period for allocation of indirect expenses should approximate the period of contract performance or should be representative of that period. The base period should be sufficiently long to avoid inequities in the allocation of costs.

15-204 APPLICATIONS OF BASIC COST PRINCIPLES AND STANDARDS TO SELECTED ITEMS OF COST. This paragraph states, in some detail, applications of the basic cost principles and standards set forth in the preceding paragraphs of this part to certain selected items of cost. The statements herein apply irrespective of whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost herein is not intended to imply that it is either allowable or unallowable. With respect to those items not specifically covered, determination as to allowability will be made in the light of the basic principles and standards and, where appropriate, the treatment of similar or related items in this Part. All of the subparagraphs below are subject to the basic principles and standards set out in paragraph 15-201.

15-204.1 ADVERTISING. Advertising expenses include the costs of advertising media and corollary administrative expenses. Advertising media include magazines, newspapers, radio and television programs, direct mail, trade papers, outdoor advertising, dealer cards and window displays, conventions and exhibits, free goods and samples, and sales literature.

a. The following advertising costs only are allowable:

(1.) Advertising in trade and technical journals, provided such advertising does not offer specific products or services 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.

(2.) Help wanted advertising, as set forth in paragraph 15-204.33.

15-204.2 BAD DEBTS. Bad debt expenses consist of losses (whether actual or estimated) arising from uncollectible customers' accounts and other claims, and include collection expenses and related legal expenses. These costs are unallowable.

15-204.3 BIDDING EXPENSE. Bidding expenses are the costs of preparing bid estimates on potential contracts or projects, including the development of engineering and cost data necessary to support the contractor's price proposal or estimated cost of work performance. Current bidding expenses of both successful and unsuccessful bids normally will be treated as indirect expenses and allocated currently to all business of the contractor, in which event no bidding expenses of past accounting periods will be chargeable to the Government contract. However, the contractor's established practice may be to treat bidding expenses by some other recognized method. Regardless of the method used, the results obtained may be accepted only if found to be reasonable and equitable.

15-204.4 CAFETERIAS, DINING ROOMS AND OTHER FOOD SERVICES. This class of expense consists of the cost, less revenue, of operating, or furnishing facilities for, cafeterias, dining rooms, canteens, lunch wagons, vending machines, or other types of food services for the contractor's employees at their regular duty station. Losses from operation of such food services are allowable when the services are fairly priced and costed and reasonably required by the nature of the contractor's operations, plant location, established policies, or employer-employee agreement. The gains or losses from these food services must be appropriately allocated to all activities benefited including Government contracts except, however, where (1) the net proceeds are for the exclusive benefit of an employee welfare organization of the contractor, or (2) the food services are rendered for gain by private interests beyond the immediate control of the contractor. Under each of the above two exceptions, no part of the gains or losses will be allocable to the contract.

15-204.5 CIVIL DEFENSE. Civil defense costs are those incurred in the planning for and the protection of life and property against the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by local and state civil defense authorities. Examples of civil defense costs include cost in excess of normal plant protection expenses and may consist of first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions and other approved civil defense measures. Reasonable costs of 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. In the case of capital assets, acquired for civil defense purposes the costs

thereof will be depreciated over a reasonable number of years in conformity with generally accepted accounting principles. Contributions to local civil defense funds or projects not on the contractor's premises are unallowable.

15-204.6 COMPENSATION FOR PERSONAL SERVICES.

a. This item includes salaries, wages, deferred compensation and fringe benefits for services rendered to the contractor by employees as well as fees paid to directors and committee members. Subject to specific limitations set forth hereunder, such costs are allowable when the total compensation is reasonable in light of the services rendered.

b. Generally, the amount of compensation established by the contractor will be considered commensurate with the services rendered. However, compensation of individuals such as corporate officials, directors, executives, department heads, partners and sole proprietors may be subject to special consideration and limitation as to allowability for contract cost purposes where amounts appear excessive. Some situations which may give rise to excessive compensation are where (i) the individual or member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization; or (ii) ownership of the contractor is limited to a small cohesive group; or (iii) the volume of Government contracts when related to the contractor's total business is such as to influence the amount of compensation.

c. The cost of options to purchase stock of the contractor corporation granted to employees is not allowable.

d. Bonuses to employees, such as production incentives and suggestion or safety awards, represent a part of their total compensation and are allowable when appropriately allocated, if they are:

(1.) Paid pursuant to an arms length agreement between the contractor and the employees before the services are rendered or pursuant to an established plan consistently followed by the contractor which constitutes, in effect, an implicit agreement on the part of the contractor.

(2.) Reasonable in amount. For the purpose of determination of reasonableness the employer contribution shall not exceed 15% of the total basic compensation paid or accrued to the participating employees in that year under consideration.

(3.) Paid for current services actually rendered by employees.

(4.) Available to all employees of the contractor or to all employees within a group or salary classification which is not unreasonably restricted.

(5.) Allowable as an ordinary or necessary business expense for tax purposes.

(6.) Not restricted to officer or other employee stockholders or are not distributed on the basis of stockholdings.

(7.) Total employee compensation, including such profit sharing distribution, is reasonable in amount for such services.

e. Profit sharing plans. These plans provide for additional compensation and are based on or measured by contractor's earnings. These plans fall into two categories, immediate distribution and deferred distribution plans.

(1.) Compensation payable under immediate distribution plans is allowable subject to the criteria set forth in subparagraph d. above.

(2.) Employer contributions under deferred distribution profit-sharing plans, to be allowable costs, must meet all pertinent conditions set

forth under subparagraph d. above and, if subject to Internal Revenue Service consideration, must have their approval. The carry-over provisions of the regulations of Internal Revenue Service with respect to contributions under qualified deferred distribution profit-sharing plans shall not be recognized for Government contract cost determination purposes. Forfeitures of non-vested benefits under a profit-sharing plan will be treated in accordance with the principles stated in paragraph 15-204.29(f).

f. Stock bonus plans. Bonuses of this nature may or may not be measured by profits. When stock bonuses are considered to be a form of compensation, the amount allowable for the contractor's cost in connection therewith shall be subject to all conditions pertinent under paragraph d. above and meet the following requirements:

(1.) The valuation placed on the stock for the purpose of calculating such cost must be computed on a sound basis.

(2.) In the case of unlisted stock having no current market, the contractor must demonstrate the values ascribed thereto are fair and reasonable.

(3.) Bonuses paid in the form of previously unissued stock of an affiliate will not ordinarily be allowed unless it can be demonstrated that there exists a bona fide arms-length agreement and the values ascribed to such stock are fair and reasonable.

(4.) Claims for accruals of compensation under a stock bonus arrangement prior to acquisition of stock by employees will not be allowable unless arrangements are made for appropriate credit adjustment of costs in the event such stock is not acquired by employees.

g. The determination of allowability of the cost of pension and retirement plans, training expense, overtime, extra pay and multi shift premiums and other fringe benefits will be in accordance with paragraphs

15-204.27, 15-204.43, 15-204.25, and 15-204.14 respectively. Any form of compensation to an employee not specifically mentioned in this Part 2, in addition to those set forth in this paragraph, will be given consideration as a part of total compensation.

15-204.7 CONTINGENCIES. This type of charge results from the creation and maintenance of reserves to provide for an event whose occurrence cannot be foretold with certainty as to time, intensity or even an assurance of its happening. These costs are not allowable. (For self-insurance programs see paragraph 15-204.11)

15-204.8 CONTRIBUTIONS AND DONATIONS. Contributions and donations to established nonprofit charitable organizations are allowable provided that such costs are reasonable and properly allocable to Government contracts.

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.

15-204.9 DEPRECIATION.

a. Depreciation as described herein is a charge to current operations intended to distribute the cost of tangible capital assets, less estimated residual value, over their estimated useful life in a systematic and logical manner. It involves a process of allocation, not of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

b. Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, provided the amount thereof is based upon original acquisition cost. Depreciation will be accounted for by

consistent application of any generally accepted accounting principles and should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation charged in any accounting period may vary with volume of production or use of multishift operations, provided the method followed is consistent with basic objectives set forth in subparagraph a. above.

c. Charges for depreciation on idle or excess facilities will not be allowed except on such facilities as are reasonably necessary for contract performance standby purposes.

d. Unless otherwise provided in the contract, no use charge will be allowed on assets still in use which have been, in accordance with the contractor's consistent accounting practice, fully depreciated on the contractor's books of account.

e. Allowances for depreciation on emergency facilities will normally be determined in accordance with subparagraphs a. through d. above. However, where the contractor has applied for and received a determination of "true depreciation" from an Emergency Facilities Board covering emergency facilities acquired under certificates of necessity, the amounts so determined for "true depreciation" over the emergency period (5 years) will be recognized in lieu of normal depreciation. After the expiration of the emergency period for the facilities concerned where a determination of "true depreciation" has been made, the remaining undepreciated portion of the cost of such facility will be depreciated over its remaining useful life and will be the only amount recognized as allowable cost, subject to paragraph 15-204.12.

15-204.10 EMPLOYEE MORALE, HEALTH AND WELFARE. Included in this category are expenses of health and welfare activities incurred for the improvement of

working conditions and the improvement of employer-employee relations and employee performance. Examples of these activities are house publications, health or first-aid clinics, and employee counselling services. These costs are allowable when incurred in accordance with the contractor's established practice or custom in the industry or area and are reasonable and equitably allocated to all classes of work performed in the contractor's plant. Income generated from any of these activities will be credited to the costs thereof.

15-204.11 ENTERTAINMENT EXPENSE. This item includes the cost of amusement, diversion, social activities and incidental costs, such as meals, lodging, rentals, transportation and gratuities. These costs are unallowable.

15-204.12 EXCESS FACILITIES. This item includes the cost of maintaining and housing idle and excess facilities, except those reasonably necessary for contract performance standby purposes. These costs are unallowable. The costs of additional plant capacity reserved for defense production shall be the subject of a separate contract.

15-204.13 FINES AND PENALTIES. Included in this item are those costs resulting from violations of, or failure of the contractor to comply with, local, state and Federal laws and regulations. These expenses are not allowable. However, fines and penalties, including interest thereon, incurred due to situations in which the contractor has been instructed in writing by the Contracting Officer to follow a certain course of action, will be allowed.

15-204.14 FRINGE BENEFITS. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries.

a. The determination as to the allowability of the cost of pension and retirement plans, profit sharing and other bonuses, and severance pay will be in accordance with sub-paragraphs 15-204.27, 15-204.6, and 15-204.38, respectively.

b. The cost of other fringe benefits such as pay for vacations, holidays, sick leave, military leave and employee insurance is allowable to the extent required by law, employer-employee agreement, or established policy of the contractor that constitutes, in effect, an implicit agreement on the contractor's part.

15-204.15 INITIAL PRODUCTION COSTS. Initial production costs, also known as "starting-load costs", are non-continuing costs that arise in early stages of production because of the Contractor's lack of experience with particular materials, manufacturing processes or techniques involved. Such costs may consist of excessive material costs resulting from abnormal scrap losses, excessive direct labor costs and related overhead resulting from idle time due to testing and change in production methods, cost of training employees, and excessive defective work due to inexperienced labor.

While initial production costs are allowable, the contractor will be expected to work actively to minimize or eliminate them as rapidly as possible. In cases where these costs continue to an unwarranted extent after the contractor has been allowed reasonable time to learn to make the product efficiently, the excessive costs will be disallowed.

15-204.16 INSURANCE AND INDEMNIFICATION

a. Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by

specific instruction of the contracting officer or his authorized representative, and (2) any other insurance for which the contractor seeks reimbursement under the contract. The kinds of insurance ordinarily included in the first category are set out in ASPR 10-501.

b. Costs of Government required insurance are allowable within the limitations as to the extent of coverage and premium rates approved by the Government. Costs of other insurance, except that applicable to Government-owned property, are allowable provided (1) the insurance has been approved by the military department concerned or (2) in the absence of such approval requirement, the types of coverage, extent of coverage, and rates are reasonable under the circumstances. Costs allowed for use and occupancy insurance, however, will in principle be limited so as to exclude coverage of profit, interest, federal income taxes, and unallowable selling and distribution expenses.

c. The costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are not allowable except to the extent that the Government may have required the contractor to every such insurance.

d. The costs of a self insurance program are allowable provided the program has been approved by the Military Departments. Actual losses sustained under such a self-insurance program are not allowable.

e. The costs of insurance on the lives of officers, partners or proprietors, are not allowable except where such insurance is part of an employee group plan which is not unduly restricted.

f. Losses resulting from failure to insure (through self insurance or otherwise) against a contingent loss or damage, where a reasonably prudent

business organization would have insured against such loss or damage, are not allowable.

g. Costs of indemnification, in lieu of insurance, will be allowable only to the extent expressly provided for in the contract. By the term "indemnification" is meant Government assumption of losses arising from (i) lack of insurance coverage of risks of an insurable nature or (ii) restrictions on the amount of such insurance coverage.

15-204.17 INTEREST AND OTHER FINANCIAL EXPENSES. This item includes interest paid or accrued (regardless of the nature of the obligation which gives rise to the interest cost), bond discount and expenses, and the cost of financing and refinancing operations as well as legal and professional fees paid in connection with the preparation of a prospectus, costs of preparation and issuance of stock rights and expenses related thereto. (See also 15-204.24) These costs are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in subparagraph 15-204.41.

15-204.18 LABOR RELATIONS. This item covers expenses incurred in maintaining satisfactory relations between the contractor and his employees. It includes the costs of shop stewards, labor management committees, employee publications and other related activities. Costs incurred for these purposes are allowable.

15-204.19 LOSSES ON OTHER CONTRACTS. This item covers any excess of costs over income under any and all other contracts, whether such other contracts are of a supply, research and development, or other nature. Costs of this nature are not allowable as a cost of performance of the Government contract.

15-204.20 MAINTENANCE AND REPAIRS. (a) This item includes those costs necessary

for the upkeep of property which neither adds to the permanent value of the property nor appreciably prolongs its intended life but keeps it in its efficient operating condition. These costs are allowable. Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation will be allowable only on a depreciation basis. Cost of maintenance and repairs of excess facilities and of idle facilities (other than reasonable standby facilities) are not allowable.

b. Deferred maintenance is defined as maintenance and repairs which for some reason such as abnormal operating conditions or lack of funds, is delayed to a future period. The cost of maintenance and repairs which has been deferred from a period prior to the contract is not allowable unless specifically provided for in the contract. Likewise, the estimated cost of maintenance and repairs normally required but not accomplished during the period of the contract will not be allowed as a cost unless specifically provided for in the contract.

15-204.21 MANUFACTURING AND PRODUCTION ENGINEERING. Manufacturing and production engineering includes the cost of engineering activities in connection with (1) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement and (2) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production. These costs are allowable. For purposes of distribution, such costs should ordinarily be divided into two categories: (i) those which directly benefit a contract, a project, or a product line and (ii) those expenses which are not subject to direct costing. Items in category (i) should be charged directly to the contract or project or allocated to the products in the product line. Costs in category (ii) should be allocated to all benefitted work.

15-204.22 MATERIALS AND SUPPLIES.

a. This item includes the net costs of such items as raw materials, parts, sub-assemblies, components, and manufacturing supplies, whether purchased outside or manufactured by the contractor, and may include such collateral items as inbound transportation and intransit insurance. These costs are allowable subject, however, to the provisions of subparagraphs b. through e. below.

b. Costs of materials and supplies shall be suitably adjusted for applicable portions of income and other credits. Such income and other credits include trade discounts, refunds, rebates and allowances, cash discounts available, and credits for scrap and salvage and materials returned to vendors. However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond his control, such lost discounts will be allowed.

c. Reasonable charges arising from differences between periodic physical inventory quantities and related material-control records will be included in arriving at the cost of materials, provided that such charges (i) do not include "write-downs" of values, and (ii) relate to the period of performance of the contract. All credits arising from differences between Periodic physical inventory quantities and related material-control records shall be taken into account.

d. When materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to the contract. Any generally recognized method of pricing materials issued from stock may be employed, provided the results obtained are equitable. When materials in stock at the commencement date of a Government contract have a provable replacement cost significantly different from book cost, the contractor and the Government may agree upon the use of a

method of pricing based upon the fair value of the materials (but not in excess of replacement cost). Such agreement should include identification of the types or kinds of materials involved and should preferably be made at the time the contract is entered into and provided for therein.

c. Ordinarily inter-company or inter-divisional sales or transfers of materials shall be stated on the basis of cost to the transferor. A departure from this cost basis is permissible when the transactions involve items regularly manufactured and sold by an affiliate or division through commercial channels except as to items on which the Government is ultimately the sole user. In these latter cases, however, the price charged to the contract must not exceed the lower of (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. In other situations where consideration of the minority interest in an affiliate would warrant departure from the cost basis, such departure may be permitted but only if expressly authorized or approved by the contracting officer.

15-204.23 ORGANIZATION EXPENSES. This item consists of expenditures in connection with organization or reorganization of a business. Examples of such costs are incorporation fee, attorneys fee, fees to promoters and organizers and costs of raising capital. These costs are unallowable. (See also paragraph 15-204.17).

15-204.24 OTHER BUSINESS EXPENSES. Included in this item are such recurring expenses as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of annual reports to shareholders,

preparation and submission of required reports and forms to taxing and other regulatory bodies and incidental costs of directors and committee meetings. The above and similar listed costs are allowable when incurred in reasonable amounts in accordance with the contractor's established practices and are allocated on an equitable basis to all classes of work.

15-204.25 OVERTIME, EXTRA PAY SHIFT AND MULTI SHIFT PREMIUMS. This item consists of the premium portion of overtime and shift payments to employees. Such premiums may be classified as either direct or indirect labor costs, but the amount of overtime premium should be separately identified. When direct labor cost is the base for distribution of overhead, overtime premiums shall not be included therein. Cost of overtime and shift premiums are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government. See ASPR 12-102 for further information concerning the policy regarding such authorization. The amount of overtime and shift premium cost charged on Government contracts shall be equitable in relation to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant and the factors which necessitate the incurrance of the cost.

15-204.26 PATENT EXPENSES. Included in this item are amortization of the cost of purchased patents and all costs leading to the issuance of patents, as well as the cost of infringement investigation and litigation. Amortization of the cost of purchased patents applicable to contract products or processes is allowable. The cost of preparing disclosures as required by the contract and of preparing assignment and other papers in connection with the filing of a patent application for the Government is allowable. All other patent expenses

and charges for the use of patents where the Government has a license or the right to free use thereof are unallowable. The cost of research and development work leading to patents is treated in subparagraph 15-204.35.

15-204.27 PENSION AND RETIREMENT PLANS

a. As used herein, a pension or retirement plan is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to his 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 retirement benefits. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation the employees. The determination of the amount of retirement benefits and received by/the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of service 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 will be considered a pension plan, if, under the plan, either the benefits payable to the employee or the required contributions by the contractor can be determined actuarially.

b. Pension and retirement plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the Military Department; however, approval of the plan by the Internal Revenue Service does not necessarily assure acceptance by the Military Department. Consideration of the plans will be the responsibility of the Department to which audit cognizance is assigned and the subsequent action taken by that

Department will generally be accepted by the other Departments. In cases where the Internal Revenue Service withdraws approval of a plan, amounts allocated to contract costs will be withdrawn accordingly. Where pension and retirement plans of non-profit or other tax-exempt organizations are not required to be reviewed and approved by the Internal Revenue Service, it will be the responsibility of the Department to which audit cognizance is assigned to give consideration to the acceptability of such plans.

c. The costs of acceptable pension and retirement plans, which are properly deductible from taxable income are allowable except as otherwise determined unallowable under this paragraph. Costs of acceptable pension and retirement plans established by nonprofit or other tax-exempt organizations are also allowable except as otherwise determined under this paragraph.

d. Pension and retirement costs constitute a part of the total compensation by a contractor to the individuals covered by the plan, and accordingly, are subject to the provisions of this section with respect to reasonableness of the total compensation paid to the individual for the services rendered. (See 15-204.6)

e. The amount of the contribution subject to allocation as a contract cost will be limited to the maximum amount required to fund an approved plan or the amount actually contributed during the taxable year, whichever is the lesser. The carryover provisions of the Internal Revenue Code with respect to contributions under pension and retirement plans shall not be recognized for the purpose of determining allowable pension and retirement costs under Government contracts.

f. Credits which arise under pension plans from various sources, such as dividends and cancellation of employee benefits which have not vested

at the time of termination of their employment, must be taken into account in an equitable manner in the determination of the allowable pension and retirement contribution. Special provision for these credits is usually necessary when the contractor's organization has substantially expanded for the performance of military contracts and there is a reasonable expectation that the employment of a large number of the additional employees will be terminated upon curtailment of military work. Under these circumstances, 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. There are two general methods which may be used, individually or in combination, in making such arrangements:

(1) A lump sum or percentage discount of current pension costs negotiated and agreed upon in advance. Determination of such allowance generally is not an actuarial problem involving a calculation based upon known factors, but rather is an attempt to reach a negotiated agreement as to various uncertain or variable factors in a complex situation.

(2) A retrospective determination at some time in the future when a more accurate estimate can be made by virtue of experience which may have developed. Until such determination, current costs, which should be net of current credits may be allowed provided an appropriate contractual agreement can be reached which reserves the Government's right to future credits.

g. The costs of lump sum purchases of annuities or of lump sum cash payments or periodic cash payments made to provide pension or retirement benefits for retiring or retired employees other than incurred under approved pension and retirement plans are not allowable.

15-204.28 PLANT PROTECTION EXPENSES. This item includes the cost of plant

protection measures such as wages of guards, equipment of guards (uniforms, firearms, etc.), and depreciation on plant protection capital assets. For the purpose of contract costing, these expenses are divided into two categories, namely, normal plant protection expenses and special plant protection expenses. Normal plant protection costs are allowable and are allocable to all work in the plant. Special plant protection costs, which term refers to an extension of the contractor's normal plant protection program are also allowable and allocable to specific Government contracts requiring special protection upon the specific direction and approval of the contracting officer.

15-204.29 PRECONTRACT COSTS. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs will not be allowed unless specifically set forth in the contract and may be limited to a period of time as well as to the type and amount of such costs.

15-204.30 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER.

a. This item includes the cost of professional services rendered by the members of the particular profession separately engaged. These costs generally are allowable when reasonable in relation to the services rendered and are not contingent upon recovery of the costs from the Government.

b. Factors to be considered (among others) in determining the allowability of costs in a particular case are: (i) 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 organization; and (iv) whether or not the proportion of Government production to the

contractor's total production 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 production under Government contracts. Retainer fees to be allowable must be reasonably supported by evidence of services rendered.

c. The costs of 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 Government are unallowable.

15-204.31 PROFITS AND LOSSES ON DISPOSITION OF PLANT, EQUIPMENT OR OTHER CAPITAL ASSETS. Included herein are gains or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments. Profits or losses on sale or exchange of capital assets, including investments, will be excluded in computing contract costs.

15-204.32 RECONVERSION EXPENSES. Reconversion expenses are those incurred in the restoration of the contractor's facilities to approximately 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 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.

15-204.33 RECRUITING EXPENSE. This item includes the costs of "help wanted" advertising and the operating costs of an employment office necessary to secure and maintain an adequate labor force. It further includes the costs of operating

an educational and aptitude testing program, travel expenses of employees while engaged in recruiting personnel, and travel expenses of applicants for interviews for prospective employment. These costs are allowable. Where the contractor uses private employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are not allowable.

15-204.34 RENTALS OF PLANT AND EQUIPMENT. (Including sale and leaseback of facilities.)

This item includes expenses for (i) use of land, buildings, and equipment or other personal property, and (ii) rental expenses under sale and lease-back agreements incurred by contractors through sale of plant facilities to investment organizations (such as insurance companies) or to private investors and concurrently leasing back the same facilities.

a. Rentals of plant and equipment under (i) above are allowable if the rates are reasonable in light of the type, condition and value of the facilities leased, options available and other provisions of the rental agreement.

b. Rentals specified in sale and lease-back agreements under (i) above are allowable only to the extent that such rentals do not exceed normal costs (such as depreciation, taxes, insurance and maintenance expenses) which would have been incurred had the contractor retained legal title to the facilities.

15-204.35 RESEARCH AND DEVELOPMENT. Research and development expenses (sometimes referred to as general engineering expenses) for the purpose of contract

costing are divided into two major categories, namely:

a. General research, also referred to as basic research, fundamental research, pure research and blue-sky research.

b. Related research or development, also referred to as applied research, product research and product line research.

(1) General research is that type of research which is directed toward increase of knowledge in science. It is research where the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. The costs of a contractor's independent general research shall be an allowable cost in all cost type contracts under the following conditions:

(i) The amount of such costs is reasonable.

(ii) The costs are equitably allocated to all works of the contractor other than its independent research.

(iii) The contractor has submitted a report covering such independent general research projects showing the following:

(1) Description and objectives of the project.

(2) Anticipated total cost.

(3) Cost during the period under review.

(4) Benefits expected to accrue to the mission of the Department of Defense as a result of project.

(iv) The business of the contractor at the time of entering the contract is predominantly (75% or more) commercial. (If less than 75% commercial at the time of entering the contract allowance may be authorized by special contract provision.)

The above conditions will also apply in the negotiation of predetermined overhead rates.

(2) Related research is that type of research which is directed toward practical application of science, and "development" is the systematic use of scientific knowledge directed toward the production of useful materials, devices, methods, or processes, exclusive of design and production engineering. The costs of a contractor's independent related research (that which is not sponsored by a contract or grant or is not otherwise reimbursed to a contractor) may, if allocated on the basis of all production, be allowed as a cost to any cost type production contract if the research is related to the product or product line. No portion of such research will be allowable under cost-type research and development contracts.

c. Research and development costs, regardless of the nature, which were incurred in accounting periods prior to the award of a particular military contract, (including amounts capitalized and the cost of patents obtained) will not be allocated to that contract unless allowable as pre-contract costs (Paragraph 15-204.29).

15-204.36 ROYALTY PAYMENTS. This item covers amounts paid for the right to use patents. Where the use of such patent is necessary for the proper performance of the contract and where the Government does not already have a license or other right to use such patents, the royalties are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the contracting officer.

15-204.37 SERVICE AND WARRANTY EXPENSES. This item includes the costs of servicing the product installation, training personnel in the use, operation and maintenance of the product, correcting product defects, replacing defective parts, and other related operations or practices. Actual costs to

be reimbursed to the contractor will be in accordance with the clause of the contract entitled "Inspection of Supplies and Correction of Defects", (See paragraph ASPR 7-203.5), or as otherwise provided in the contract.

15-204.38 SEVERANCE PAY. Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated.

The cost of severance pay is allowable only to the extent that, in each case, it is required by (i) law, (ii) employer-employee agreements, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) the circumstances of the particular employment.

For contract costing purposes severance pay is divided into two categories as follows:

a. Normal Turnover Severance Pay. The cost of severance payments is allowable and must be allocated to all classes of work being performed in the contractor's plant at the time of payment. However, 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.

b. Mass Severance Pay. The cost of abnormal or mass severance pay 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 entire period of employment with the contractor and equitably apportioning such cost to all business of the contractor performed during that period.

A reservation in the final release of claims (see ASPR 7-203.4) may be made in the case of completed cost-reimbursement type contracts when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

15-204.39 SPECIAL TOOLING. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or to the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. The cost of special tooling, when acquired for and its usefulness is limited to government contracts, is allowable and will be charged directly to the government contracts. When such special tooling is acquired it shall be subject to the provisions of the contract clause set forth in ASPR 13-503 entitled "Government Property".

15-204.40 STRIKES AND LOCKOUTS, EXPENSES OF. The situations and conditions surrounding strikes and lockouts are so varied that it is impossible to establish a general principle providing for allowance or disallowance of costs incurred during such occurrences. Each case must be considered on its own merits.

15-204.41 TAXES. Taxes are charges levied by a government unit. They do not include fines and penalties except as otherwise provided herein.

a. In general, taxes which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except (i) for Federal income and excess profits taxes; (ii) taxes in connection with financing, refinancing or refunding operations (see paragraph 15-204.19); (iii) taxes from which exemptions are

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

b. Taxes otherwise allowable under a. above, but which may be illegally or erroneously assessed may be allowed as a cost of work performed, provided that the contractor, prior to payment of such taxes, (i) promptly requests instructions from the contracting officer concerning such taxes; (ii) agrees to comply with such instructions; and (iii) if so directed by the contracting officer also agrees to take all necessary action in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer, shall be allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs.

c. Any refund of taxes, penalties or interest thereon shall be credited to contract costs in the proportion in which contract costs absorbed the costs of taxes, interest or penalties. If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

15-204.42 TRADE, BUSINESS, AND PROFESSIONAL ACTIVITIES.

a. Memberships. This item includes costs of membership in trade, business, and professional organizations and such costs are allowable.

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

c. Meetings and Conferences. All other entertainment expenses, including those classified as gratuities in accordance with ASPR 7-204.13, are unallowable.

15-204.43 TRAINING EXPENSES.

a. This item includes the costs of preparing and maintaining a program of instruction designed to increase the over-all effectiveness of employees. Included are the costs of the director of training and staff, training materials and text books when the training program is controlled by the contractor, and tuition, fees, training materials and text books when the training is in educational institutions.

b. Such costs which are limited to on the job training are allowable when properly allocated.

c. Costs of training in educational institutions are not allowable, except to the extent specifically provided in the contract.

15-204.44 TRANSPORTATION EXPENSES. Transportation expenses include the cost of freight, express, cartage and postage relating either to goods purchased, in process, or delivered.

When such costs can readily be identified with the items involved they may be direct costed or added to the cost of such material. (See paragraph 15-204.24). Where identification with the materials received cannot readily be made, inbound transportation expense may be charged to the appropriate indirect expense accounts, provided the contractor follows a consistent procedure in this

respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as direct charges.

15-204.45 TRAVEL EXPENSES. This includes costs of transportation, lodging, subsistence and incidental expenses incurred by contractor personnel in a travel status while on official company business.

a. Travel expenses incurred in the normal course of overall administration of the business and applicable to the entire business are allowable when properly allocated.

b. Travel expenses directly attributable to contract performance may be charged to the contract in accordance with the principle of direct costing.

c. Subsistence and lodging including tips or similar incidental expenses may be reimbursed either on an actual or per diem basis. The basis selected should be consistently followed.

d. Costs of premium transportation may be allowed when it is shown to be necessary to performance of the contract.

e. Entertainment expenses are not allowable.

f. Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the Contracting Officer.

RESTRICTED
SECURITY INFORMATION

ARMED SERVICES PROCUREMENT REGULATIONS

Proposed Revision

SECTION XV

CONTRACT COST PRINCIPLES AND STANDARDS

May 1953

RESTRICTED

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15 May 1953

PROPOSED REVISION

OF

SECTION XV

CONTRACT COST PRINCIPLES AND STANDARDS

15-000 Scope of Section. This section sets forth, in general, principles and standards for the determination of costs to be utilized in connection with the negotiation of prices and cost reimbursements for all contracts under the jurisdiction of the Department of Defense.

15-001 Effective Date of Section. This section shall be complied with on and after _____, 1953, although compliance is authorized from the date of its issuance.

PART 1 - APPLICABILITY AND PURPOSE

15-101 General. The principles and standards set forth herein are intended to apply uniformly (except as expressly qualified) to the determination of either estimated or actual costs of performance of all prime contracts and subcontracts, the prices of which are subject to approval or review by the Department of Defense.

15-102 Reasons for Issuance of This Statement. Defense procurement is a matter of great public interest. It is important that it be conducted on a plane that assures the Congress and the taxpaying public that defense materiel is being obtained at fair and reasonable prices without waste and extravagance. It is also important to assure defense manufacturers (especially competitors), of fair and equitable treatment, without discrimination, in contract pricing. A vast amount of defense materiel is obtained, especially in periods of emergency, under conditions where prices cannot be established simply by competitive bidding. The nature of the inherent risks in defense production, especially in the time-length of contract performance, and the frequent absence of complete product specifications, result in the use of various forms of contracts in which prices are determined to a greater-or-lesser degree by the use of cost data -- both estimated and actual. The gathering, analysis, and use of cost data are complex problems, both for contractors and Government negotiators, as well as industrial and Government accountants and auditors who are more skilled in such matters. Cost problems are serious and diverse, both with respect to more basic business practices and to application of appropriate accounting principles. An adequate statement of cost principles and standards is necessary in order to avoid misunderstanding,

as well as confusion, delay, and expense in contract negotiation and administration, including auditing and settlement of contracts. Every defense contractor, therefore, should recognize the necessity of the adoption of these principles and standards in the common good -- not merely for cost-reimbursement-type contracts, but also for other special types of contracts the use of which has greatly increased.

15-103 Application of Cost Estimates. Cost estimates submitted by contractors are used for the following purposes:

(a) Under outright fixed-price contracts:

(1) Negotiating fixed prices, to the extent there is an absence of other objective criteria to enable the determination of a fair and reasonable price.

(b) Under fixed-price contracts containing price-redetermination provisions:

(1) Determination of tentative initial prices.
(2) Firm revision of initial prices on a forward basis.

(c) Under incentive-type contracts:

(1) Determination of tentative target prices and target costs when firm targets cannot be initially determined.
(2) Determination of firm target prices and target costs, including those cases where there is delayed determination.

(d) Under cost-reimbursement-type contracts:

(1) Initial estimates as a basis for establishing fixed fees.

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

(1) Contract price ceilings.
(2) Adjustment of prices, price ceilings, targets, fees, etc. for all contract changes.

15-104 Application of Historical (Actual) Costs. Historical (actual) costs are used for the following purposes:

(a) Under cost-reimbursement-type contracts: retroactive determination of prices.

(b) Under fixed-price contracts, with retroactive price-redetermination provisions: retroactive determination of fixed-prices based on actual costs, to extent permitted by Armed Services Procurement Regulations.

(c) Under incentive-type contracts: determination of adjusted prices after contract completion in light of actual costs and adjusted profits or fees, based upon sharing of increased or reduced costs as compared with estimated target costs.

(d) Settlements in connection with termination of contracts for the convenience of the Government to the extent provided by the Armed Services Procurement Regulations.

15-105 Contract Provisions. Where the nature of a contract requires or may involve future determinations of price, these principles and standards must be incorporated specifically by reference in the contract or be set forth in the contract or appended thereto, in order to be binding upon the Government and upon the contractor. These principles and standards shall be thus made a part of every contract and subcontract whose costs are subject to approval or review by the Department of Defense, or any of its subdivisions, executed as of a date on or after , 1953. Any such contract or subcontract may treat any element of cost thereunder more specifically than provided by this statement of principles and standards so long as there is no inconsistency therein.

15-106 Implementation by the Military Departments. This statement of contract cost principles and standards shall be followed in procurement operations of the three military departments without modification or expansion in any way except as to instructions on administrative procedures or as provided in the last sentence of the preceding paragraph. Any expansion of or change in this section, deemed to be desirable, will be referred to the Office of the Secretary of Defense for consideration. Any interpretations of these principles and standards made in the course of contract administration shall be on a case-by-case basis in the light of the specific facts thereof -- no system of written interpretations to be generally followed will be permitted. Administration of these problems is a matter for practical business judgment rather than rigid adherence to established precedents.

PART 2 - GENERAL PRINCIPLES AND STANDARDS FOR DETERMINATION OF COSTS

15-201 Meaning of Total Cost. The total cost of work performed or to be performed under a contract or subcontract, the prices of which are subject to the approval or review of the Department of Defense, is the net sum of (a) the allowable direct costs reasonably incident to the performance of the contract or subcontract, (b) the properly allocable portion of allowable indirect costs, and (c) less applicable income and other credits. According to the circumstances involved, these costs may be stated either in terms of the aggregate for an entire contract or in terms of individual units of products or services covered by the contract with equal application of these principles and standards.

15-202 Factors Determining Allowability of Costs. Factors used in determining the allowability of costs include (a) conformity with the meaning of total cost outlined in the immediately preceding paragraph (15-201); (b) reasonableness in the amounts of particular elements of costs; (c) allowability of the costs as deductions in determining taxable income under the Internal Revenue Code; (d) application of generally accepted accounting principles and practices; (e) coordination between the factors considered in determining allowability of costs and in determining a reasonable profit under the contract, to the end that such allowances will not result in duplicating the allowance for any factor; and (f) exclusions of specific elements of costs as a matter of public or business policy, as set forth in this section.

15-203 Actual and Estimated Costs. Costs used in negotiating contracts, or in making settlements thereunder, may be either of a historical nature (actual costs) or may be estimates of future costs, in whole or in part, whichever is appropriate for the specific type of contract pricing as indicated in paragraphs 15-103 and 15-104.

15-203.1 Applicability of Principles to Determination of Cost Estimates as Well as Actual Costs. In general, the same principles apply to making cost estimates as to determination of actual costs. Therefore, this section will consider cost principles interchangeably as applicable to either cost estimates or actual costs, except as may be indicated specifically to the contrary.

15-203.2 Use of Standard Costs in Cost Estimates. Wherever future cost estimates are required, the use so far as practicable, of modern standard cost methods should be encouraged, because they provide the best means of cost estimating and cost analysis, as well as enable more effective control of actual costs during contract performance. Such methods provide for pricing material costs on the basis of bills of materials, labor costs on the basis of studies of time requirements, and overhead costs on the basis of budgeted expenses for the expected volume and types of production, with reasonable allowances for cost variances indicated by experience to be expected for defective work and failure to achieve full efficiency. Such methods provide the best

possible assurance of accuracy of cost estimates, as well as the means of more effective cost control, when variances of actual costs from standards are measured regularly and recorded in the formal accounts.

15-203.3 Use of Standard Costs in Determining Actual Costs. Wherever contract price negotiations or settlements depend upon actual costs, and contractors have reasonably satisfactory standard cost systems, standard costs of products, or parts thereof, with appropriate adjustments for variances from actual costs, may be considered to represent actual costs, provided such costs are believed to otherwise reflect the application of the principles and standards set forth in this section. However, normally where adequate standard costs are available for complete end-products, fixed-price contracts should be used.

15-203.4 Use of Job-Order or Process Cost-Accounting Method. The use of either the job-order or process cost-accounting method in determining historical costs of actual contract performance is acceptable. Wherever there is to be a retroactive determination of initial fixed-prices under a price-redetermination clause, or of a revised target cost under an incentive-type contract, it is essential to determine the actual cost of production of those items delivered upon which the revised price and cost determinations depend; this generally requires separate job costing of that portion of production, but any other method of cost determination may be used which will yield equally reliable results.

15-203.5 Use of Historical Costs for Purposes of Cost Estimating. When used in the preparation of cost estimates, unmodified historical cost data may not provide a satisfactory standard of future performance; in this event their use would be undesirable. Where no more satisfactory cost data are available, historical costs may be used in the preparation of estimates provided they are adjusted to eliminate nonrecurring costs and to reflect new conditions, if any, which may be applicable to future production.

15-204 Basis of Application of Principles and Standards to Pricing of Standard Commercial Products. Standard commercial products are those which are normally manufactured and sold in large volume to customers who are neither prime contractors nor subcontractors for defense work, notwithstanding the fact that substantial quantities may be sold to defense contractors or the Government with relatively little or no change in specifications. In general, it will be expected that standard commercial products will be purchased under fixed-price contracts, and that prices will be established without primary reference to the respective contractor's costs. The use of escalation clauses generally should take care of major contingencies which should not be added to estimated costs in contract pricing of such products. However, in those instances where cost analyses for standard commercial products are required in firm price negotiations under fixed-price contracts, these principles and standards will be applicable to the extent appropriate. Care must be used in such cases in order not to impose impractical requirements on contractors for cost estimates -- to meet which requirements might result in work entirely disproportionate to the amounts involved. Cost analyses in such cases may sometimes be based upon other data than current cost estimates --

for example, when a manufacturer has no cost data for a specific standard commercial product, he may have available for analysis, historical sales, costs and profit data on a group of products, including the specific one subject to price negotiation.

15-205 Application of Generally Accepted Accounting Principles. It is to be understood that generally accepted accounting principles with respect to product or contract costs are nowhere codified or reduced to rigid formulae. Such principles permit the use of alternative practices or conventions, particularly in different types of business activities; yet in the main there are generally accepted limits in principle regarding accounting practices, the violation of which would not be condoned by the accounting profession. To the extent there is a twilight zone between accepted and non-accepted practices, definite understanding should be reached between the contracting parties. This section covers a number of subjects of this nature, so far as they can be covered for general application. Yet inevitably there will be a requirement for specific contractual provisions or supplementary interpretations of the contract terms in the application of cost principles.

15-206 Contractor's Accounting System. Subject to the observance of the cost principles set forth in this section, any system of accounts and any method of cost accounting or estimating will be acceptable, if they are in accord with generally accepted accounting principles and practices and if they produce equitable and reasonably accurate results under the particular circumstances.

15-207 Relation of Contract Costs and Profits. The use of actual or estimated costs in procurement pricing is only one phase of establishing the total price or monetary consideration under a contract. The determination of reasonable profit is another important phase. These two phases of pricing are mutually dependent to the extent that certain factors may be considered in determining either costs or profit (or fee). Major factors to be considered in this respect relate to risks of cost increases or losses in performance. Depending upon the type of contract, either the contractor or the Government may assume such risks. Where the Government assumes all the risk of cost increases or additional unknown costs, or a major share thereof (as it generally does when these risks are great) through the use of cost-reimbursement-type contracts, escalation or price-redetermination clauses, or incentive-type contracts, the profit allowance for cost contingencies should be reduced to the extent appropriate. Normally in negotiation of prices under outright fixed-price contracts, risks of loss or cost increases will be compensated in allowable profit margins rather than in allowances for contingent increases in cost. However, no hard and fast line may be drawn here, but it is important that such allowances not be duplicated. For example, a contractor's cost estimates may properly include reasonable estimates of cost applicable to normally experienced defective work in manufacturing processes. Cost estimates generally include reasonable depreciation on plant and equipment; this cost factor is based largely upon risks of obsolescence of the facilities. In such cases these factors

should not be considered as elements of risk in determining the allowable profit. There are other factors having a similar bearing on cost and profit determination; for example, because interest on borrowed capital is not allowed as a cost, it should be covered in the interest return on capital allowed as a part of profit or fee; again in contracting for construction under cost-reimbursement-type contracts, it is customary practice to exclude general, administrative and financial expenses from costs, but to allow instead for these factors as a part of the fixed fee.

15-208 Relation of Contract Cost Principles to Federal Income Taxation. In general, all business costs allowable as deductions for the purpose of determining taxable income under the Internal Revenue Code should be allocated (assigned) to the extent appropriate, to the cost of performance of specific contracts, except as otherwise set forth in this statement of principles and standards.

15-209 Special Provisions Relating to Cost Determinations, Including Limitations. Because of the need for standards of reasonableness in determining either estimated or actual costs of performance of specific contracts, including the application of business and public policies, a considerable portion of this Section, namely Part 3, is devoted to standards of allowability of specific elements of costs under supply and research contracts with commercial organizations. Moreover, because of unusual accounting practices or problems involved in determining costs under facilities contracts, construction contracts and research and development contracts with non-profit institutions, Parts 4, 5, and 6 respectively, are devoted thereto.

15-210 Direct vs. Indirect Costs. Every method of cost accounting or estimating embodies the principle of direct costing of materials and subcontract work. Direct costing of productive labor is general practice. Other expenses may be costed directly sometimes, but generally many of them are allocated to products, job orders, or contracts, etc. on an arithmetical basis in ratio to appropriate measures of performance -- for this reason, such allocated expenses are termed "indirect costs."

15-211 Principle of Direct Costing. Every major item of cost (actual or estimated) should be identified with the unit being costed, whether it be the product, a job order, or a contract, when such items of cost do not, in fact, have substantially proportionate applicability to all classes of work. This principle may often be applicable to such elements of expense (when of major consequence), as travel, commissions, advertising, engineering services, etc., as well as the normal items of materials and productive labor. This principle should be applied equally to the costing of both defense and nondefense products or services by any contractor who is engaged in mixed production. There are no absolute rules by which to determine which items or elements of cost should be direct costed. In applying the principle, any contractor should follow a consistent pattern of costing if the results are to be equitable. In some instances, this principle may be applied by direct costing only the major items of a given cost element to all products, leaving minor items, if appropriate, subject to indirect cost allocations.

15-215 Indirect Costs. Indirect costs, which have the character of common or joint costs, usually consist of indirect materials, indirect labor, and other items. These costs generally are grouped in classes, as follows:

(a) Manufacturing (shop, laboratory) expenses (often termed "manufacturing overhead" or "burden"), which are incurred in fabricating the article or service rendered;

(b) Engineering expenses to extent not included in (a) or (c);

(c) Selling and distribution expenses, incurred in marketing the products manufactured;

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

(e) Financial and other expenses.

15-216 Methods of Allocation of Indirect Costs. No general rules regarding allocation of indirect costs to products, job orders, or contracts can be stated for all individual cases, because the nature of the particular operations and the actual conditions in each instance determine the most suitable method or methods to be employed. The best general test which may be applied to determine an appropriate method is to find the answer to the question: Does the method result in an allocation of the indirect costs to the products, job orders, or contracts, most equitably in relation to the machine or other work being performed on each?

15-216.1 Use of Predetermined Rates for Indirect Expenses (Overhead Costs).

(a) Indirect expenses must always be predicted for purposes of cost estimates. This involves determination by the contractor of expense rates in accordance with whatever method or methods of expense allocation are followed. In accordance with the aim of encouraging the use of standard costs (paragraph 15-203.2), contractors should be encouraged to use accepted standard cost methods of budgeting based upon distinguishing between fixed and variable expenses and upon estimating variable expenses by cost centers in proportion to estimated levels of production or work loads; such budgets provide the best means for estimating expense rates. Historical indirect expenses, or expense rates, should not be used indiscriminately as the equivalent of budgeted rates for this purpose without adjustment for nonrecurring expenses and adjustment of the portion of the rates representing fixed expenses when substantial changes in production or work loads are expected.

(b) The use of predetermined rates for indirect expenses is acceptable in lieu of actual rates of indirect expenses in determining otherwise historical costs of products or contracts, including costs under cost-reimbursement-type contracts, provided there is reasonable assurance that

the results would be fairly comparable with the use of actual rates. This practice may expedite the determination of contract prices and reduce auditing. When predetermined expense rates are so used, the contractor must exclude from direct costs any cost element included in predetermining expense rates in order to avoid duplicate charges.

15-219 Financial and Other Expenses and Federal Income and Excess Profits Taxes. Neither product nor contract costs shall include interest charges (except under special circumstances -- see Part 3) or Federal income taxes because such charges are allowed for in determining overall prices. It would be improper to allow for federal excess profits taxes in determining overall prices. Profit margins allowable in contract pricing are based, among various factors, upon consideration of normal interest return on total capital employed (including borrowed capital) and compensation for risks (including loss of any capital) except to the extent that risks are the subject of compensation through cost allowances or are assumed by the Government under special forms of contract pricing, when no pricing allowance for such risks should be made. In this way, every contractor should receive nondiscriminatory treatment, whether he furnished his entire capital or borrows a large portion thereof, or whether he is organized in the form of a corporation, a partnership, or a sole proprietorship. Any other financial or miscellaneous expenses must be considered item by item in determining costs of a product or contract.

PART 3--APPLICATION OF COST PRINCIPLES IN SUPPLY AND RESEARCH CONTRACTS WITH COMMERCIAL ORGANIZATIONS

15-300 Scope of Part. This part sets forth, in some detail, applications of cost principles and standards of Part 2 of this Section in determining costs to be utilized in connection with the negotiation of prices and cost reimbursements for all contracts other than (i) facilities contracts, (ii) construction contracts and contracts for architect-engineer services related to construction, and (iii) research and development contracts with educational or other nonprofit institutions. It is impracticable and unnecessary to cover every element of cost or possible situation that might arise in a particular case. However, when the items contained in this part do not furnish specific guidance, cost determinations should be made in light of the philosophy expressed or implied in the principles and standards comprising Part 2 of this Section and the more detailed discussions of similar or related items in this Part 3.

15-310 Manufacturing Costs.

15-311 Materials. The costs of materials, both direct and indirect, used or consumed in performance of Government contracts are allowable on the basis hereinafter outlined. As used hereinafter, the term "materials" includes subcontract work.

15-311.1 Collateral Elements of Material Cost. In establishing direct material costs, consideration may be given to including the following elements, to the extent they are reasonable:

(a) transportation, insurance, purchasing, receiving, handling, and storage;

(b) overruns, spoilage, and defective work;

(c) adjustments between book and physical inventories due to variations in weights and measures and errors in record-keeping reasonably related to the period of contract performance.

To the extent such items are included as direct material cost, no additional allowance therefor may be made in the determination of manufacturing expenses. If not so handled, they are properly includable in manufacturing expenses.

15-311.2 Material Credits. In establishing material cost, effect shall be given, either directly or as a reduction of total manufacturing costs, to such items as:

(a) Cash discounts taken. However, in determining costs under cost reimbursement-type contracts, if the contractor does not exercise reasonable precautions in taking advantage of cash discounts available, all cash discounts lost may be excluded in determining allowable costs;

(b) Trade discounts, rebates, and allowances on material purchased;

(c) Value of scrap and salvage and materials returned to vendors.

15-311.3 Pricing.

(a) In determining historical costs, any generally recognized method of pricing materials issued from stock may be employed for determining actual cost, provided it has been consistently used by the contractor, is acceptable for internal revenue purposes, and does not discriminate against the Government. However, if the contractor so elects, materials in inventory or under binding purchase contracts at the commencement date of a Government contract may be charged to the Government contract at provable replacement cost as of the date of its commencement, provided that, once the election is made, the method must be followed consistently thereafter. When special materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to the contract. Costs of subcontract work should be determined similarly; provided that, when subcontracts are performed under contract pricing arrangements other than outright fixed prices, the determination of prices shall conform to this section so far as considerations of costs are concerned.

(b) For purposes of estimating material cost, either current market prices or replacement cost may be used, provided, under most circumstances, replacement cost is not in excess of current market. In order to avoid the allowance of contingencies in cases in which replacement cost may be estimated to be in excess of market, escalation or price-redetermination provisions may be made a part of the contract. However, situations involving increases in material costs which are reasonably certain and determinable or relatively minor in amount may warrant recognition being given thereto in making estimates.

(c) In cases in which the contractor has integrated operations involving inter-company or inter-divisional sales or transfers of materials, and it is possible objectively to determine market prices thereof, such prices may be used in determining or estimating the cost of the composite product. In objectively determining market prices, consideration may be given to the lowest sales price to nonaffiliated customers, if any, of the transferror for like items, quantity and quality considered. When objective pricing in such situations is not possible, the cost of materials so transferred or acquired shall be no greater, for pricing purposes, than the cost to the transferror. An exception to this may be made in case of suppliers in which nonaffiliated parties hold a minority interest of 10% or more. Under such conditions a reasonable margin of profit on such sales, in recognition of the minority interest, may be permitted by agreement. In other cases when there are indications that less than an arm's length relationship exists between the contractor and the supplier, similar consideration is required in determining the propriety of the amounts allowed as contract costs. Whenever such purchases of materials are made at other than cost to the supplier, pursuant to the provisions of this paragraph, they shall be treated as subcontracts in determining the profit or fee.

15-312 Labor. Direct labor cost consists of salaries and wages identified specifically with the performance of a contract, job, or product. In determining historical costs, labor will generally be charged at actual rates paid by the contractor. However, if it is the contractor's consistent practice to charge for performance of groups of labor at an average rate, or to use standard labor rates, with consequent savings in clerical expense or improvement in labor control, such methods may be used, provided labor groupings and the adjustment for cost variances result in a reasonably accurate assessment of total charges. Similarly, when labor costs are required for making cost estimates, the use of standard labor rates and standard time allowances (appropriately adjusted for experience variances) or reliable engineering estimates is acceptable. Ordinarily the use of wage rates higher than current going-rates will not be permitted for estimating purposes. In order to avoid substantial allowances for such contingencies, escalation or price-redetermination clauses are provided. However, situations involving increases in wage rates which are reasonably certain and determinable or relatively minor in amount may warrant recognition being given thereto in making estimates.

Common labor services may be treated as indirect costs if specific identification is impractical or uneconomical and the results of allocation are equitable. Similarly, supplemental or premium pay and fringe benefits may be so treated, although the relative size of such payments in relation to base pay may indicate the desirability of treating them as a separately identifiable direct labor charge as indicated hereinafter in this Part.

15.312.1 Fringe Benefits--Vacations, Holidays, Sick Leave, Military Leave, Severance Pay, Pension and Retirement Plans, and Employee Insurance. Compensation of these types is allowable to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment.

"Fringe benefits" arise because of the work performed by the employee while on the job, and the cost thereof must be considered as having a direct relationship to such work. However, in recognition of the different accounting treatment accorded fringe benefits, the cost thereof may be allocated to Government contracts on any of the following bases, provided equitable results are achieved:

(a) Each class of compensation is preferably to be accrued as a cost over the period in which it is earned.

(b) Where it is the contractor's established practice to record the costs at the time of payment, such practice may be acceptable. This is the most commonly used method of accounting for "fringe benefits," but its use might result in inequities in some cases. For example, if a Government contract was performed over the summer months during which most of the contractor's employees took vacations or military leaves,

recognition of the cost at time of payment would be inequitable to the Government. On the other hand, if the contract or contracts extended over approximately one year and the proportion of Government work to the contractor's commercial work remained stable, this method might be equitable. Also, severance payments made in the event of termination should not be allocated entirely to the terminated portion of the contract or even to the terminated contract, since the employee's right to severance pay has accrued over his entire period of employment.

(c) When the costs of any of the elements of fringe benefits are greater or lesser with respect to defense business as compared with nondefense business, such costs should be allocated, so far as feasible and appropriate, between the two classes of business before further allocation of such costs to individual contracts or products. If this method of cost allocation is used, it should be used consistently for all elements of fringe benefits having a different cost relationship to defense business as compared with nondefense business (for example, severance pay and pension costs—which may have an opposite relationship).

(d) Regardless of the accounting treatment accorded these costs in the contractor's accounts, an equitable amount may be determined by establishing an experience rate for such costs based on a representative period. Changed conditions and circumstances would have to be considered in making such a determination. The experience rate would then be applied to the more direct labor costs to determine the allowable costs. The use of such rate should be subject to semiannual revision in light of changed conditions.

The cost of pension and retirement plans is covered more fully as the subject of a directive set forth as Appendix __ to this Section.

Employee insurance includes group insurance and individual life and accident insurance.

15-312.2 Premium Payments for Overtime and Extra-Shift Work. Costs of this nature consist of only the premium portion of overtime and extra-shift payments or accruals to employees, not the straight-time portion. Thus, if the rate for overtime work is time-and-one-half of the regular rate, the premium portion is the additional one-half. Similarly, if the wage rate for a second shift is twenty cents an hour above the regular rate, this additional amount is the premium.

Overtime and shift premiums are allowable, but the contractor must disclose and justify the amounts of other than occasional overtime. Whenever such allowances are claimed as costs, prior approval of the contracting officer must be obtained.

Such premiums may be classified as either direct or indirect labor cost, but should be separately stated in either event. Where treated as direct labor cost, they should not be included in the base for distribution

of overhead. The amount of overtime and shift premium cost charged on Government contracts shall not be disproportionate to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant.

15-312.3 Unclaimed Wages. Costs under cost-reimbursement-type contracts should reflect a credit for unclaimed wages based upon agreement as to the amount thereof reasonably expected not to be paid subsequent to the date of settlement. In this event, all unclaimed wage liability rests with the contractor. When such an agreement cannot be reached, the Government will assume liability for payment of unclaimed wages and eliminate all allowances therefor from reimbursement to the contractor.

15-313 Other Manufacturing Expenses.

15-313.01 Method of Allocation of Indirect Manufacturing Expenses. Among the acceptable bases, depending upon circumstances, for allocating indirect manufacturing expenses are direct-labor-cost, direct-labor-hours, machine-hours, and units processed. In more complex manufacturing plants, it is appropriate to departmentalize the plant for purposes of accounting for manufacturing expenses when any given type of defense production is concentrated in departments having a much higher or lower expense rate than the average. Expense departmentalization is also 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. When manufacturing expenses are departmentalized, it is necessary to charge service-department expenses (such as the power plant) and factory general expenses (such as taxes, insurance, 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 should be selected for service-department and other expense distributions to productive departments--e.g., kilowatts of connected power load or metered power consumption, in the case of electric power.

When direct-labor dollars expended fairly reflect machine effort, as well as labor-effort, in any productive department it is most simple, as well as appropriate, to use that basis of expense allocation in preference to a direct-labor-hour or machine-hour basis. When there is much automatic or semiautomatic machinery in a productive department, the use of a machine-hour-rate is more appropriate for expense allocation. The units-processed-basis of allocation is appropriate when a given productive department processes only one item, or the several items are so similar as to be susceptible to measurement of units processed in terms of a common denominator--e.g. steel sheets of various gauges processed through a rolling mill.

15-313.02 Allocation of Engineering Expenses. Whenever engineering activities are substantial, it is appropriate that the expenses be separately allocated so far as feasible to products, job-orders, contracts, etc. The work to which expenses are allocated may include facilities or

equipment constructed or acquired and research and development work, as well as products. Engineering activities include product design, tool design, layout of production lines, determination of machine methods, drafting, etc. Engineering labor should generally be direct costed, as should any other major items of engineering expenses. Further treatment of various problems in connection with the costing of research and development, tooling, and preproduction expenses is included in Part 3 of this Section; facilities contracts are covered under Part 4.

15-313.03 Depreciation and Amortization. Depreciation on a contractor's plant and equipment and other capital facilities is an allowable element of contract cost, usually but not always of an indirect nature. It is the most difficult element of cost to determine because determination is largely a matter of judgment or opinion.

(a) In determining annual depreciation on the cost of a contractor's facilities, the following shall be considered:

(i) In the case of buildings and most machinery used in manufacturing, prospective economic obsolescence, either individually by item or enmasse, and not wear and tear, is the major factor covered by the depreciation charge. Wear and tear of such facilities may be made good indefinitely by repairs and maintenance. On the other hand, in the case of automobiles and certain items of machinery and equipment, as time goes on the excessive cost of repairs and maintenance makes it more economical to replace the items after a certain optimum period of use or age. Again, some items are expendable in use. Obsolescence of facilities may be brought about by reduced economic utility without loss of productive utility, such as by technological changes affecting the economic use of individual machines. Special requirements for relocation of facilities may also result in obsolescence. Obsolescence is always prospective with reference to an entire enterprise or an individual plant as well as individual items of plant and equipment. Defense industries generally have a special problem of obsolescence due to their character.

(ii) In general, every contractor is entitled to write off the entire cost (less estimated salvage value, if any) of facilities used in production over their estimated useful life in anticipation of possible obsolescence or replacement for other reasons, without requirement for proof of economic obsolescence accrued at any time from a technical standpoint. This will generally mean that the cost of facilities will be written off before their productive usefulness actually expires. Depreciation is too intangible to warrant attempts at meticulous determination by individual items of plant and equipment, although such attempts are frequent and may be recognized. Hence, depreciation will generally be determined by types of facilities, in each of which the items are subject to similar incidence of obsolescence or other causes of replacement. The amount of depreciation written off in any fiscal period may vary with volume of production, provided a systematic method is followed consistently from year to year which is directed at

the primary objective of writing off the cost of facilities over their useful life. Generally, when such a method is employed in the case of any facilities subject primarily to loss through obsolescence, the adjusted rates should be less than normal when production volume is below normal to compensate for higher rates where production is greater than normal (the term "normal" being used in the sense of "average").

(iii) Depreciation should be based upon original cost of the facilities, whether measured by purchase agreement for a cash consideration, the fair value of securities issued in exchange, or similar appropriate measures, although it is permissible that such cost of facilities be adjusted, where desired by the contractor for purposes of depreciation computations for contract pricing, to current price levels by the use of a general price index, provided in such event that the practice will be followed consistently in the future and also provided that otherwise the charge is made at the same annual rates applied to such adjusted costs as would have been appropriately applied on original costs in view of the estimated useful life of the facilities. In other words, no deficiency in actual depreciation provisions in any prior year, based upon current price levels, should be included in the depreciation charge for the current year. No other basis of determining appreciation in value of facilities may be utilized in determining depreciation for purposes of contract costs; for this purpose the provisions of the Internal Revenue Code governing the tax basis of facilities values are applicable.

(iv) No depreciation will be allowable as such, or as a rental or use charge, on the cost of facilities which are fully depreciated but still in use when a substantial portion of such depreciation was on a basis that represented, in effect a recovery thereof as a charge against defense contracts or subcontracts in initial negotiated pricing or renegotiation of contracts. Otherwise, the contractor may compute normal depreciation on the cost of facilities in use without reference to previous depreciation provisions. Fully depreciated facilities will be determined on the basis of relating original cost to accumulated depreciation on such cost, regardless of whether there is an adjustment of current depreciation charges based upon adjusting the cost of facilities to current price levels.

(v) No depreciation may be allowed on facilities which are not in use, except such facilities as are held for standby purposes including additional plant capacity reserved for defense production.

(b) In applying the foregoing considerations, depreciation rates established with the approval of the Bureau of Internal Revenue for income-tax purposes generally may be utilized in determining contract costs. When such rates have not been approved, it may be necessary to use independent judgment in the determination of reasonable rates. Bulletin F of the Bureau of Internal Revenue provides general guidance for income-tax purposes on depreciation rates for normal facilities in normal peacetime use; care must be taken in the use of Bulletin F rates for purposes of contract

pricing as they may not be typical for the facilities of any specific contractor or industry, especially when the facilities are acquired for emergency use. Special methods have been established for determining depreciation on emergency facilities subject to Certificates of Necessity authorizing special tax amortization by a special directive set forth in an appendix of this Section. When a contractor desires to establish depreciation rates which vary in relation to production there must generally be a departure from the depreciation method used for income-tax purposes. Again, the allowance of a computation of annual depreciation upon costs adjusted to current-price levels is at variance with income-tax depreciation methods.

15-313.04 Repairs and Maintenance. Repairs and maintenance of facilities (including Government-owned facilities) are allowable elements of contract costs. It is necessary that such expenses exclude expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and made the subject of depreciation. There is, of course, a twilight zone between repairs and maintenance and and capital expenditures within which a contractor should be permitted to operate upon the basis of his established accounting practice, if the results are quitable. For example, certain major costs of building alterations and rebuilding or rehabilitating machinery and equipment may reasonably be treated in some instances as either repairs and maintenance expenses or capital expenditures, depending in part upon the contractor's depreciation policy. In making decisions with respect to the alternative accounting treatment of these items, consideration should be given to the materiality of the amounts involved, and the question of the substantial enhancement in value of a contractor's facilities at the expense of the Government for use during periods in which the contractor will have little defense business. In the latter case, for contract pricing purposes, the cost generally should be considered to be of a capital nature and the subject of depreciation. In those instances where it may be appropriate to charge the cost of extraordinary rehabilitiation to expense, special care should be taken in equitably allocating the costs to all the benefited classes of work (see 15-313.07 "Preparatory Costs"). In some instances, allowance of substantial extraordinary rehabilitation expenses as a charge against defense business may be conditioned upon the contractor's agreement to hold the facilities available for defense work for a stated minimum period. Repairs and maintenance costs on facilities which are not in use will not be allowed, except on facilities held for standby purposes including additional plant capacity reserved for defense production.

15-313.05 Profits or Losses on Disposition of Plant and Equipment. Normally, in determining contract costs, no recognition will be given to profits or losses on disposition of plant and equipment for the reason that depreciation, reasonably determined, provides the exclusive charge for the cost of using a contractor's facilities. However, when a contractor has capitalized special facilities acquired solely for performance under defense contracts (rather than charge the costs thereof to specific contracts) and termination of contracts finds such facilities not fully depreciated, an additional cost allowance may be made in determining costs

of the terminated contracts for the purpose of contract settlement, provided such facilities are transferred to the Government, if so desired, or an equitable adjustment is made in favor of the Government in recognition of any salvage value estimated for such facilities.

15-313.06 Rentals of Plant and Equipment. Ordinary rentals of plant or equipment are allowable if bona fide and reasonable. Special care should be exercised in determining reasonableness of rentals in cases in which rates were arrived at as a result of less than arm's length bargaining. Rental costs will not be considered to be bona fide under the following circumstances:

(a) Rentals are paid to persons, including corporations, affiliated with the contractor.

(b) Rentals are paid to unaffiliated persons, including corporations, upon property formerly owned by the contractor when such property was fully depreciated or substantially fully depreciated before sale or transfer through charges against the costs of defense business.

In either case (a) or (b), rentals will be limited to a reasonable amount of depreciation, as might be determined if the property were owned by the contractor, plus carrying costs which are not paid by the contractor under the terms of the lease, including maintenance, taxes, and insurance (but not interest on the investment).

15-313.07 Preparatory Costs, including Engineering. Preparatory costs or expenses, also known as "make-ready costs," are costs specially incurred in preparing to operate under a specific contract or contracts. They include costs of organization and planning, employee recruitment and training, engineering and development (including product design, product specifications, and planning of production processes and layout) and plant alteration and rearrangement. Preparatory costs do not include initial production (starting load) costs which are treated in paragraph 15-313.08 of this Part.

Preparatory costs, when incurred for the exclusive benefit of Government production, are allocable directly or indirectly to the contracts benefiting from such costs. When preparatory costs benefit other classes of work as well as Government work, an equitable allocation to all benefited classes of work is proper.

Preparatory costs may have been incurred prior to the award of a definitive contract. The amounts of such costs, for purposes of contract cost allowances, are subject to approval of contracting officers based upon advance understandings or upon subsequent negotiation. In such case a specific provision covering the allowability of pre-award preparatory costs should be incorporated in any definitive contract when future pricing or repricing may be based in part upon actual contract costs. However, the absence of such provision will not preclude consideration of the costs in subsequent price negotiations or determinations under such contracts.

15-313.08 Initial Production Costs. Initial production costs, also known as "starting-load costs," are non-recurring costs that arise in the early stages of production because of the contractor's unfamiliarity or lack of experience with the particular materials, manufacturing processes, or techniques involved. They are to be distinguished from preparatory costs or expenses (also known as "make-ready costs"), which comprise such costs as tooling, engineering and development, and cost of equipment, and which are treated separately in this Section.

Initial production costs may consist of the excessive portion of material costs incurred in the early stages of production, on contracts requiring new products or greatly increased production, as the result of abnormal quantities of materials used or abnormal scrap losses. Initial costs may also consist of the excessive portion of direct-labor costs, plus a proper portion of the related overhead, incurred in the early stages of production due to such causes as excessive defective work resulting from inexperienced labor, idle time and subnormal production occasioned by testing and changing methods of processing, and cost of training employees. The justification for such special costs depends upon their nature and causes, and not merely upon the fact that total production costs are high.

After a reasonable volume of production has been attained and initial manufacturing difficulties have been overcome, unit cost will usually tend to level off, thereby evidencing the end of the initial period of production but not necessarily representing the lowest unit cost eventually attainable during the operation of the entire contract. If, however, rejects continue abnormally high after a contractor has been allowed a reasonable length of time in which to learn how to make a product efficiently, the resulting excessive costs may not properly be allowable for purposes of cost estimating for formal pricing purposes or in establishing costs under terminated contract settlements.

15-313.09 Reconversion Expenses. Reconversion expenses are those connected with restoration of facilities to approximately the same physical arrangement and condition they were in immediately prior to beginning of defense work, including the removal of Government-furnished property. Such expenses exclude the costs of acquiring and installing entirely new or different equipment or otherwise altering the facilities for an entirely different purpose after defense work is completed. Specific contractual provisions may be included in cost-reimbursement-type contracts to compensate the contractor for actual reconversion costs incurred. Reconversion expenses may also be allowed as an element of contract costs in other types of contracts on the basis of reasonable estimates under the following conditions:

(a) The contract price contains no other allowance for use of facilities which would compensate the contractor for reconversion expenses.

(b) The facilities must have been altered or rearranged at the inception of defense work or they were newly acquired buildings in which Government machinery and equipment has been installed.

(c) There must be a reasonable basis for the assumption that the facilities must and will be reconverted.

(d) Reconversion costs shall be allowed only in pricing those contracts in existence or being actively negotiated at the time the costs of conversion were incurred. In the event of subsequent conversions or modifications for additional contracts, care must be exercised to avoid duplications of allowances for reconversion costs.

15-313.10 Special Tooling. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment.

The cost of special tooling, when acquired for and its usefulness is limited to one or more Government contracts in force or being negotiated at the time of acquisition, is allocable to the specific Government contracts. The cost of tooling which is special to other classes of work will be allocated to such work. The cost of non-special tooling is not subject to direct allocation, but is subject to depreciation, which is presented elsewhere in this Part, except that in the production of standard commercial products such tooling costs may be treated as indirect manufacturing expense on an expenditure basis, in lieu of depreciation, when the resultant charges are reasonably equitable between fiscal years. When the entire cost has been allocated to Government contracts, the asset concerned shall become contractor-acquired Government property and be subject to the provisions of Section XIII and Appendices B and C, ASPR, applicable to contractor-acquired Government property.

15-313.11 Research and Development. Research and development expenses may be divided into two major categories--product research and general research.

(a) Product research is that research which is directed toward the the solution of specific problems encountered in the design or production of a particular product which has or is anticipated to have military or commercial use. The costs of current product research are allowable as costs on defense contracts and may be allocated thereto to the extent applicable to the supplies or services covered by the contracts, provided such costs are not reimbursed to the contractor under separate research contracts.

(b) General research is all research other than that which is directed toward the solution of specific problems encountered in the design or production of a particular product which has or is anticipated to have military or commercial use. The cost of general research, when reasonable in amount and incurred in accordance with the contractor's established practice, is allocable to all classes of work, including defense work, provided such costs are not reimbursed to the contractor under

separate research contracts. No general research costs which were incurred in accounting periods prior to the award of the particular defense contract(s) (including amounts capitalized in the cost of patents obtained) shall be allocated thereto, nor will the contractor be required to defer research costs incurred during the period of performance of defense contracts to subsequent accounting periods.

(c) At the option of the procuring agency, cost allowances for research and development work may be made contingent upon the contractor agreeing to waive any royalty charges, under all patents previously obtained or which may be obtained in the future from such work, to the extent such royalties are applicable to defense work, either directly or indirectly.

15-313.12 Patents and Royalties.

(a) Amortization of the cost of purchased patents owned by a contractor applicable to products or processes covered by a contract is an allowable element of cost to the extent reasonably allocable to the contract. Research and development costs leading to patents are allowed as provided in paragraph 15-313.11.

(b) Royalty costs are allowable if bona fide and reasonable. Special care should be exercised in determining reasonableness of royalties in cases in which amounts were arrived at as a result of less than arm's length bargaining. Royalty costs will not be considered to be bona fide under the following circumstances:

(i) Royalties are paid to persons, including corporations, affiliated with the contractor.

(ii) Royalties are paid to unaffiliated persons, including corporations, upon patents formerly owned by the contractor when the costs of such patents or the research and development work thereon were substantially recovered through charges against the costs of defense business.

In either case (i) or (ii) royalties will be limited to such charges as might be determined if the patent were owned by the contractor in accordance with the provisions of this paragraph and paragraph 15-313.11 relative to research and development.

(c) Care should be exercised in preventing charges for the use of patents when the Government, in fact, already has rights to such patents. (See Section IX, ASPR)

15-313.13 Plant Protection Expenses.

(a) These expenses represent costs incurred in protecting the contractor's personnel and plant against fire, theft, sabotage, espionage, civil disorder, enemy attack, or other violent destructive forces. Plant protection expenses are allowable costs of defense contracts. Normally they will consist of guards' wages and labor costs related thereto, costs

of individual equipment, cost of plant equipment if of minor amount, and depreciation of plant equipment. To the extent these costs are attributable solely to defense special security requirements, they are allocable entirely to defense contracts. Costs of normal plant protection not resulting from such special requirements, generally, should be indirectly allocated to all classes of work.

(b) A special problem may arise in the case of fixed price contracts, the security classification of which is altered after the contract has been entered into. When such a contract price is negotiated, the contractor is presumed to know the plant protection requirements under the contract and is expected therefore to meet such requirements without additional charge to the Government. However, if the security classification of the contract were changed by the Government after entering into the contract, additional costs of plant protection will be allowed the contractor. The additional costs may include not only current costs of an operating nature but also costs of a capital nature if the parties agree that the capital costs are incurred solely because of the changed security classification of the contract and would not have been necessary from the contractor's point of view. Also, if a classified contract is reclassified downward during its performance thereby permitting a savings in plant protection costs, such savings should, if material, be the subject of a contract amendment passing the savings on to the Government.

(c) Civil defense costs must be allocated to all work of the contractor performed at the particular location where the costs are incurred. When the Government's portion of the output of the particular plant is not material, the reasonableness of the incurred costs need not be questioned. However, since usually past experience will not provide a guide as to reasonableness, civil defense costs should be the subject of specific agreement when the amount of such costs to be allocated to Government contracts is substantial. When this is the case, reasonableness may be judged in light of:

(i) Recommendations and requirements of the duly constituted Governmental authority having jurisdiction over civil defense in the local area.

(ii) The extent of like measures being taken by other businesses within the local area, particularly those not producing under Government contracts.

(iii) The portion of total cost likely to be allocated to Government contracts as furnishing an inducement to the contractor to incur the cost.

15-313.14 Insurance and Bonds.

(a) The net cost of insurance and bonds, after deduction of dividends or other allowances which may be expected, if reasonably necessary to the operation of a business, is an allowable cost on Government contracts to the extent allocable. Some, but not all, of the types of

coverage which may be reasonably necessary are property, aircraft, automobile, general liability, product liability, workmen's compensation, employees' group, accident and disability, use and occupancy, and employees' fidelity and surety bonds (including performance bonds).

(b) Insurance on the lives of officers is not an allowable cost, except when premiums are paid in behalf of executives or employees pursuant to specific agreement or established policy whereby such payment may be properly considered as additional compensation (Paragraph 15-312.1).

(c) When a contractor assumes insurable risks of any type, a reasonable provision for losses estimated by the contractor is an allowable cost if such provision is based upon actual loss experience to the extent feasible; or, in the absence of adequate loss experience data, it is not in excess of net costs which would be paid for such insurance if carried by private insurance companies.

15-313.15 Taxes.

(a) In general, all taxes paid or accrued in accordance with generally accepted accounting principles are allowable, except for Federal income and excess profits taxes (see paragraph 15-219). Special assessments on land are not allowable because they represent capital improvements.

(b) The Federal Government is subject to certain exemptions from payment of Federal customs duties and excise taxes and State sales or use taxes on the purchase of materiel, either directly or for conversion, as indicated in Parts 2 and 3 of Section XI of the Armed Services Procurement Regulations. On the other hand, such taxes are generally properly assessed on materials and property purchased by a defense contractor. It is generally illegal for a State or local authority to assess a contractor for property taxes upon the basis of including in his assessed property valuation any amount for Government-furnished property. For this purpose, the Government is not considered to own raw materials in stock or work in process acquired and fabricated by the contractor under contracts subject to progress payments or advance financing, including cost-reimbursement-type contracts.

(c) Whenever taxes are believed to be illegally assessed against the contractor and the cost thereof may be included in historical costs for the purpose of contract pricing, contractors should request contracting officials for instructions concerning the payment of such taxes, possibly under protest, and with further respect to instituting litigation to obtain tax refunds, including interest, in which the Government would share in ratio to the charge made against the contracts. When litigation is involved in which the Government has an interest, it will bear its share of expenses of litigation either as a contract cost or as a reduction of any recoveries of costs for its account.

(d) State income taxes are an allowable item of cost, subject to a reasonable allocation to defense business, considering if desirable the

portion of total taxable profits which may be attributable to such business. Allowance of such taxes is necessary from the standpoint of equity, because many State or local governments do not have an income tax, and those which do, use it in lieu of some other form of taxes which would be an allowable element of contract costs.

15-313.16 Strikes and Lockouts. The situations and consitions surrounding strikes and lockouts are so varied that it is impossible to establish a general principle providing for allowance or disallowance of costs incurred during such occurrences. Each case must be considered on its own merits in the light of the philosophy expressed or implied in the principles and standards expressed in Part 2 of this Section.

15-320 Selling and Distribution Expenses.

15-320.1 Basis of Allocation of Selling and Distribution Expenses. Selling and distribution expenses in general are subject to allocation to the cost of defense work to the extent appropriate, considering the methods of selling and distribution to the Government or to prime contractors or subcontractors. Generally, selling and distribution expenses should be allocated between product lines, or to products sold to the respective customer types (where sales methods are different), based on analysis of the cost elements in relation to the sales efforts. In some cases, it may be appropriate to first allocate these expenses in whole or in part as between defense and nondefense business, and then to allocate the expenses applicable to defense business against the individual defense contracts or products. The principle of direct costing is very important in this area. For example, when special defense products are sold to the Government or to defense contractors by separately identifiable employees of the manufacturer, the compensation and expenses of such employees may be appropriately charged to costs of such products. When, in such cases, there is a separate sales organization or identifiable group of representatives engaged in selling to nondefense customers, no portion of compensation and expenses thereof should be charged to defense products. On the other extreme, when standard commercial products are sold at fixed prices direct to the Government or to defense contractors, as well as to numerous customers not engaged either directly or indirectly in defense production, by means of one established sales organization, the same selling expense per unit of product may be used in cost estimating, except when the quantities sold are so abnormal in relation to sales effort that such an averaging of costs would result in significantly excessive total cost estimates. In the latter case, the fixed selling expenses should be charged to normal nondefense sales, leaving the defense sales chargeable only with a proper share of the variable costs. For an illustration of this principle see paragraph 15-320.5 re advertising.

Many businesses have not yet extended refined methods of cost accounting to selling and distribution expenses; in this, there is a lag behind methods of cost accounting for manufacturing expenses--in consequence improvements in cost accounting in this area are more frequently required than in the area of manufacturing costs.

15-320.2 Salesmen's or Agents' Compensation.

(a) Salesmen's or agents' compensation allocable to defense contracts should be reasonable in the light of the services rendered. When it is apparent that sales efforts are disproportionately low in relation to amounts of defense contracts, it may be desirable that the contractor adjust the basis of compensation accordingly. For example, when defense business consists of standard commercial products which are sold normally on a commission basis, sudden expansion of defense business due to emergency should require change in basis of compensation to a salary or maximum commission ceiling in order to prevent unreasonable windfalls to salesmen or agents. If inequitable or exorbitant compensation is paid, it shall be subject to disallowance, to the degree deemed excessive, for the purpose of allocation of costs to defense contracts.

(b) No fee, commission, percentage, or brokerage fee shall be allowed as a contract cost when contingent upon or resulting from an award of a contract, except commissions paid to bona fide employees or established commercial or selling agencies maintained by the contractor for the purpose of securing business in a normal manner. This provision shall be applied in a manner consistent with representations or agreements of contractors or prospective contractors in the light of ASPR, Section I, Part 5.

15-320.3 General Sales Expenses. These expenses, consisting of salaries and expenses in connection with direction and supervision of all sales efforts, clerical expenses in maintaining sales records and statistics in some cases, and similar overall sales expenses, may be considered to be allocable indirectly to defense products or contracts in some cases based upon the specific facts in each case, provided the basis of allocation is equitable as between defense and nondefense business as a whole in the light of the relative services rendered.

15-320.4 Bidding Expenses. Normally bidding expenses will be treated as indirect expenses and apportioned as costs of specific contracts or products, as generally provided in paragraph 15-320.3, "General Sales Expenses." When bidding expenses are minor, there is no reason to separately identify them. However, when such expenses are large, especially on defense work, it is appropriate that they be separately classified, including engineering work, and charged to contract or product costs, either directly or indirectly; if indirectly it would generally be appropriate to first separate the expenses overall between defense and nondefense work in order to exclude the cost of the latter from charges to defense contracts. Expenses of unsuccessful bids may be treated as normal indirect costs to be so allocated to defense contracts provided they do not become unreasonable in relative amounts, as may be the result if there is a large disporportion of unsuccessful bids on defense business.

15-320.5 Advertising. Advertising expenses, including costs of materials, space, time, layout, and expenses of the department which supervises such activities, are allowable for purpose of allocation to defense contracts when such expenses may be appropriately considered as having a

direct or indirect benefit in performance of such contracts. In each case, the method of cost allocation to defense and nondefense contracts or products should be appropriate in the light of the respective benefits. Advertising may be appropriately considered for allocation to the cost of defense contracts in the following cases:

(a) Advertising directed solely towards the recruitment of new employees.

(b) Advertising in trade and technical journals for the purpose of establishing necessary business contacts in connection with the sale of defense products to Government contractors or when such periodicals are believed to be valuable for the dissemination of technical information within the contractor's industry.

(c) Publication of house organs and other similar materials which are disseminated to employees for the purpose of maintaining good labor relations.

(d) Publication of catalogs, price lists, and technical pamphlets which aid users of the contractor's products, including the Government or defense contractors, excluding, of course, the cost of technical pamphlets prepared for the Government under separate contract consideration.

(e) Advertising for standard commercial products, other than as in (a) through (d) above, pursuant to the contractor's established practice, may be allocated to defense prime contracts and subcontracts on the basis that such costs will first be assigned to the contractor's nondefense business in the same amount per unit sold as was assigned to such units prior to obtaining defense business; the amount remaining after such assignment may be allocated to defense prime and subcontracts but not in excess of the amount per unit on nondefense business; provided, however, that when defense sales are merely incidental, such cost allocations may be made on an overall prorata basis.

(f) Advertising for special purpose products, other than as in (a) through (d) above, may not be allocated to defense prime contracts and subcontracts, except in cases where, in connection with undertaking defense work, the contractor's volume of nondefense work is reduced substantially. In such cases, in order to maintain good will, the contractor may need to continue advertising at a cost per unit higher than the reduced volume of nondefense business may equitably sustain based upon the contractor's established pricing and sales policies. In such event, the excess of reasonable advertising costs over the amount chargeable to nondefense business at per unit rates previously prevailing may be allocated to defense business.

15-320.6 Product Transportation and Delivery Expenses. These expenses, when required by the terms of a contract, are properly allowable. Whenever significant in amount and provided it is feasible, they should be determined and allocated as a direct cost of the product or contract.

15-320.7 Warehousing Expenses. Whenever a manufacturer maintains and ships products from warehouses strategically located in order to provide better service or reduce transportation costs to customers (as is frequently found with standard commercial products or spare parts), the expenses of warehousing such stocks, including transportation from factory to warehouse, are allowable when fairly allocated to defense sales in relation to total sales of products delivered from such warehouses.

15-320.8 Service and Warranty Expenses. When the contract terms covering sale of defense products include an obligation on the part of the contractors, without additional separate compensation, to provide service in installation, training operators, correcting defects in the product, replacing defective parts, making refunds in case of inadequate performance, etc., the cost of the product should include an allowance for the cost of such undertakings. Generally, any warranty of the product as to performance, materials, and workmanship will be for a definite period of time. In the case of cost-reimbursement-type contracts, actual costs of performance to be reimbursed to the contractor will include all of the foregoing costs, and the period of performance of the contract will usually not expire until the end of warranty period and completion of performance of any work required by the terms of the warranty. However, in a fixed-price contract, a warranty may extend for a period of time considerably beyond delivery. In such cases, it is necessary to estimate the cost of services and warranties, usually as a percentage of product cost, for purposes of price negotiation. Estimating warranty costs must usually be based upon past experience in similar cases. When allowances are made for costs of performance under warranties as product costs, there should be no duplication of the allowance for the risks in figuring allowable profits.

15-320.9 Entertainment Expenses. Entertainment expenses, as such, shall not be considered either directly or indirectly as a cost of performing Government contracts. However, when expenses arise as a result of purchase of meals, local transportaion, rental of facilities for meetings, and other incidental costs, and the primary purpose of incurring such costs is the dissemination of technical information or the stimulation of production, such costs are allowable in determining the cost of Government contracts.

15-330 General and Administrative Expenses.

15-330.01 Allocation of General and Administrative Expenses. These expenses are most often allocated simply in ratio to direct-labor costs, total manufacturing costs, or sales dollars. Where there are wide differences in profit margins on different lines of product, the sales basis is inequitable. The relative importance of subcontracting and facility construction programs in different cases and circumstances has a bearing on the appropriate basis of allocation of these expenses.

15-330.02 Executive Compensation. Executive compensation consists of all emoluments paid or accrued for services actually rendered to the

contractor by executives, officers, partners, sole proprietors, and others of similar rank and abilities. Such costs are allowable when reasonable in amount in the light of the services rendered and incurred in accordance with law and established policy of the contractor. The amount of compensation established by the contractor will normally be considered reasonable except in special cases when the amount thereof may not have been determined through arm's length bargaining between the employer and the executive. Arm's length bargaining may be indicated to be lacking in any one of the following situations:

(a) The executive or a member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization; or

(b) Ownership of the contractor is limited to a small cohesive group; or

(c) The volume of Government contracts when related to the contractor's total business is such as to influence the contractor in his determination of executive compensation; or

(d) The services rendered by any individual are clearly disproportionate in a major degree to the compensation paid.

Where executive compensation has not been determined through arm's length bargaining and is considered to be unreasonable in amount, the excess over the amount considered reasonable will not be included in determining the amount allocable to Government contracts. Allowances for compensation of partners or sole proprietors may properly be included in executive compensation even though not actually paid or accrued in the accounts.

15-330.03 Stock Options. The cost of options to purchase stock of the contractor corporation granted to executives thereof may be computed and considered as executive compensation, subject to allocation to Government contracts, as follows:

(a) The cost of stock options to the grantor corporation is the excess, if any, over the option price of the fair market value of the stock on the date the option is granted to a specific individual.

(b) This cost is to be amortized at an annual rate equal to 3% of the so-determined fair market value beginning with the date the option is granted in recognition of the fact that the benefits to the corporation extend over a period of years and do not accrue in one year when the option is granted or when it is exercised.

15-330.04 Bonuses. The payment of executive bonuses, in addition to normal salaries, generally in relation to profits, is a common practice to encourage special efforts and initiative on the part of executives. In an industry which is predominately devoted to defense work of a cost-type nature (excluding only forward fixed-price contracts) such a practice

is inappropriate from the standpoint of the usual bonus objectives, if bonuses are based directly upon profits of such work because in such case profits are more-or-less fixed and do not represent a measure of efficiency; in such cases, bonuses, if any, should not be based directly upon profits but upon efforts. For the purpose of forward pricing of fixed-priced defense contracts executive bonuses of any type may be considered as an element of executive compensation upon the basis of advance estimates; in contract pricing, depending upon historical costs, executive bonuses may be allowed generally for purposes of cost allocation only when they are computed upon some other basis than profits; provided, however, that in any case the overall executive compensation is deemed reasonable in the light of the provisions of paragraph 15-330.02. It is not intended by the foregoing to disturb practices in payments of bonuses to top executives of corporations engaged in mixed business, but in such cases cost allocations should be made in such a manner as to fairly apportion such bonuses between defense and nondefense business. Similar considerations are applicable in the allowance of bonuses to employees other than executives.

15-330.05 Travel Expense. Travel expense, when incurred for business purposes, is an allowable cost. The cost may represent payment for actual costs incurred, or payment may be on a per diem or mileage basis in lieu of actual cost, or a combination of the two methods may be used, provided the method used does not result in an unreasonable charge.

The mode of travel, accommodation or subsistence shall be in keeping with the contractor's established practice. Should there be no established practice, the cost shall not exceed an amount commensurate with the nature and responsibilities of the traveler. Costs of entertainment shall not be included.

Special circumstances create situations for which there may be no precedent. For example, costs of transporting entire families from one geographic location to another, and reestablishing them thereat, may have to be incurred if a competent skilled labor force is to be recruited and maintained. Generally such costs are allowable, but there may be specific instances in which a part or all will be excluded if considered excessive or unnecessary.

15-330.06 Legal, Accounting, and Other Professional Expenses. Costs of professional services, whether performed by the contractor's employees or by other members of the particular profession retained by the contractor, are generally allowable. Such costs must be reasonable in light of services rendered, and payment must not be contingent upon recovery of the cost from the Government.

Such services must have been reasonably required by the business, although not necessarily required solely for the performance of Government contracts. Factors to be considered (among others) when determining the reasonableness or necessity of incurring the cost are: (i) past pattern of such costs, particularly in the years prior to the award of

Government contracts; (ii) the impact of Government contracts on the size of the contractor's business (i.e., what new problems arise); (iii) the nature and scope of managerial services expected of the contractor's own organization; and (iv) whether or not the proportion of Government production of the contractor's total production 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 production under Government contracts.

If, in light of the foregoing, it appears that the costs are not reasonably required by the business or are excessive, the allowable portion will be reduced to an appropriate amount, if any, for purposes of allocation.

15-330.07 Business Organization Expenses. Business organization expenses consist of those ordinary and reasonably necessary expenses which are incurred because of the use of the corporate, partnership, or other form of organization. Recurring business organization expenses are allowable. Examples of such recurring expenses, with respect to a corporate form of organization, are fees paid to members of the board of directors, cost of shareholders meetings, proxy solicitations, preparation and publication of annual reports to shareholders and preparation and submission of required reports to regulatory bodies having jurisdiction. Non-recurring expenses, particularly those directly related to the acquisition of additional capital, are not allowable. Examples of unallowable costs would include legal and professional fees paid in connection with the preparation of a prospectus, costs of preparation and issuance of stock rights, and amortization of "organization expense." Allowable costs shall normally be considered to be reasonable in amount when incurred in accordance with the contractor's established practices, particularly those in effect prior to the award of Government contracts.

15-330.08 Bad Debts. Bad debt losses, whether actual or estimated, arise from the contractor's non-Government business. No allowance for such losses shall be made in costs or prices under Government prime contracts. However, in the case of subcontracts, particularly lower-tier subcontracts several contracts removed from the prime contractor, consideration may be given to a reasonable allowance for bad debt losses not to exceed the rate experienced by the subcontractor in doing business with the same class of customer.

15-330.09 Contributions and Donations. Contributions and donations to established nonprofit charitable, scientific, and educational organizations are properly allocable to Government contracts; provided that such costs (i) may reasonably be expected to result in future benefits to the contractor through advancing, directly or indirectly, the technology of his industry or increasing the supply of trained manpower available to it; (ii) are in lieu of the cost of similar facilities, which facilities the contractor would otherwise have to provide, as for example, employee medical or recreational facilities; or (iii) are expected of the contractor by the community and it can reasonably be expected that the prestige

of the contractor in the community would suffer through the lack of such contributions. In general, item (iii) will not be applied unless it is the practice of most business firms in the same community to make contributions to such organizations.

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.

15-330.10 Trade, Business, and Professional Activities.

(a) Memberships. Costs of membership in trade, business, and professional organizations are allowable when incurred in accordance with the following standards:

(i) Memberships are consistent with the established practice of the contractor, particularly his practice prior to the award of Government contracts. However, if the nature or volume of the contractor's production has been altered significantly by Government contracts, departure from the prior program may be justified.

(ii) When the organization is a local one and membership would be expected of all similar business firms in the business community. Local organizations must be primarily for trade, business, or professional purposes. Social, cultural, or recreational activities, if any, of such organizations must be incidental.

(iii) If the organization is regional, national, or international in scope, membership therein should be held by a majority of like firms in the same industry when the organization is a general purpose one. When the purpose of the organization is primarily to gather, develop, and disseminate information of a technical nature or information regarding Government regulations on procurement, controlled materials, and wage stabilization, the membership shall be considered to have value and the application of any other standard in this paragraph is unnecessary.

(b) Subscriptions. The cost of subscriptions to trade, business, professional, or technical periodicals or services is allowable when incurred in accordance with the contractor's established practice and the costs are reasonable in amount.

15-330.11 Employee Health and Welfare. Expenses for employee health and welfare activities, such as illness or first aid clinics, improvement of working conditions, and others aimed to improve employer-employee relations or employee performance, may be considered to be allowable if they are reasonable and necessary. The contractor's established practice or custom in the industry or area will be considered in making such determination.

15-330.12 Cafeterias, Commissaries, Dormitories, and Canteens. This class of expense consists of the cost, less revenue, of food, beverages, or living accommodations provided for members of the contractor's organization at their regular duty stations. When reasonably required by the nature of the contractor's operations, plant location, established policies, or employer-employee agreement, such costs shall be allowable. On the other hand, any profit on such activities shall be considered as a credit to the contractor's overall expenses before allocation to defense contracts, unless such expenses are reduced for all the costs of such activities, including use of facilities, space, and utilities with elimination of such credits from the contractor's general expenses subject to cost allocations to defense business.

15-340 Financial and Other Expenses.

15-340.1 Interest on Borrowed Captial. Interest paid or accrued, regardless of the nature of the obligation which gives rise to the interest cost, is not an allowable item of cost to be charged directly or indirectly to Government contracts. (See paragraph 15-219)

The sole exception to this rule arises in situations in which the Government, through no fault of the contractor, fails to make timely payments to the contractor as provided for by the definitive contract (if any); by the letter contract, if there are payment provisions therein; or by whatever understanding between the parties as may otherwise exist. For example, if a letter contract did not contain payment provisions because it was contemplated at the time the contract was awarded that the letter contract would soon be superseded by a definitive contract, but in fact (through no fault of the contractor) months passed without such definitive contract, during which time costs were incurred beyond the amount or time at which payment (progress, partial, provisional or final) or reimbursement would probably have been made under a definitive contract, interest cost incurred may be allowed to the extent the contractor must finance his operations beyond that financing which he would otherwise have to provide. Likewise, long-delayed settlements of terminated contracts, where the fault does not rest with the contractor, may include an allowance for interest cost incurred on a principal amount not to exceed the amount of the settlement agreement for a period beginning 60 days after the termination of the contract to the approximate date of payment.

15-340.2 Contingencies. Provisions for general contingencies are not allowable items of cost. Allowances for specific contingencies may be made in cost estimates under fixed-price contracts when such contingencies are reasonably certain and predictable in amount. Escalation and price redetermination clauses and cost-reimbursement-type contracts are ordinarily used to avoid including allowances for most major contingencies which are not predictable within a reasonable degree of accuracy. Self-insurance charges and service and warranty expenses are treated separately in this Part as paragraphs 15-313.14 and 15-320.8.

15-340.3 Termination Costs. The additional costs that reasonably and necessarily arise as the result of termination or cancellation of Government contracts (or subcontracts, including purchase orders), for the convenience of the Government, fall into the three following main classes, all of which are allowable in nature:

(a) Costs of effecting termination, as of the date specified, of the designated work in the contractor's (or subcontractor's) plant. (Examples are costs of taking inventory of terminated Government work, telephone and telegram expenses of notifying subcontractors, etc.)

(b) Costs of effecting settlement of the terminated work and obtaining payment. These costs may arise in settlement with (i) the purchaser, that is, with the Government, a prime contractor, or a higher-tier subcontractor; or (ii) the supplier, that is, a subcontractor. (Examples are accounting, legal, and clerical costs incidental to settlement.)

(c) Protection and disposition of termination inventory. These costs comprise, in turn, the four following categories:

(i) Costs of transporting termination inventory from contractor's (or subcontractor's) plant to a place of storage under conditions satisfactory to the Government.

(ii) Costs of preserving, packing, and conditioning termination inventory in order to place it in suitable condition or form to be stored.

(iii) Costs of protecting termination inventory.

(iv) Costs of disposing of termination inventory, under regulations issued by the Government.

The costs enumerated above may be composed of amounts either (1) paid or payable to outside parties, or (2) determined by allocation of costs incurred within the contractor's own organization, or of both.

Where practicable, termination costs should be segregated and charged directly to particular terminated contracts. Otherwise, however, allocation, by estimation or some reasonable basis, of the termination portion of indirect costs is acceptable; provided that the cumulative sum so allocated up to a certain date does not exceed the cumulative sum of such costs actually incurred up to that date, and provided that the total allocated to a specific, single termination is reasonable. The method of allocation may consist of estimates based on past experience and on reasonably-anticipated future terminations. Under some conditions, moreover, costs not charged directly may be allocated to a particular terminated contract by applying against the contractor's own costs in the settlement proposal a properly-computed rate.

Termination costs may include a properly-allocable portion of the expenses of special termination units or departments within a contractor's organization. In these instances the expenses of such units or departments need not be identified with specific contracts, but the services performed must be directly related to termination activities. For practicality, factory and general administrative overhead may be included in termination costs only to the extent properly allocable to the aforesaid termination units or departments.

Expenses of preserving or duplicating a contractor's records are ordinarily to be classed as general and administrative expense, rather than as termination cost.

Excluded from allowable termination costs are the following:

1. Costs due to the negligence or willful failure of the contractor to discontinue, with reasonable promptness, incurring expenses otherwise unnecessary after the effective date of the termination notice.

2. Costs incurred as the result of purchasing or producing facilities, materials, or services in excess of the reasonable quantitative requirements of the entire contract.

3. Costs incurred in a formal submission or appeal by the particular contractor, before a Government administrative tribunal or before a court of law, for the purpose of obtaining payment in excess of the settlement amount already offered by the Government or an intervening contractor.

Other costs allowable in connection with terminations of contracts are set forth in Part 3 of this Section as follows:

Paragraph	Subject
15-312.1	Severance Pay.
15-313.05	Profits or Losses on Disposition of Plant and Equipment.
15-340.1	Interest on Delayed Settlements.

15-340.4 Losses on Other Contracts. A loss sustained by a contractor on any contract is not allowable as a cost of performance of any other contract.

15-204.2 (aa) Training and Educational Costs. (1) Costs of preparation and maintenance of a program of instruction at non-college level, designed to increase the vocational effectiveness of bona fide employees, including training materials, textbooks, salaries or wages of trainees during regular working hours, and

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

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

are allowable.

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

(i) training materials;

(ii) textbooks;

(iii) fees charged by the educational institution;

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

(v) (A) tuition charged by the educational institution; or

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

are allowable.

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

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

(5) Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships, are considered contributions (see ASPR 15-204.3(c)).

Part 2 - Supply, Service, and Research and Development Contracts, with Commercial Organizations

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.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (1) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

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

15-201.3 Credits. The applicable portion of income, rebates, allowances, and other credits received by or accruing to the contractor which is related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

15-202 Direct Costs.

15-202.1 General. Items of cost which are readily identifiable with (i) a contract, or (ii) other work of the contractor, should be charged directly to the contract or other work with which identified. This principle may be applied to items of cost, such as freight, travel, communications, and engineering services, as well as materials and productive labor, but when used must be applied consistently to all work of the contractor. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, which otherwise would be treated as direct costs, may be treated as indirect costs. Each element of direct cost is subject to the limitations of this Part as to allowability.

15-202.2 Direct Material Costs. Direct material costs include the cost of raw materials, purchased items, and items supplied from stock, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically identifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable.

Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable only to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

15-203 Indirect Costs.

15-203.1 General. (a) Items of cost which are incurred for common or joint objectives, and which are not readily subject to treatment as direct costs in accordance with ASPR 15-202, should be accumulated for accounting purposes by logical cost groupings and charged by a process of allocation. Each element of indirect cost is subject to the limitations of this Part as to allowability.

(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.

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

15-203.2 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 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. 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(v)(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. 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.

15-203.5 General and Administrative Costs. General and administrative costs consist of items of cost attributable to the over-all 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. Methods acceptable where the circumstances are appropriate include allocation on such basis as:

(i) allocation of general and administrative costs on a total cost incurred basis (exclusive of general and administrative costs);

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

(iii) factory input costs (processing costs plus direct material);

(iv) cost of goods completed;

(v) cost of sales; and

(vi) sales (where no more satisfactory method is available).

15-204 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below. These applications govern whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

15-204.2 Costs Allowable in Whole or in Part.

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

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

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

All other advertising costs are unallowable.

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

(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 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 (f) below. Contributions to local civil defense funds, or to projects not on the contractor's premises, are allowable. (See (e) below).

(d) Compensation for Personal Services. (1) Compensation is allowable subject to the specific limitations set forth hereunder. 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. Subject to specific limitations set forth hereunder, 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.

(2) Generally, the amount of compensation established by the contractor will be considered commensurate with the services rendered. However, compensation of individuals such as corporate officials, directors, executives, department heads, may be subject to special consideration and limitation as to allowability for contract cost purposes where amounts appear excessive. Some situations which may give rise to excessive compensation are where (i) the individual or member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization; or (ii) ownership of the contractor is limited to a small cohesive group; or (iii) the volume of Government contracts when related to the contractor's total business is such as to influence the amount of compensation.

(3) The cost of options to purchase stock of the contractor corporation granted to employees is not allowable as an item of cost.

(4) Subject to the provisions of (5) below, bonuses to employees, such as production incentives and suggestion or safety awards, represent a part of their total compensation and are allowable when appropriately allocated, if they are:

(i) Incurred pursuant to an arms length understanding between the contractor and the employees before the services are rendered or pursuant to an established plan consistently followed by the contractor.

(ii) Reasonable in amount when considered in the light of total compensation for work done.

(iii) Incurred for current services actually rendered by employees.

(iv) Available to all employees of the contractor or to all employees within a group or salary classification which is not unreasonably restricted.

(v) Allowable as an ordinary or necessary business expense for tax purposes.

(vi) Not restricted to officer or other employee stockholders or are not distributed on the basis of stockholdings.

(5) Profit Sharing Plans.

(i) As used herein profit sharing is construed to be any plan (immediate or deferred-regardless of method of payment or participation)which includes, in whole or in part, a formal sharing of profits or is in any manner measured by dependent upon or contingent upon profit.

(ii) The cost of profit-sharing plans shall be treated as follows:

(A) Compensation payable under immediate distribution plans is allowable if the plans meet the criteria set forth in (4) above.

(B) Employer contributions incurred under deferred distribution profit-sharing plans other than pension plans (see (q) below) are allowable costs if the plans meet the requirements of the applicable provisions of the Internal Revenue Code and the regulations of the Internal Revenue Service.

(6) Stock Bonus Plans. Stock bonuses which are not disallowed by the provisions of (5) above are acceptable as a form of compensation, and the costs thereof are allowable subject to all conditions pertinent under subparagraph (4) above and meet the following requirements:

(i) The valuation placed on the stock for the purpose of calculating such cost must be computed on a sound basis.

(ii) In the case of unlisted stock having no current market, the contractor must demonstrate the values ascribed thereto are fair and reasonable.

(iii) Bonuses paid in the form of previously unissued stock of an affiliate will not ordinarily be allowed unless it can be demonstrated that there exists a bona fide arms-length agreement and the values ascribed to such stock are fair and reasonable.

(iv) Claims for accruals of compensation under a stock bonus arrangement prior to acquisition of stock by employees will not be allowable unless arrangements are made for appropriate credit adjustment of costs in the event such stock is not acquired by employees.

(7) The determination of allowability of the cost of pension plans, training and education, overtime, extra pay and multi-shift premiums and other fringe benefits will be in accordance with paragraphs (q), (bb), (o), and (i) respectively.

(e) Contributions and Donations. Reasonable contributions and donations to established non-profit charitable, scientific, educational and civil defense organizations are allowable provided they (i) may reasonably be expected to result in future benefits to the contractor through advancing, directly or indirectly, the technology of his industry or increasing the supply of trained manpower available to it, (ii) are in lieu of the cost of similar facilities which the contractor would have to provide, such as employee medical or recreational facilities, or (iii) are expected of the contractor by the community and it can reasonably be expected that the prestige of the contractor in the community would suffer through the lack of such contributions.

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

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

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

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

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

(iii) by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954.

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

(3) Where a contractor has received a determination of "true depreciation" from an Emergency Facilities Depreciation Board relating to an emergency facility covered by a certificate of necessity, it may elect to use either normal or "true" depreciation. However, the method elected must be followed consistently throughout the life of the emergency facility. Where an election is made to use normal depreciation, the amount thereof shall be computed in accordance with (2) above. Where an election is made to use "true depreciation," the amount allowable as depreciation:

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

(ii) after the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life (but see (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.

(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. Use charges for assets not fully depreciated on the contractor's books are unallowable.

(g) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred, in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(h) 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 or facilities controlled by the contractor. 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.

(i) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor (but see (d) above, and (j)(3)(v), (o) and (x) below).

(j) Insurance and Indemnification.

(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes securing the contractor against liabilities to third persons not compensated by insurance or otherwise.

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

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

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

(ii) costs allowed for use and occupancy insurance shall be limited to exclude coverage of profit, interest, Federal income taxes, and 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 unallowable except to the extent that the Government shall have approved or required such insurance or reserve;

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

(v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(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.

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

(l) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable (but see ASPR 15-204.3(d)). Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis.

(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) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

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

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

are allowable.

(n) Material Costs.

(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.

(5) Reasonable charges or credits arising from a difference 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 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 sales price to its most favored customer.

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise approved by the Government and may be classified as either direct or indirect labor costs. When direct labor cost is the base for distribution of overhead, such premiums shall not be included in that base. When such premiums are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work.

(p) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. 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 (v) and (w) below.)

(q) Pension Plans.

(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, either the 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 (q).).

(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 plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P. L. 591, 83rd Cong., 2d 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 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-emempt 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) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall 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) in determining the net 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 —

(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 adjustment 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.

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

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

(1) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(f)).

(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 a continuing nature and have little relationship to work under Government contracts.

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

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

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

(u) 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 agreement.

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

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

(v) Research and Development Costs.

(1) Research and development costs (sometimes referred to as general

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

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable to the extent specifically provided in the contract.

(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 (m) 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.

(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 allowable as precontract costs (see ASPR 15-204.3(k)).

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

(x) Severance Pay.

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

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

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

(ii) abnormal or mass severance payments actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of the 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.

(y) Special Tooling Costs. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling acquired for performance of the contract are allowable and shall be charged directly thereto.

(z) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(f));

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

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

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

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

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

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

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

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

(1) Memberships. Costs of membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(bb) Training and Educational Costs.

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

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

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

are allowable.

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

(i) training materials;

(ii) textbooks;

(iii) fees charged by the educational institution;

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

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

are allowable.

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

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

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

(cc) Transportation Costs. Transportation costs include freight, express, cartage, and postage charges relating either to goods purchased, in process, or delivered. When such costs can readily be identified with the items involved, they may be direct costed as transportation costs or added to the cost of such items (see (n) above). Where identification with the materials

received cannot readily be made, inbound transportation costs may be charged to the appropriate indirect cost accounts if the contractor follows a consistent equitable procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as a direct cost.

(dd) Travel Costs.

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

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

(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.

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

(ee) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

(i) ASPR 15-204.3(e)

(ii) ASPR 15-204.3(i)

(iii) ASPR 15-204.3(k)

15-204.3 Unallowable Costs.

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

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs, see ASPR 15-204.2(j)).

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

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

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

(f) Interest and Other Financial Costs. Interest (however represented), bond discounts, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of the prospectus, costs of preparation and issuance of stock rights, and costs related thereto are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in ASPR 15-204.2(z) (but see ASPR 15-204.2(ee)(1)).

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

(h) Organization Costs. Expenditures, such as incorporation fees, attorney's fees, accountants fees, brokers fees, fees to promotors and organizers, in connection with (i) organization or reorganization of a business, or (ii) raising capital, are unallowable (see (f) above).

(i) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract.

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments, shall be excluded in computing contract costs (but see ASPR 15-204.2(f)(2) as to basis for depreciation).

(k) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately

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 unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(1) General.

(1) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

(i) Advertising Costs, ASPR 15-204.2(a), last sentence;

(ii) Compensation for Personal Services, ASPR 15-204.2(d)(3)

(iii) Depreciation, ASPR 15-204.2(f)(4), and (5), last sentence;

(iv) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), first sentence;

(v) Recruiting Costs, ASPR 15-204.2(t), last sentence;

(vi) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w), both provisos; and

(vii) Taxes, ASPR 15-204.2(z)(1)(i) through (iv).

(2) Certain other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

(i) Depreciation, ASPR 15-204.2(f)(5), first sentence;

(ii) Food Service Costs and Credits, ASPR 15-204.2(h), last sentence;

(iii) Insurance and Indemnification, ASPR 15-204.2(j)(3)(iii) and (iv), and (4);

(iv) Maintenance and Repair Costs, ASPR 15-204.2(l)(2);

(v) Overtime, Extra-Pay Shift, and Multi-Shift Premiums, ASPR 15-204.2(o), second sentence;

(vi) Patent Costs, ASPR 15-204.2(p), second sentence;

(vii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), last sentence;

(viii) Rental Costs (Including Sale and Leaseback of Facilities), ASPR 15-204.2(u)(3);

(ix) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w);

(x) Taxes, ASPR 15-204.2(z)(2); and

(xi) Travel Costs, ASPR 15-204.2(dd)(4).

15-204.2 (aa) Training and Educational Costs. (1) Costs of preparation and maintenance of a program of instruction at non-college level, designed to increase the vocational effectiveness of bona fide employees, including training materials, textbooks, salaries or wages of trainees during regular working hours, and

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

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

are allowable.

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

(i) training materials;

(ii) textbooks;

(iii) fees charged by the educational institution;

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

(v) (A) tuition charged by the educational institution; or

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

are allowable.

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

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

(5) Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships, are considered contributions (see ASPR 15-204.3(c)).

Part 2 - Supply, Service, and Research and Development Contracts, with Commercial Organizations

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.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (1) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

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

15-201.3 Credits. The applicable portion of income, rebates, allowances, and other credits received by or accruing to the contractor which is related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

15-202 Direct Costs.

15-202.1 General. Items of cost which are readily identifiable with (i) a contract, or (ii) other work of the contractor, should be charged directly to the contract or other work with which identified. This principle may be applied to items of cost, such as freight, travel, communications, and engineering services, as well as materials and productive labor, but when used must be applied consistently to all work of the contractor. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, which otherwise would be treated as direct costs, may be treated as indirect costs. Each element of direct cost is subject to the limitations of this Part as to allowability.

15-202.2 Direct Material Costs. Direct material costs include the cost of raw materials, purchased items, and items supplied from stock, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically identifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable.

Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable only to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

15-203 Indirect Costs.

15-203.1 General. (a) Items of cost which are incurred for common or joint objectives, and which are not readily subject to treatment as direct costs in accordance with ASPR 15-202, should be accumulated for accounting purposes by logical cost groupings and charged by a process of allocation. Each element of indirect cost is subject to the limitations of this Part as to allowability.

(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.

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

15-203.2 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 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. 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(v)(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. 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.

15-203.5 General and Administrative Costs. General and administrative costs consist of items of cost attributable to the over-all 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. Methods acceptable where the circumstances are appropriate include allocation on such basis as:

(i) allocation of general and administrative costs on a total cost incurred basis (exclusive of general and administrative costs);

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

(iii) factory input costs (processing costs plus direct material);

(iv) cost of goods completed;

(v) cost of sales; and

(vi) sales (where no more satisfactory method is available).

15-204 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below. These applications govern whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

15-204.2 Costs Allowable in Whole or in Part.

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

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

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

All other advertising costs are unallowable.

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

(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 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 (f) below. Contributions to local civil defense funds, or to projects not on the contractor's premises, are allowable. (See (e) below).

(d) Compensation for Personal Services. (1) Compensation is allowable subject to the specific limitations set forth hereunder. 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. Subject to specific limitations set forth hereunder, 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.

(2) Generally, the amount of compensation established by the contractor will be considered commensurate with the services rendered. However, compensation of individuals such as corporate officials, directors, executives, department heads, may be subject to special consideration and limitation as to allowability for contract cost purposes where amounts appear excessive. Some situations which may give rise to excessive compensation are where (i) the individual or member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization; or (ii) ownership of the contractor is limited to a small cohesive group; or (iii) the volume of Government contracts when related to the contractor's total business is such as to influence the amount of compensation.

(3) The cost of options to purchase stock of the contractor corporation granted to employees is not allowable as an item of cost.

(4) Subject to the provisions of (5) below, bonuses to employees, such as production incentives and suggestion or safety awards, represent a part of their total compensation and are allowable when appropriately allocated, if they are:

(i) Incurred pursuant to an arms length understanding between the contractor and the employees before the services are rendered or pursuant to an established plan consistently followed by the contractor.

(ii) Reasonable in amount when considered in the light of total compensation for work done.

(iii) Incurred for current services actually rendered by employees.

(iv) Available to all employees of the contractor or to all employees within a group or salary classification which is not unreasonably restricted.

(v) Allowable as an ordinary or necessary business expense for tax purposes.

(vi) Not restricted to officer or other employee stockholders or are not distributed on the basis of stockholdings.

(5) Profit Sharing Plans.

(i) As used herein profit sharing is construed to be any plan (immediate or deferred-regardless of method of payment or participation)which includes, in whole or in part, a formal sharing of profits or is in any manner measured by dependent upon or contingent upon profit.

(ii) The cost of profit-sharing plans shall be treated as follows:

(A) Compensation payable under immediate distribution plans is allowable if the plans meet the criteria set forth in (4) above.

(B) Employer contributions incurred under deferred distribution profit-sharing plans other than pension plans (see (q) below) are allowable costs if the plans meet the requirements of the applicable provisions of the Internal Revenue Code and the regulations of the Internal Revenue Service.

(6) Stock Bonus Plans. Stock bonuses which are not disallowed by the provisions of (5) above are acceptable as a form of compensation, and the costs thereof are allowable subject to all conditions pertinent under subparagraph (4) above and meet the following requirements:

(i) The valuation placed on the stock for the purpose of calculating such cost must be computed on a sound basis.

(ii) In the case of unlisted stock having no current market, the contractor must demonstrate the values ascribed thereto are fair and reasonable.

(iii) Bonuses paid in the form of previously unissued stock of an affiliate will not ordinarily be allowed unless it can be demonstrated that there exists a bona fide arms-length agreement and the values ascribed to such stock are fair and reasonable.

(iv) Claims for accruals of compensation under a stock bonus arrangement prior to acquisition of stock by employees will not be allowable unless arrangements are made for appropriate credit adjustment of costs in the event such stock is not acquired by employees.

(7) The determination of allowability of the cost of pension plans, training and education, overtime, extra pay and multi-shift premiums and other fringe benefits will be in accordance with paragraphs (q), (bb), (o), and (i) respectively.

(e) Contributions and Donations. Reasonable contributions and donations to established non-profit charitable, scientific, educational and civil defense organizations are allowable provided they (i) may reasonably be expected to result in future benefits to the contractor through advancing, directly or indirectly, the technology of his industry or increasing the supply of trained manpower available to it, (ii) are in lieu of the cost of similar facilities which the contractor would have to provide, such as employee medical or recreational facilities, or (iii) are expected of the contractor by the community and it can reasonably be expected that the prestige of the contractor in the community would suffer through the lack of such contributions.

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

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

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

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

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

(iii) by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954.

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

(3) Where a contractor has received a determination of "true depreciation" from an Emergency Facilities Depreciation Board relating to an emergency facility covered by a certificate of necessity, it may elect to use either normal or "true" depreciation. However, the method elected must be followed consistently throughout the life of the emergency facility. Where an election is made to use normal depreciation, the amount thereof shall be computed in accordance with (2) above. Where an election is made to use "true depreciation," the amount allowable as depreciation:

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

(ii) after the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life (but see (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.

(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. Use charges for assets not fully depreciated on the contractor's books are unallowable.

(g) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred, in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(h) 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 or facilities controlled by the contractor. 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.

(i) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor (but see (d) above, and (j)(3)(v), (o) and (x) below).

(j) Insurance and Indemnification.

(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes securing the contractor against liabilities to third persons not compensated by insurance or otherwise.

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

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

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

(ii) costs allowed for use and occupancy insurance shall be limited to exclude coverage of profit, interest, Federal income taxes, and 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 unallowable except to the extent that the Government shall have approved or required such insurance or reserve;

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

(v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(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.

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

(l) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable (but see ASPR 15-204.3(d)). Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis.

(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) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

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

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

are allowable.

(n) Material Costs.

(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.

(5) Reasonable charges or credits arising from a difference 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 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 sales price to its most favored customer.

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise approved by the Government and may be classified as either direct or indirect labor costs. When direct labor cost is the base for distribution of overhead, such premiums shall not be included in that base. When such premiums are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work.

(p) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. 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 (v) and (w) below.)

(q) Pension Plans.

(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, either the 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 (q).).

(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 plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P. L. 591, 83rd Cong., 2d 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 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-emempt 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) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall 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) in determining the net 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 —

(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 adjustment 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.

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

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

(1) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(f)).

(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 a continuing nature and have little relationship to work under Government contracts.

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

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

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

(u) 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 agreement.

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

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

(v) Research and Development Costs.

(1) Research and development costs (sometimes referred to as general

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

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable to the extent specifically provided in the contract.

(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 (m) 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.

(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 allowable as precontract costs (see ASPR 15-204.3(k)).

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

(x) Severance Pay.

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

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

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

(ii) abnormal or mass severance payments actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of the 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.

(y) Special Tooling Costs. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling acquired for performance of the contract are allowable and shall be charged directly thereto.

(z) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(f));

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

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

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

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

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

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

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

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

(1) Memberships. Costs of membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(bb) Training and Educational Costs.

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

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

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

are allowable.

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

(i) training materials;

(ii) textbooks;

(iii) fees charged by the educational institution;

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

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

are allowable.

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

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

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

(cc) Transportation Costs. Transportation costs include freight, express, cartage, and postage charges relating either to goods purchased, in process, or delivered. When such costs can readily be identified with the items involved, they may be direct costed as transportation costs or added to the cost of such items (see (n) above). Where identification with the materials

received cannot readily be made, inbound transportation costs may be charged to the appropriate indirect cost accounts if the contractor follows a consistent equitable procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as a direct cost.

(dd) Travel Costs.

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

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

(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.

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

(ee) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

(i) ASPR 15-204.3(e)

(ii) ASPR 15-204.3(i)

(iii) ASPR 15-204.3(k)

15-204.3 Unallowable Costs.

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

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs, see ASPR 15-204.2(j)).

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

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

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

(f) Interest and Other Financial Costs. Interest (however represented), bond discounts, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of the prospectus, costs of preparation and issuance of stock rights, and costs related thereto are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in ASPR 15-204.2(z) (but see ASPR 15-204.2(ee)(1)).

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

(h) Organization Costs. Expenditures, such as incorporation fees, attorney's fees, accountants fees, brokers fees, fees to promotors and organizers, in connection with (i) organization or reorganization of a business, or (ii) raising capital, are unallowable (see (f) above).

(i) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract.

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments, shall be excluded in computing contract costs (but see ASPR 15-204.2(f)(2) as to basis for depreciation).

(k) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately

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 unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(1) General.

(1) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

(i) Advertising Costs, ASPR 15-204.2(a), last sentence;

(ii) Compensation for Personal Services, ASPR 15-204.2(d)(3)

(iii) Depreciation, ASPR 15-204.2(f)(4), and (5), last sentence;

(iv) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), first sentence;

(v) Recruiting Costs, ASPR 15-204.2(t), last sentence;

(vi) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w), both provisos; and

(vii) Taxes, ASPR 15-204.2(z)(1)(i) through (iv).

(2) Certain other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

(i) Depreciation, ASPR 15-204.2(f)(5), first sentence;

(ii) Food Service Costs and Credits, ASPR 15-204.2(h), last sentence;

(iii) Insurance and Indemnification, ASPR 15-204.2(j)(3)(iii) and (iv), and (4);

(iv) Maintenance and Repair Costs, ASPR 15-204.2(l)(2);

(v) Overtime, Extra-Pay Shift, and Multi-Shift Premiums, ASPR 15-204.2(o), second sentence;

(vi) Patent Costs, ASPR 15-204.2(p), second sentence;

(vii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), last sentence;

(viii) Rental Costs (Including Sale and Leaseback of Facilities), ASPR 15-204.2(u)(3);

(ix) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w);

(x) Taxes, ASPR 15-204.2(z)(2); and

(xi) Travel Costs, ASPR 15-204.2(dd)(4).

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Part 2 - Supply, Service, and Research and Development Contracts, with Organizations Having Commercial Type Accounting Systems

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 having commercial type accounting systems. However, this Part does not apply to contracts for facilities, construction, or architect-engineer services related to construction. It also does not apply to clauses in supply or service contracts which provide for the furnishing of industrial facilities.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (i) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

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

15-201.3 Credits. The applicable portion of income, rebates, allowances, and other credits received by or accruing to the contractor which is related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

15-202 Direct Costs.

15-202.1 General. Items of cost which are readily identifiable with (i) a contract, or (ii) other work of the contractor, should be charged directly

to the contract or other work with which identified. This principle may be applied to items of cost such as freight, travel, communications, and engineering services, as well as materials and productive labor, but when used must be applied consistently to all work of the contractor. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, which otherwise would be treated as direct costs, may be treated as indirect costs. Each element of direct cost is subject to the limitations of this Part as to allowability.

15-202.2 Direct Material Costs. Direct material costs include the cost of raw materials, purchased items, and items supplied from stock, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically identifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable. Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable only to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

15-203 Indirect Costs.

15-203.1 General. (a) Items of cost which are incurred for common or joint objectives, and which are not readily subject to treatment as direct costs in accordance with ASPR 15-202, should be accumulated for accounting purposes by logical cost groupings and charged by a process of allocation. Each element of indirect cost is subject to the limitations of this Part as to allowability.

(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, be applied consistently, and produce equitable results. Any significant change in the nature of the business, the extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, the contractor's products, or other factors may require reconsideration of the method previously used. Individual categories of indirect cost are discussed in ASPR 15-203.2 through 15-203.5.

(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 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.

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 manhours 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 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. 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(v)(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. 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.

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. Factors to be considered in determining whether the results are equitable include:

(i) the ultimate objective of allocating general and administrative costs to the various activities of the contractor's business in proportion to the general and administrative effort involved;

(ii) the results obtainable by using the input cost method (as used herein the input cost method means the total costs incurred during the period, exclusive of general and administrative costs; however, inventories acquired for use under the contract shall be treated in the same manner as inventories acquired for other work of the contractor and facilities purchased under the contract shall not become part of input cost unless facilities acquired by the contractor for its own use are included therein);

(iii) the ratio of each of the several cost components to the total cost of the contract (exclusive of general and administrative costs) compared to the corresponding ratios for the contractor's plant or activity as a whole; and

(iv) other revelant factors including those mentioned in ASPR 15-203.1(b).

15-204 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below. These applications govern whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

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 (t) below.

All other advertising costs are unallowable.

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

(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 (f) 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.

(d) Compensation for Personal Services. (Reserved)

(e) Contributions and Donations. Reasonable contributions and donations to established nonprofit charitable, scientific, and educational organizations are allowable if they are deductible for Federal income tax purposes; however, such deductibility does not in itself justify allowance as a contract cost. The reasonableness 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. Allowable contributions and donations shall be allocated to all work of the contractor.

(f) Depreciation.

(1) Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the

estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

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

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

(ii) is computed by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954.

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

(3) Where a contractor has received a determination of "true depreciation" from an Emergency Facilities Depreciation Board relating to an emergency facility covered by a certificate of necessity, it may elect to use either normal or "true" depreciation. However, the method elected must be followed consistently throughout the life of the emergency facility. Where an election is made to use normal depreciation, the amount thereof shall be computed in accordance with (2) above. Where an election is made to use "true depreciation," the amount allowable as depreciation:

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

(ii) after the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life (but see (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.

(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. Use charges for assets not fully depreciated on the contractor's books are unallowable.

(g) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred, in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(h) 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.

(i) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor which constitutes, in effect, an implied agreement on the contractor's part (but see (d) above, and (j)(3)(v), (q) and (x) below).

(j) Insurance and Indemnification.

(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes liabilities to third persons not compensated by insurance or otherwise.

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

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

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

(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 unallowable except to the extent that the Government shall have approved or required such insurance or reserve;

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

(v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(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.

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

(l) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable (but see ASPR 15-204.3(d)). Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis.

(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) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

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

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

are allowable.

(n) Material Costs.

(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.

(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.

(5) Reasonable charges or credits arising from a difference 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 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 the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is lower;

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 either (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.

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government and may be classified as either direct or indirect labor costs. When direct labor cost is the base for distribution of overhead, such premiums shall not be included in that base. When such premiums are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work.

(p) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. 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 by the Government, are allowable. (See also (v) and (w) below.)

(q) Pension Plans.

(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, either the 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 (q).)

(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 plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P.L. 591, 83rd Cong., 2d 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 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)(i)(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) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall 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) in determining the net 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 —

(A) when all 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 adjustment 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 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.

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

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

(1) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(f)).

(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 organization; and

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

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

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

(t) Recruiting Costs. Costs of "help wanted" advertising, operating costs of an employment office necessary to secure and maintain an adequate labor force, costs of operating an aptitude and educational testing program, travel costs of employees while engaged in recruiting personnel, and travel costs of applicants for interviews for prospective employment are

allowable. Where the contractor uses employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are unallowable.

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

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

(v) Research and Development Costs.

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

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject

under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable to the extent specifically provided in the contract. /Generally, the contractor shall be required to disclose to the Government the purposes and results of such independent general research. In specifically providing for such costs, factors to be considered include:

(i) scope, nature, and quality of the contractor's independent general research program;

(ii) capability of the contractor in the particular research field;

(iii) benefits which may accrue to the Government;

(iv) comparison of size and cost of contractor's previous years' independent research programs; and

(v) proportion of Government business to contractor's total business./

(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 (m) 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.

(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 allowable as precontract costs (see ASPR 15-204.3(i)).

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

(x) Severance Pay.

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

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

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

(ii) abnormal or mass severance payments actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of the 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.

(y) Special Tooling Costs. The term special tooling means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling acquired for performance of the contract, are allowable and shall be charged directly thereto.

(z) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(f));

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

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

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

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

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

Reasonable costs of any such proceeding instituted by the contractor at the direction of the contracting officer are allowable. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are also allowable.

(3) Any refund of taxes, interest, or penalties, and any payment to the contractor of interest thereon, attributable to taxes, interest, or penalties which were allowed as contract costs, shall be credited or paid to the Government in the manner directed by the Government.

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

(1) Memberships. Costs of contractor's membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(bb) Training Costs. Costs of preparing and maintaining a program of instruction designed to increase the overall effectiveness of employees, including costs of the director of training and staff, training materials, and text books, and tuition and fees when part-time training is conducted by educational institutions, are allowable when limited to on-the-job type training and when properly allocated. Costs of training in educational institutions are unallowable, except to the extent specifically provided for in the contract in accordance with Departmental instructions.

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

(dd) Travel Costs.

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

(2) Travel costs incurred in the normal course of overall administration of the business and applicable to the entire business are allowable. Such costs shall be equitabl 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.

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

(ee) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

(i) ASPR 15-204.3(e);

(ii) ASPR 15-204.3(i); and

(iii) ASPR 15-204.3(k).

15-204.3 Unallowable Costs.

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

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs see ASPR 15-204.2(j).)

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

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

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

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

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

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

(i) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract. (See ASPR 15-1xx.)

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange or either short or long term investments, shall be excluded in computing contract costs (but see ASPR 15-204.2(f)(2) as to basis for depreciation).

(k) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitiation of the contractor's facilities to approximately 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 unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(l) General.

(1) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

(i) Advertising Costs, ASPR 15-204.2(a), last sentence;

(ii) Depreciation, ASPR 15-204.2(f)(4), and (5) last sentence;

(iii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), first sentence;

(iv) Recruiting Costs, ASPR 15-204.2(t), last sentence;

(v) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w), both provisos; and

(vi) Taxes, ASPR 15-204.2(z)(1)(i) through (iv).

(2) Certain Other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

(i) Civil Defense Costs, ASPR 15-204.2(c), last sentence;

(ii) Depreciation, ASPR 15-204.2(f)(5), first sentence;

(iii) Food Service Costs and Credits, ASPR 15-204.2(h), last sentence;

(iv) Insurance and Indemnification, ASPR 15-204.2(j)(3)(iii) and (iv), and (4);

(v) Maintenance and Repair Costs, ASPR 15-204.2(l)(2);

(vi) Overtime, Extra-Pay Shift, and Multi-Shift Premiums, ASPR 15-204.2(o), second sentence;

(vii) Patent Costs, ASPR 15-204.2(p), second sentence;

(viii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), last sentence;

(ix) Rental Costs (Including Sale and Leaseback of Facilities), ASPR 15-204.2(u)(3);

(x) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w);

(xi) Special Tooling Costs, ASPR 15-204.2(z)(2);

(xii) Training Costs, ASPR 15-204.2(bb), last sentence; and

(xiii) Travel Costs, ASPR 15-204.2(dd)(4).

15-204.2 (aa) Training and Educational Costs. (1) Costs of preparation and maintenance of a program of instruction at non-college level, designed to increase the vocational effectiveness of bona fide employees, including training materials, textbooks, salaries or wages of trainees during regular working hours, and

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

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

are allowable.

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

(i) training materials;

(ii) textbooks;

(iii) fees charged by the educational institution;

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

(v) (A) tuition charged by the educational institution; or

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

are allowable.

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

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

(5) Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships, are considered contributions (see ASPR 15-204.3(c)).

Part 2 - Supply, Service, and Research and Development Contracts, with Commercial Organizations

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.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (1) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

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

15-201.3 Credits. The applicable portion of income, rebates, allowances, and other credits received by or accruing to the contractor which is related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

15-202 Direct Costs.

15-202.1 General. Items of cost which are readily identifiable with (i) a contract, or (ii) other work of the contractor, should be charged directly to the contract or other work with which identified. This principle may be applied to items of cost, such as freight, travel, communications, and engineering services, as well as materials and productive labor, but when used must be applied consistently to all work of the contractor. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, which otherwise would be treated as direct costs, may be treated as indirect costs. Each element of direct cost is subject to the limitations of this Part as to allowability.

15-202.2 Direct Material Costs. Direct material costs include the cost of raw materials, purchased items, and items supplied from stock, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically identifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable.

Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable only to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

15-203 Indirect Costs.

15-203.1 General. (a) Items of cost which are incurred for common or joint objectives, and which are not readily subject to treatment as direct costs in accordance with ASPR 15-202, should be accumulated for accounting purposes by logical cost groupings and charged by a process of allocation. Each element of indirect cost is subject to the limitations of this Part as to allowability.

(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.

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

15-203.2 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 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. 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(v)(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. 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.

15-203.5 General and Administrative Costs. General and administrative costs consist of items of cost attributable to the over-all 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. Methods acceptable where the circumstances are appropriate include allocation on such basis as:

(i) allocation of general and administrative costs on a total cost incurred basis (exclusive of general and administrative costs);

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

(iii) factory input costs (processing costs plus direct material);

(iv) cost of goods completed;

(v) cost of sales; and

(vi) sales (where no more satisfactory method is available).

15-204 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below. These applications govern whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

15-204.2 Costs Allowable in Whole or in Part.

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

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

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

All other advertising costs are unallowable.

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

(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 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 (f) below. Contributions to local civil defense funds, or to projects not on the contractor's premises, are allowable. (See (e) below).

(d) Compensation for Personal Services. (1) Compensation is allowable subject to the specific limitations set forth hereunder. 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. Subject to specific limitations set forth hereunder, 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.

(2) Generally, the amount of compensation established by the contractor will be considered commensurate with the services rendered. However, compensation of individuals such as corporate officials, directors, executives, department heads, may be subject to special consideration and limitation as to allowability for contract cost purposes where amounts appear excessive. Some situations which may give rise to excessive compensation are where (i) the individual or member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization; or (ii) ownership of the contractor is limited to a small cohesive group; or (iii) the volume of Government contracts when related to the contractor's total business is such as to influence the amount of compensation.

(3) The cost of options to purchase stock of the contractor corporation granted to employees is not allowable as an item of cost.

(4) Subject to the provisions of (5) below, bonuses to employees, such as production incentives and suggestion or safety awards, represent a part of their total compensation and are allowable when appropriately allocated, if they are:

(i) Incurred pursuant to an arms length understanding between the contractor and the employees before the services are rendered or pursuant to an established plan consistently followed by the contractor.

(ii) Reasonable in amount when considered in the light of total compensation for work done.

(iii) Incurred for current services actually rendered by employees.

(iv) Available to all employees of the contractor or to all employees within a group or salary classification which is not unreasonably restricted.

(v) Allowable as an ordinary or necessary business expense for tax purposes.

(vi) Not restricted to officer or other employee stockholders or are not distributed on the basis of stockholdings.

(5) Profit Sharing Plans.

(i) As used herein profit sharing is construed to be any plan (immediate or deferred-regardless of method of payment or participation)which includes, in whole or in part, a formal sharing of profits or is in any manner measured by dependent upon or contingent upon profit.

(ii) The cost of profit-sharing plans shall be treated as follows:

(A) Compensation payable under immediate distribution plans is allowable if the plans meet the criteria set forth in (4) above.

(B) Employer contributions incurred under deferred distribution profit-sharing plans other than pension plans (see (q) below) are allowable costs if the plans meet the requirements of the applicable provisions of the Internal Revenue Code and the regulations of the Internal Revenue Service.

(6) Stock Bonus Plans. Stock bonuses which are not disallowed by the provisions of (5) above are acceptable as a form of compensation, and the costs thereof are allowable subject to all conditions pertinent under subparagraph (4) above and meet the following requirements:

(i) The valuation placed on the stock for the purpose of calculating such cost must be computed on a sound basis.

(ii) In the case of unlisted stock having no current market, the contractor must demonstrate the values ascribed thereto are fair and reasonable.

(iii) Bonuses paid in the form of previously unissued stock of an affiliate will not ordinarily be allowed unless it can be demonstrated that there exists a bona fide arms-length agreement and the values ascribed to such stock are fair and reasonable.

(iv) Claims for accruals of compensation under a stock bonus arrangement prior to acquisition of stock by employees will not be allowable unless arrangements are made for appropriate credit adjustment of costs in the event such stock is not acquired by employees.

(7) The determination of allowability of the cost of pension plans, training and education, overtime, extra pay and multi-shift premiums and other fringe benefits will be in accordance with paragraphs (q), (bb), (o), and (i) respectively.

(e) Contributions and Donations. Reasonable contributions and donations to established non-profit charitable, scientific, educational and civil defense organizations are allowable provided they (i) may reasonably be expected to result in future benefits to the contractor through advancing, directly or indirectly, the technology of his industry or increasing the supply of trained manpower available to it, (ii) are in lieu of the cost of similar facilities which the contractor would have to provide, such as employee medical or recreational facilities, or (iii) are expected of the contractor by the community and it can reasonably be expected that the prestige of the contractor in the community would suffer through the lack of such contributions.

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

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

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

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

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

(iii) by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954.

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

(3) Where a contractor has received a determination of "true depreciation" from an Emergency Facilities Depreciation Board relating to an emergency facility covered by a certificate of necessity, it may elect to use either normal or "true" depreciation. However, the method elected must be followed consistently throughout the life of the emergency facility. Where an election is made to use normal depreciation, the amount thereof shall be computed in accordance with (2) above. Where an election is made to use "true depreciation," the amount allowable as depreciation:

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

(ii) after the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life (but see (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.

(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. Use charges for assets not fully depreciated on the contractor's books are unallowable.

(g) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred, in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(h) 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 or facilities controlled by the contractor. 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.

(i) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor (but see (d) above, and (j)(3)(v), (o) and (x) below).

(j) Insurance and Indemnification.

(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes securing the contractor against liabilities to third persons not compensated by insurance or otherwise.

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

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

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

(ii) costs allowed for use and occupancy insurance shall be limited to exclude coverage of profit, interest, Federal income taxes, and 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 unallowable except to the extent that the Government shall have approved or required such insurance or reserve;

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

(v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(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.

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

(l) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable (but see ASPR 15-204.3(d)). Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis.

(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) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

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

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

are allowable.

(n) Material Costs.

(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.

(5) Reasonable charges or credits arising from a difference 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 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 sales price to its most favored customer.

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise approved by the Government and may be classified as either direct or indirect labor costs. When direct labor cost is the base for distribution of overhead, such premiums shall not be included in that base. When such premiums are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work.

(p) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. 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 (v) and (w) below.)

(q) Pension Plans.

(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, either the 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 (q).).

(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 plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P. L. 591, 83rd Cong., 2d 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 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-emempt 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) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall 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) in determining the net 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 —

(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 adjustment 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.

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

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

(1) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(f)).

(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 a continuing nature and have little relationship to work under Government contracts.

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

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

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

(u) 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 agreement.

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

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

(v) Research and Development Costs.

(1) Research and development costs (sometimes referred to as general

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

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable to the extent specifically provided in the contract.

(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 (m) 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.

(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 allowable as precontract costs (see ASPR 15-204.3(k)).

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

(x) Severance Pay.

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

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

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

(ii) abnormal or mass severance payments actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of the 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.

(y) Special Tooling Costs. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling acquired for performance of the contract are allowable and shall be charged directly thereto.

(z) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(f));

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

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

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

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

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

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

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

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

(1) Memberships. Costs of membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(bb) Training and Educational Costs.

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

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

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

are allowable.

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

(i) training materials;

(ii) textbooks;

(iii) fees charged by the educational institution;

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

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

are allowable.

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

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

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

(cc) Transportation Costs. Transportation costs include freight, express, cartage, and postage charges relating either to goods purchased, in process, or delivered. When such costs can readily be identified with the items involved, they may be direct costed as transportation costs or added to the cost of such items (see (n) above). Where identification with the materials

received cannot readily be made, inbound transportation costs may be charged to the appropriate indirect cost accounts if the contractor follows a consistent equitable procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as a direct cost.

(dd) Travel Costs.

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

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

(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.

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

(ee) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

(i) ASPR 15-204.3(e)

(ii) ASPR 15-204.3(i)

(iii) ASPR 15-204.3(k)

15-204.3 Unallowable Costs.

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

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs, see ASPR 15-204.2(j)).

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

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

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

(f) Interest and Other Financial Costs. Interest (however represented), bond discounts, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of the prospectus, costs of preparation and issuance of stock rights, and costs related thereto are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in ASPR 15-204.2(z) (but see ASPR 15-204.2(ee)(1)).

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

(h) Organization Costs. Expenditures, such as incorporation fees, attorney's fees, accountants fees, brokers fees, fees to promotors and organizers, in connection with (i) organization or reorganization of a business, or (ii) raising capital, are unallowable (see (f) above).

(i) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract.

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments, shall be excluded in computing contract costs (but see ASPR 15-204.2(f)(2) as to basis for depreciation).

(k) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately

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 unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(1) General.

(1) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

(i) Advertising Costs, ASPR 15-204.2(a), last sentence;

(ii) Compensation for Personal Services, ASPR 15-204.2(d)(3)

(iii) Depreciation, ASPR 15-204.2(f)(4), and (5), last sentence;

(iv) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), first sentence;

(v) Recruiting Costs, ASPR 15-204.2(t), last sentence;

(vi) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w), both provisos; and

(vii) Taxes, ASPR 15-204.2(z)(1)(i) through (iv).

(2) Certain other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

(i) Depreciation, ASPR 15-204.2(f)(5), first sentence;

(ii) Food Service Costs and Credits, ASPR 15-204.2(h), last sentence;

(iii) Insurance and Indemnification, ASPR 15-204.2(j)(3)(iii) and (iv), and (4);

(iv) Maintenance and Repair Costs, ASPR 15-204.2(l)(2);

(v) Overtime, Extra-Pay Shift, and Multi-Shift Premiums, ASPR 15-204.2(o), second sentence;

(vi) Patent Costs, ASPR 15-204.2(p), second sentence;

(vii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), last sentence;

(viii) Rental Costs (Including Sale and Leaseback of Facilities), ASPR 15-204.2(u)(3);

(ix) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w);

(x) Taxes, ASPR 15-204.2(z)(2); and

(xi) Travel Costs, ASPR 15-204.2(dd)(4).

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Part 2 - Supply, Service, and Research and Development Contracts, with Organizations Having Commercial Type Accounting Systems

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 having commercial type accounting systems. However, this Part does not apply to contracts for facilities, construction, or architect-engineer services related to construction. It also does not apply to clauses in supply or service contracts which provide for the furnishing of industrial facilities.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (i) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

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

15-201.3 Credits. The applicable portion of income, rebates, allowances, and other credits received by or accruing to the contractor which is related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

15-202 Direct Costs.

15-202.1 General. Items of cost which are readily identifiable with (i) a contract, or (ii) other work of the contractor, should be charged directly

to the contract or other work with which identified. This principle may be applied to items of cost such as freight, travel, communications, and engineering services, as well as materials and productive labor, but when used must be applied consistently to all work of the contractor. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, which otherwise would be treated as direct costs, may be treated as indirect costs. Each element of direct cost is subject to the limitations of this Part as to allowability.

15-202.2 Direct Material Costs. Direct material costs include the cost of raw materials, purchased items, and items supplied from stock, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically identifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable. Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable only to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

15-203 Indirect Costs.

15-203.1 General. (a) Items of cost which are incurred for common or joint objectives, and which are not readily subject to treatment as direct costs in accordance with ASPR 15-202, should be accumulated for accounting purposes by logical cost groupings and charged by a process of allocation. Each element of indirect cost is subject to the limitations of this Part as to allowability.

(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, be applied consistently, and produce equitable results. Any significant change in the nature of the business, the extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, the contractor's products, or other factors may require reconsideration of the method previously used. Individual categories of indirect cost are discussed in ASPR 15-203.2 through 15-203.5.

(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 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.

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 manhours 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 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. 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(v)(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. 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.

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. Factors to be considered in determining whether the results are equitable include:

(i) the ultimate objective of allocating general and administrative costs to the various activities of the contractor's business in proportion to the general and administrative effort involved;

(ii) the results obtainable by using the input cost method (as used herein the input cost method means the total costs incurred during the period, exclusive of general and administrative costs; however, inventories acquired for use under the contract shall be treated in the same manner as inventories acquired for other work of the contractor and facilities purchased under the contract shall not become part of input cost unless facilities acquired by the contractor for its own use are included therein);

(iii) the ratio of each of the several cost components to the total cost of the contract (exclusive of general and administrative costs) compared to the corresponding ratios for the contractor's plant or activity as a whole; and

(iv) other revelant factors including those mentioned in ASPR 15-203.1(b).

15-204 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below. These applications govern whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

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 (t) below.

All other advertising costs are unallowable.

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

(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 (f) 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.

(d) Compensation for Personal Services. (Reserved)

(e) Contributions and Donations. Reasonable contributions and donations to established nonprofit charitable, scientific, and educational organizations are allowable if they are deductible for Federal income tax purposes; however, such deductibility does not in itself justify allowance as a contract cost. The reasonableness 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. Allowable contributions and donations shall be allocated to all work of the contractor.

(f) Depreciation.

(1) Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the

estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

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

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

(ii) is computed by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954.

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

(3) Where a contractor has received a determination of "true depreciation" from an Emergency Facilities Depreciation Board relating to an emergency facility covered by a certificate of necessity, it may elect to use either normal or "true" depreciation. However, the method elected must be followed consistently throughout the life of the emergency facility. Where an election is made to use normal depreciation, the amount thereof shall be computed in accordance with (2) above. Where an election is made to use "true depreciation," the amount allowable as depreciation:

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

(ii) after the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life (but see (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.

(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. Use charges for assets not fully depreciated on the contractor's books are unallowable.

(g) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred, in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(h) 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.

(i) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor which constitutes, in effect, an implied agreement on the contractor's part (but see (d) above, and (j)(3)(v), (q) and (x) below).

(j) Insurance and Indemnification.

(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes liabilities to third persons not compensated by insurance or otherwise.

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

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

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

(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 unallowable except to the extent that the Government shall have approved or required such insurance or reserve;

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

(v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(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.

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

(l) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable (but see ASPR 15-204.3(d)). Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis.

(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) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

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

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

are allowable.

(n) Material Costs.

(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.

(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.

(5) Reasonable charges or credits arising from a difference 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 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 the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is lower;

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 either (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.

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government and may be classified as either direct or indirect labor costs. When direct labor cost is the base for distribution of overhead, such premiums shall not be included in that base. When such premiums are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work.

(p) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. 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 by the Government, are allowable. (See also (v) and (w) below.)

(q) Pension Plans.

(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, either the 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 (q).)

(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 plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P.L. 591, 83rd Cong., 2d 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 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)(i)(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) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall 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) in determining the net 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 —

(A) when all 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 adjustment 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 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.

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

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

(1) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(f)).

(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 organization; and

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

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

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

(t) Recruiting Costs. Costs of "help wanted" advertising, operating costs of an employment office necessary to secure and maintain an adequate labor force, costs of operating an aptitude and educational testing program, travel costs of employees while engaged in recruiting personnel, and travel costs of applicants for interviews for prospective employment are

allowable. Where the contractor uses employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are unallowable.

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

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

(v) Research and Development Costs.

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

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject

under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable to the extent specifically provided in the contract. /Generally, the contractor shall be required to disclose to the Government the purposes and results of such independent general research. In specifically providing for such costs, factors to be considered include:

(i) scope, nature, and quality of the contractor's independent general research program;

(ii) capability of the contractor in the particular research field;

(iii) benefits which may accrue to the Government;

(iv) comparison of size and cost of contractor's previous years' independent research programs; and

(v) proportion of Government business to contractor's total business./

(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 (m) 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.

(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 allowable as precontract costs (see ASPR 15-204.3(i)).

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

(x) Severance Pay.

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

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

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

(ii) abnormal or mass severance payments actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of the 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.

(y) Special Tooling Costs. The term special tooling means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling acquired for performance of the contract, are allowable and shall be charged directly thereto.

(z) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(f));

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

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

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

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

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

Reasonable costs of any such proceeding instituted by the contractor at the direction of the contracting officer are allowable. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are also allowable.

(3) Any refund of taxes, interest, or penalties, and any payment to the contractor of interest thereon, attributable to taxes, interest, or penalties which were allowed as contract costs, shall be credited or paid to the Government in the manner directed by the Government.

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

(1) Memberships. Costs of contractor's membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(bb) Training Costs. Costs of preparing and maintaining a program of instruction designed to increase the overall effectiveness of employees, including costs of the director of training and staff, training materials, and text books, and tuition and fees when part-time training is conducted by educational institutions, are allowable when limited to on-the-job type training and when properly allocated. Costs of training in educational institutions are unallowable, except to the extent specifically provided for in the contract in accordance with Departmental instructions.

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

(dd) Travel Costs.

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

(2) Travel costs incurred in the normal course of overall administration of the business and applicable to the entire business are allowable. Such costs shall be equitabl 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.

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

(ee) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

(i) ASPR 15-204.3(e);

(ii) ASPR 15-204.3(i); and

(iii) ASPR 15-204.3(k).

15-204.3 Unallowable Costs.

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

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs see ASPR 15-204.2(j).)

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

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

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

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

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

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

(i) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract. (See ASPR 15-1xx.)

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange or either short or long term investments, shall be excluded in computing contract costs (but see ASPR 15-204.2(f)(2) as to basis for depreciation).

(k) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitiation of the contractor's facilities to approximately 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 unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(l) General.

(1) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

(i) Advertising Costs, ASPR 15-204.2(a), last sentence;

(ii) Depreciation, ASPR 15-204.2(f)(4), and (5) last sentence;

(iii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), first sentence;

(iv) Recruiting Costs, ASPR 15-204.2(t), last sentence;

(v) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w), both provisos; and

(vi) Taxes, ASPR 15-204.2(z)(1)(i) through (iv).

(2) Certain Other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

(i) Civil Defense Costs, ASPR 15-204.2(c), last sentence;

(ii) Depreciation, ASPR 15-204.2(f)(5), first sentence;

(iii) Food Service Costs and Credits, ASPR 15-204.2(h), last sentence;

(iv) Insurance and Indemnification, ASPR 15-204.2(j)(3)(iii) and (iv), and (4);

(v) Maintenance and Repair Costs, ASPR 15-204.2(l)(2);

(vi) Overtime, Extra-Pay Shift, and Multi-Shift Premiums, ASPR 15-204.2(o), second sentence;

(vii) Patent Costs, ASPR 15-204.2(p), second sentence;

(viii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), last sentence;

(ix) Rental Costs (Including Sale and Leaseback of Facilities), ASPR 15-204.2(u)(3);

(x) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w);

(xi) Special Tooling Costs, ASPR 15-204.2(z)(2);

(xii) Training Costs, ASPR 15-204.2(bb), last sentence; and

(xiii) Travel Costs, ASPR 15-204.2(dd)(4).

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DRAFT 11/1/55
SECTION XV SUBCOMMITTEE

Return to A.B. Carter. - 3-D-781

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 contract and cost-reimbursement type subcontracts thereunder for procurement of supplies, services, and research and development work with organizations having commercial type accounting systems. However, this part does not apply to contracts for facilities,* construction and architect-engineer services related to construction.

15-201 BASIC PRINCIPLES AND STANDARDS.

a. Composition of Total Cost. The total cost of a cost-reimbursement type contract is the net sum of (i) the allowable direct costs, (ii) the properly allocable portion of allowable indirect costs and (iii) applicable income and other credits.

b. Factors Affecting Allowability of Costs. The factors to be considered in determining the allowability of costs include (i) reasonableness, (ii) application of generally accepted accounting principles and practices, (iii) significant deviations in the established practices of the contractor which substantially increase the contract costs, and (iv) any limitations as to types or amounts of cost items set forth in this Part 2 of Section XV or otherwise included in the contract.

c. Credits. The applicable portion of income and other credits, rebates, and allowances, received by or accruing to the contractor and which are related to any allowed cost will be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

d. 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).

15-202 DIRECT COSTS. Subject to the provisions of paragraph 15-201, allowable direct costs are those items of cost, or aggregate thereof, which can be identified specifically with any objective, service, program or project under the contract and

* Notes and Filing Instructions. This Part may be used for "facilities" pending publication of a Part for this purpose

are chargeable directly thereto. Major items of cost readily identifiable with the contract or with other work of the contractor should be charged directly thereto. This principle may often be applicable to such elements of expense as freight, travel, communications, engineering services, etc., as well as the normal items of materials and productive labor. However, when the contractor is engaged in mixed production, this principle must be applied consistently to the costing of both defense and non-defense products or services, in order to produce equitable results. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect expenses.

15-202.1 DIRECT MATERIALS. The cost of direct materials includes 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 furnishing such product. Costs of reasonable overruns, spoilage, and defective work may also be included (as to defective work, see paragraph 7-203.5(c)).

15-202.2 DIRECT LABOR. The cost of direct labor includes salaries and wages specifically identifiable with and properly chargeable directly to the performance of contract or other work of the contractor. Average rates may be used where it is demonstrated by the contractor that the results are equitable. Direct labor may also include other associated costs such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.3 OTHER DIRECT COSTS. Where other items of cost are charged directly to the contract consistent with paragraph 15-202 above, the contractor must demonstrate that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of like items applicable to other work of the contractor must be eliminated from indirect costs allocated to the contract.

15-203 INDIRECT COSTS.

(a) Indirect costs are expenses which are incurred for common or joint objectives, are accumulated for accounting purposes by departmental activity or other logical cost grouping and are charged to the contract and other work of the contractor by a process of allocation. Each element thereof is subject to the limitations of this part as to allowability.

(b) No specific rules can be stated as to the method of allocation of indirect costs because the actual condition in each instance must be taken into accour in determining the most suitable method or methods. The objective should be the selection of a method or methods which will distribute the indirect costs in a fair and equitable manner. The method used in connection with Government contracts must, in order to be acceptable, conform with generally accepted accounting practices, be applied consistently, and produce equitable results. Any significant change, such as in the nature of the business, extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, or the products being produced, may require reconsideration of the methods previously in use to determine whether they continue to be equitable. Further discussion relative to allocation of the individual categories of indirect costs will be found in the subparagraphs below.

15-203.1 INDIRECT MANUFACTURING AND PRODUCTION EXPENSES. Indirect manufacturing and production expenses consist of costs which are incurred in the productive process as a whole and are not readily subject to treatment as direct costs in accordance with paragraph 15-202. Allocation of indirect manufacturing and production expenses on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable bases, in appropriate circumstances, include direct labor dollars (exclusive of overtime premium), units processed and prime costs of units processed. The contractor may departmentalize or establish cost centers in order to distribute equitably the

indirect costs. The factors to be considered in determining the extent of departmentalization or establishment of cost centers include variety of products, complexity of processes and relative labor and facility requirements for the various products.

15-203.2 INDIRECT ENGINEERING EXPENSES. Indirect engineering expenses include engineering supervision, engineering administrative expense, engineering general supplies, and other related expenses. These expenses arise out of engineering activities which 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 expenses should be allocated to the benefited activities, i.e., contract and other work of the contractor (~~including independent research projects~~ see also paragraphs 15-204.3(c)) on the basis of direct engineering man-hours expended, direct engineering labor dollars, extra pay shift and multi-shift (exclusive of overtime premium), or other equitable basis. Direct costs of engineering activities should be charged directly to the benefited activities, i.e., contract and other work of the contractor in accordance with paragraph 15-202.

15-203.3 SELLING AND DISTRIBUTION EXPENSES. The expenses in this group consist of items which represent the cost of marketing the contractor's products and include sales promotion, advertising, distribution costs and other related items. Generally, such expenses are not considered to be allowable as a charge to Government cost-reimbursement type contracts for the reason that marketing, in the ordinary commercial sense, is not necessary for doing business with the Government. However, dependent upon a reasonable demonstration of benefits to Government contracts and subject to the other provisions of this part, there may be an allocation to government work of those expenses in this category which consist of technical, consulting and such other beneficial services (including related supervision and clerical expenses) which are for purposes such as application and adaptation of the

contractor's products rather than pure selling. Such costs should first be allocated between the contractor's commercial line and its Government contracts. The amount allocated to the latter should then be charged to the individual contracts on any equitable basis. Because of the special problems that arise in this area, it is usually desirable for the contractor to identify in its records by means of sub-accounts or otherwise, the items of these expenses considered properly allocable to Government contracts.

15-203.4 GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses consist of costs incurred in the over-all management, supervision and conduct of the business. Any recognized method of allocating general and administrative expense is acceptable provided equitable results are thereby obtained. Some of the factors that should receive consideration in determining whether the results are equitable are (i) the cost pattern of the Government contracts (that is, the percentage of the total cost of the contract, exclusive of general and administrative expenses, represented by each of the several cost components thereof) in relation to the cost pattern for the plant or activity as a whole, and (ii) the ultimate objective of distribution of these expenses in approximate ratio to the general and administrative effort involved in the two categories of work. In addition, consideration should be given to any significant variations of inventories between accounting periods, variations in the ratio of contract inventory levels to all other inventory levels, and other relevant factors including those mentioned in para. 15-203(b).

15-203.5 BASE PERIOD FOR ALLOCATION OF INDIRECT EXPENSES. The base period for allocation of indirect expenses should ~~approximate~~ be representative of the period of contract performance ~~or should be representative of that period. The base period~~ and should be sufficiently long to avoid inequities in the allocation of costs, but in no event longer than the contractor's fiscal year.

15-204 APPLICATIONS OF BASIC COST PRINCIPLES AND STANDARDS TO SELECTED ITEMS OF COST. This paragraph states, in some detail, applications of the basic cost principles and standards set forth in the preceding paragraphs of this part to certain selected

items of cost. The statements herein apply irrespective of whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost herein is not intended to imply that it is either allowable or unallowable. With respect to those items not specifically covered, as well as all the subparagraphs below, determination as to allowability will be made in the light of the basic principles and standards herein and, where appropriate, the treatment of similar or related items in this Part.

15-204.1 ADVERTISING. Advertising expenses include the costs of advertising media and corollary administrative expenses. Advertising media include magazines, newspapers, radio and television programs, direct mail, trade papers, outdoor advertising, dealer cards and window displays, conventions, and exhibits, free goods and samples, and sales literature.

a. The following advertising costs only are allowable:

(1) 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.

(2) Help wanted advertising, as set forth in paragraph 15-204.32.

15-204.2 BAD DEBTS. Bad debt expenses consist of losses (whether actual or estimated) arising from uncollectible customers' accounts and other claims, and include related collection expenses and related legal expenses. These costs are unallowable.

15-204.3 BIDDING EXPENSE. Bidding expenses are the costs of preparing bid estimates on potential contracts or projects, including the development of engineering and cost data necessary to support the contractor's price proposal or estimated cost of work performance. Bidding expenses of the current accounting period of both successful and unsuccessful bids normally will be treated as indirect expenses and allocated currently to all business of the contractor, in which event no

bidding expenses of past accounting periods will be allocable in the current period to the Government contract. However, the contractor's established practice may be to treat bidding expenses by some other recognized method. Regardless of the method used, the results obtained may be accepted only if found to be reasonable and equitable.

15-204.4 CAFETERIAS, DINING ROOMS, AND OTHER FOOD SERVICES. This class of expenses consists of cost, less revenue, of operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, or other types of services for contractors employees at the contractor's facilities. Profits accruing to the contractor from the operation of these services whether operated by the contractor or by a concessionaire, will be treated as a credit to costs of all production within the contractor's plant in which the services are furnished, except for services from which the profits are 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. Reasonable losses of operation from such services are allowable when it is the policy of the contractor to operate such services at no loss or profit; provided, however, that any gains or losses from these services must be appropriately allocated to all activities benefited including Government contracts. When it is the policy of the contractor to furnish such services at a loss, losses on such operation will not be allowed as a cost, unless authorized by special contract provision.

15-204.5 CIVIL DEFENSE. Civil defense costs are those incurred in the planning for and the protection of life and property against the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by local and state civil defense authorities. Examples of civil defense costs include cost in excess of normal plant protection expenses and may consist of first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions and other approved civil defense measures. Reasonable costs of 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. In the case of capital assets, acquired for civil defense purposes the costs thereof will be depreciated over a reasonable number of years in conformity with generally accepted accounting principles. Except as specifically provided in the contract, contributions to local/civil defense funds or projects not on the contractor's premises are unallowable.

15-204.6 COMPENSATION FOR PERSONAL SERVICES. (To be inserted later on this page and pages 1509, 1510 and 1511).

15-204.7 CONTINGENCIES. This type of charge results from the creation and maintenance of reserves to provide for an event whose occurrence cannot be foretold with certainty as to time, intensity or even an assurance of its happening. These costs are not allowable. (For self-insurance programs see paragraph 15-204.15).

15-204.8 CONTRIBUTIONS AND DONATIONS. 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.

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15-204.9 DEPRECIATION.

a. Depreciation as described herein is a charge to current operations intended to distribute the cost of tangible capital assets, less estimated residual value, over their estimated useful life in a systematic and logical manner. It involves a process of allocation, not of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

b. Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, provided the amount thereof is based upon original acquisition cost. Depreciation will be accounted for by consistent application to the asset(s) concerned of any generally accepted accounting principles, including those recognized by Section 167 of the Internal Revenue Code of 1954, and should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation charged in any accounting period may vary with volume of production or use of multishift operations, provided the method

followed is consistent with basic objectives set forth in subparagraph a. above.

c. Charges for depreciation on idle or excess facilities will not be allowed except on such facilities as are reasonably necessary for standby purposes.

d. Unless otherwise provided in the contract, no use charge will be allowed for assets still in use which have been, in accordance with the contractor's consistent accounting practice, fully depreciated on the contractor's books of account.

e. Where the contractor has applied for, received, and accepted a determination of "true depreciation" from an Emergency Facilities Board covering an emergency facility acquired under a certificate of necessity, the amounts so determined for "true depreciation" over the emergency period (5 years) will be recognized in lieu of normal depreciation. After the expiration of the emergency period for the facility concerned where a determination of "true depreciation" has been made, the remaining undepreciated portion of the cost of such facility will be depreciated over its remaining useful life and will be the only amount recognized as allowable cost, subject to paragraph 15-204.12. (INSERT) The contractor may elect to use normal depreciation rather than the "true depreciation" as determined by the Emergency Facilities Board. However, the method chosen after such determination of "true depreciation" must be followed consistently throughout the life of the emergency facility.

The remaining undepreciated amount shall be only the normal depreciation remaining after the end of the 'true depreciation' period and shall not include any amount of unrecovered normal or 'true depreciation' allowable during the 'true depreciation' period.

15-204.10 EMPLOYEE MORALE, HEALTH AND WELFARE. Included in this category are expenses of health and welfare activities incurred for the improvement of working conditions and the improvement of employer-employee relations, employee morale, and employee performance. Examples of these activities are house publications, health or first-aid clinics, and employee counselling services. These costs are allowable when incurred in accordance with the contractor's established practice or custom in the industry or area and are reasonable and equitably allocated to all classes of work performed in the contractor's plant. Income generated from any of these

activities will be credi[illegible]o the costs thereof unless s[illegible]ncome has been irrevocably set over to employee welfare organizations.

15-204.11 ENTERTAINMENT EXPENSE. This item includes the cost of amusement, diversion, social activities and incidental costs relating thereto, such as meals, lodging, rentals, transportation and gratuities. These costs are unallowable.

15-204.12 EXCESS FACILITIES. This item includes the cost of maintaining and housing idle and excess facilities, except those reasonably necessary for standby purposes. These costs are unallowable. The costs of additional plant capacity reserved for defense production shall be the subject of a separate contract.

15-204.13 FINES AND PENALTIES. Included in this item are those costs resulting from violations of, or failure of the contractor to comply with, local, state and Federal laws and regulations. These expenses are not allowable except when incurred as a result of compliance with specific provisions of the contract or instructions in writing from the contracting officer.

15-204.14 FRINGE BENEFITS. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries.

a. The determination as to the allowability of the cost of pension and retirement plans, profit sharing and other bonuses, and severance pay will be in accordance with sub-paragraphs 15-204.26, 15-204.6 and 15-204.37 respectively.

b. The cost of other fringe benefits such as pay for vacations, holidays, sick leave, military leave and employee insurance (but see subparagraph 204.15e) is allowable to the extent required by law, employer-employee agreement, or established policy of the contractor that constitutes, in effect, an implicit agreement on the contractor's part.

15-204.15 INSURANCE AND INDEMNIFICATION.

a. Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative, and

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15-204.15 INSURANCE AND INDEMNIFICATION.

a. Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative (see ASPR 10-501 for kinds of insurance ordinarily required), (2) any other insurance for which the contractor seeks reimbursement under the contract, and (3) liabilities to third persons not compensated by insurance or otherwise.

b. The contractor shall be reimbursed for (1) insurance required to be submitted for approval or required to be procured and maintained pursuant to ASPR 7-203.22 and (2) other insurance maintained by the contractor in connection with the performance of this contract if the types and extent of coverage are in accord with sound business practice and the rates are reasonable under the circumstances, subject to the following limitations or restrictions:

(i) Costs allowed for use and occupancy insurance will ~~be~~ be limited so as to exclude coverage of profit, interest, federal income taxes, and any other items of expense unallowable under this part.

(ii) ~~The~~ Costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are not allowable except to the extent that the Government may have approved or required such insurance or reserve.

(iii) ~~Provision for losses under~~ Cost of a reserve for a self insurance program are allowable provided the program has been approved by the Military Departments concerned.

(iv) ~~The~~ Costs of insurance on the lives of officers, partners or proprietors, are not allowable except where such insurance is part of an employee plan which is not unduly restricted.

c. The obligation of the Government to indemnify the contractor will be allowable only to the extent expressly provided for in the contract (For

Except as otherwise expressly provided in the contract,

example, see ASPR 7-203.22). ~~When the costs of insurance would have been allowable under paragraph b. above,~~ actual losses not reimbursed by insurance ~~because of failure to insure~~ (through an approved self insurance program or otherwise), are not allowable.

(2) any other insurance for which the contractor seeks reimbursement under the contract. The kinds of insurance ordinarily included in the first category are set out in ASPR 10-501.

b. Costs of Government required insurance are allowable within the limitations as to the extent of coverage and premium rates approved by the Government. Costs of other insurance, except that applicable to Government-owned property, are allowable provided (1) the insurance has been approved by the military department concerned or (2) in the absence of such approval requirement, the types of coverage, extent of coverage, and rates are reasonable under the circumstances. Costs allowed for use and occupancy insurance, however, will in principle be limited so as to exclude coverage of profit, interest, federal income taxes, and any other items of expense unallowable under this part.

c. The costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are not allowable except to the extent that the Government may have required the contractor to carry such insurance.

d. Provision for losses under a self insurance program are allowable provided the program has been approved by the Military Departments concerned. Actual losses sustained under such a self-insurance program are not allowable.

e. The costs of insurance on the lives of officers, partners or proprietors, are not allowable except where such insurance is part of an employee plan which is not unduly restricted.

f. Losses resulting from failure to insure (through self insurance or otherwise) are not allowable unless approved by the Department concerned.

g. Cost of indemnification will be allowable only to the extent expressly provided for in the contract.

15-204.16 INTEREST AND OTHER FINANCIAL EXPENSES. This item includes interest (however represented), bond discount and expenses, and the cost of financing and refinancing operations as well as legal and professional fees paid in connection

with the preparation of a prospectus, cost of preparation and issuance of stock rights and expenses related thereto. (See also 15-204.23). These costs are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in subparagraph 15-204.39.

15-204.17 LABOR RELATIONS. This item covers expenses incurred in maintaining satisfactory relations between the contractor and his employees. It includes the cost of shop stewards, labor management committees, employee publications and other related activities. Costs incurred for these purposes are allowable.

15-204.18 LOSSES ON OTHER CONTRACTS. This item covers any excess of costs over income under any and all other contracts, whether such other contracts are of a supply, research and development or other nature (including the contractor's contributed portion under cost sharing R+D contracts). Costs of this nature are not allowable as a cost of performance of the Government contract.

15-204.19 MAINTENANCE AND REPAIRS.

a. This item includes those costs necessary for the upkeep of property (including Government property unless otherwise provided for) which neither adds to the permanent value of the property nor appreciably prolongs its intended life but keeps it in an efficient operating condition. These costs are allowable. Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation will be allowable only on a depreciation basis. Cost of maintenance and repairs of excess facilities and of idle facilities (other than reasonable standby facilities) are not allowable.

b. Deferred maintenance is defined as maintenance and repairs which for some reason such as abnormal operating conditions or lack of funds, is delayed to a future period. The cost of maintenance and repairs which has been deferred from a period prior to the contract is not allowable unless specifically provided for in the contract. Likewise, the estimated cost of maintenance and repairs normally required but not accomplished during the period of the contract will not be allowed as a cost unless specifically provided for in the contract.

15-204.20 MANUFACTURING AND PRODUCTION ENGINEERING. Manufacturing and production engineering includes the cost of engineering activities in connection with (1) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement and (2) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production. These costs are allowable.

15-204.21 MATERIALS AND SUPPLIES.

a. This item includes the net costs of such items as raw materials, parts, sub-assemblies, components, and manufacturing supplies, whether purchased outside or manufactured by the contractor, and may include such collateral items as inbound transportation and intransit insurance. In computing materials costs consideration will be given to reasonable overruns, spoilage, or defective work (as to defective work, see paragraph 7-203.5(c)). These costs are allowable subject, however, to the provisions of subparagraphs b. through f. below.

b. Costs of materials and supplies shall be suitably adjusted for applicable portions of income and other credits. Such income and other credits include trade discounts, refunds, rebates and allowances, cash discounts available, credits for scrap and salvage and materials returned to vendors. Such discounts, rebates, allowances and credits, may be applied directly to the charges for materials involved or may be apportioned through credits to indirect costs. However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond his control, such lost discounts will be allowed.

c. When materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to the contract.

d. If materials are issued from stock, any generally recognized method of pricing such materials will be acceptable, provided the 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 and the Government may, by contract provision, agree upon the use of a method of pricing based upon the fair value of the materials as of the date of the contract, but not in excess of replacement cost on such date. Such agreement should include identification of the types or kinds of materials involved and should be made at the time the contract is entered into and provided for therein.

e. Reasonable charges arising from difference between periodic physical inventory quantities and related material control records will be included in arriving at the cost of materials, provided that such charges (1) do not include "write-downs" of values, and (2) relate to the period of performance of the contract. All credits arising from differences between periodic physical inventory quantities and related material control records shall be taken into account.

f. Ordinarily sales or transfers of materials, services and supplies between plants, divisions, or organizations, under a common control, shall be stated on the basis of cost to the transferor. 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, provided that the price charged to the contract does not exceed the lower of (1) the transferor's sales price to its most favored customer for the same item in like quantity, or (2) the prices of other suppliers for the same or substantially similar items.

15-204.22 ORGANIZATION EXPENSES. This item consists of expenditures in connection with organization or reorganization of a business. Examples of such costs are incorporation fee, attorneys fee, accountants fees, fees to promoters and organizers and costs of raising capital. These costs are unallowable. (See paragraph 15-204.16).

15-204.23 OTHER BUSINESS EXPENSES. Included in this item are such recurring expenses as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy

solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies and incidental costs of directors and committee meetings. The above and similar costs are allowable when allocated on an equitable basis to all classes of work.

15-204.24 OVERTIME, EXTRA PAY SHIFT AND MULTI-SHIFT PREMIUMS. ~~This item consists~~

"This item consists of the premium portion of overtime, extra pay shift and multi-shift payments to employees. Such premiums on direct labor may be classified as either direct or indirect labor costs, but the amount of such premiums should be separately identified. When direct labor cost is the base for distribution of overhead, such premiums shall not be included therein. Cost of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government. Cost of such premiums for indirect labor is allowable without prior approval, if reasonable, and the cost is allocated on a pro rata basis to commercial as well as Government work. See ASPR 12-102 for further information concerning the policy regarding such authorization. The amount of such premium cost charged on Government contracts shall be equitable in relation to the amount of such premium costs charged on non-Government work being concurrently performed in the Contractor's plant and the factors which necessitate the incurrence of the cost."

"15-204.25 PATENT EXPENSES. This item relates to such expenses as costs leading to the issuance of patents, costs required to search the art and costs necessary to comply with invention disclosure provisions of the contract. The costs of searching the art in order to make invention disclosures, and of preparing disclosures and other reports, as required by the contract are allowable. The costs of preparing assignment and other papers in connection with the filing of a patent application by the Government and any other such costs are allowable, upon the written authorization of the contracting officer. The cost of research and development work is treated in 15-204.34. (See also paragraph 15-204.35)."

~~tization of the cost of purchased patents applicable to contract products or pro-~~

cesses is allowable. The cost of preparing disclosures and other reports as required by the contract and of preparing assignment and other papers in connection with the filing of a patent application by or for the Government, and any expenses ~~incident to patents incurred upon the written authorization of the contracting officer, are allowable. All other patent expenses and charges for the use of~~

~~patents where the Government has a license or the right to free use thereof, are unallowable unless otherwise provided in the contract. The cost of research and development work leading to patents is treated in subparagraph 15-204.34.~~

15-204.26 PENSION PLANS.

a. A pension plan as used herein is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to his 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 will be considered a pension plan, if, under the plan, either the 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 be subject to paragraph 15-204.6e).

b. Pension plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the Military Department; however, approval of the plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such plan by the Military Department. Consideration of a plan and the method of determination of cost thereof will be the responsibility of the Department to which audit cognizance is assigned and the subsequent action taken by that Department will generally be accepted by the

other Departments. Where pension and retirement plans of non-profit or other tax exempt organizations are not required to be reviewed and approved by the Internal Revenue Service, it will be the responsibility of the Department to which audit cognizance is assigned to give consideration to the acceptability of such plans.

c. The costs of a pension plan approved by the Military Department concerned, to the extent such costs are claimed and deductible for income tax purposes (or are determined to be reasonable in the case of non-profit or tax exempt organizations), are allowable except as otherwise determined unallowable under this paragraph. Such costs may include excess contributions ~~of previous years~~ Federal income to the extent such contributions are claimed and allowed for tax purposes in the current taxable period. In cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract cost will be made for contributions disallowed for tax purposes which previously had been allocated to and allowed as contract costs.

d. In determining the net costs allocable to military contracts, consideration will be given to the possibility of future abnormal termination credits or gains and the effect such credits or gains would have upon current costs. These termination credits or gains will arise with respect to individuals for whom current costs are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits purchased or funded by current costs. When such credits or gains are foreseeable and their worth can be evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to the anticipated future credits or gains will be made. Such equitable adjustment can be accomplished either by discounting 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 discount for the abnormal termination credits or gains which are anticipated. However, most often such abnormal credits or gains, if foreseeable at all, are not susceptible of being evaluated at

the time of contracting because neither the timing nor the severity of the termination actions will be known. Under these circumstances, the Government's interest in such abnormal credits or gains will be preserved for retrospective evaluation and accounting. If a contractor has but one or relatively few Government contracts, an appropriate contractual provision may be used to preserve the Government's interest ~~and~~ by provide ~~for the~~ and any necessary adjustment to pension plan cost incurred under the contra retrospective accounting. In other cases, where a contractor is not limited to one or few Government contracts or there is reasonable probability he will receive follow-on contracts, a separate contractual "side" agreement will be negotiated having application to all pension costs allowed under contracts with the particular contractor and provide for an accounting of abnormal credits or gains, as that term is defined in the agreement, arising by reason of a cutback or cessation of Government contract work.

e. 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 incurred under approved pension plans will be subject to consideration on an individual case basis.

15-204.27 PLANT PROTECTION EXPENSES. This item includes the cost of wages, uniforms and equipment of personnel engaged in plant protection, supplies, depreciation on plant protection capital assets, and necessary expenses to comply with military security requirements. These costs are allowable.

15-204.28 PRECONTRACT COSTS. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs will not be allowed unless specifically set forth in the contract ~~and may be limited to a period of time as well as to the type and amount of such costs.~~

15-204.29 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER.

a. This item includes the cost of professional services rendered by the members of the particular profession separately engaged. These costs generally

rable when reasonable in relation to the services rendered and are not
it upon recovery of the costs from the Government.

b. Factors to be considered (among others) in determining the allowa-
costs in a particular case are: (1) past pattern of such costs, partic-
the years prior to the award of Government contracts; (2) the impact of
t contracts on the contractor's business; (3) the nature and scope of
l services expected of the contractor's own organization; and (4) whether
e proportion of Government work to the contractor's total business is
o influence the contractor in favor of incurring the cost, particularly
services rendered are not of a continuing nature and have little rela-
to work under Government contracts. Retainer fees to be allowable must
ably supported by evidence of services rendered.

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

O PROFITS AND LOSSES ON DISPOSITION OF PLANT, EQUIPMENT OR OTHER CAPITAL

Included herein are gains or losses of any nature arising from the sale or
of plant, equipment, or other capital assets, including sale or exchange
r short or long term investments. Profits or losses on sale or exchange
al assets, including investments, will be excluded in computing contract

I RECONVERSION EXPENSES. Reconversion expenses are those incurred in the
ion of the contractor's facilities to approximately the same physical
ent and condition existing immediately prior to commencement of the mili-
tract work and include the cost of removal of Government property. Recon-
expenses are not allowable except that the cost of removing Government
and the restoration costs caused by such removal are allowable if specifi-
ovided for in the contract.

15-204.32 RECRUITING EXPENSE. This item includes the costs of "help wanted" advertising and the operating costs of an employment office necessary to secure and maintain an adequate labor force. It further includes the costs of operating an ~~educational and~~ and educational aptitude testing program, travel expenses of employees while engaged in recruiting personnel, and travel expenses of applicants for interviews for prospective employment. These costs are allowable. Where the contractor uses private employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are not allowable.

15-204.33 RENTALS OF PLANT AND EQUIPMENT. (Including sale and leaseback of facilities.) This item includes expenses for (1) use of land, buildings, and equipment or other personal property, and (2) rental expenses under sale and lease-back agreements incurred by contractors through sale of plant facilities to investment organizations (such as insurance companies) or to private investors and concurrently leasing back the same facilities.

a. Rentals of plant and equipment under (1) above are allowable if the rates are reasonable in light of the type, condition and value of the facilities leased, options available and other provisions of the rental agreement.

b. Unless specifically provided for otherwise in the contract, rentals specified in sale and lease-back agreements under (2) above are allowable only to the extent that such rentals do not exceed normal costs (such as depreciation, taxes, insurance and maintenance expenses borne by the lessor) which would have been incurred had the contractor retained legal title to the facilities.

15-204.34 RESEARCH AND DEVELOPMENT. Research and development expenses (sometimes referred to as general engineering expenses) for the purpose of contract costing are divided into two major categories, namely:

a. General research, also referred to as basic research, fundamental research, pure research and blue-sky research.

b. Related research or development, also referred to as applied research, product research and product line research.

> "(i) General research is that type of research which is directed towards increase of knowledge in science. It is research where the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. The cost of Independent General Research (that which is not sponsored by a contract or grant or other arrangement) shall be allowed to the extent specifically provided in the contract.
>
> (A) To the extent such costs are allowed, they will be equitably allocated to all work of the contractor other than its independent general and related research.
>
> (B) Generally, the contractor shall be required to disclose to the Government the purposes and results of such independent general research.
>
> In specially providing for such cost, consideration shall be given to the following factors among others:
>
> a. Scope, nature and quality of the contractor's independent general research program.
> b. The capability of the contractor in the particular research field.
> c. Benefits which may accrue to the Government.
> d. Comparison of size and cost of contractor's previous years' research programs.
> e. The proportion of the Government business to the contractor's total business."

development (that which is not sponsored by a contract or grant or ~~is not otherwise reimbursed to a contractor~~ other arrangement) may, if allocated on the basis of all production, be allowed as a cost under any cost type production contract if the research is related to the contract product or product line. No portion of such research will be allowable under cost-type research and development contracts.

c. Independent research projects will absorb their appropriate share of the indirect expenses of the department where the research work is performed.

d. Research and development costs (including amounts capitalized), regardless of the nature, which were incurred in accounting periods prior to the award of a particular military contract, will not be allocated to that contract unless allowable as pre-contract costs (Paragraph 15-204.28)."

"15-204.35 ROYALTIES AND OTHER COSTS FOR USE OF PATENTS.

This item covers amounts paid or payable for the right to use patents or inventions. Where the use of such a patent or invention is necessary for the proper performance of the contract and where the Government does not already have a license or other right to use such a patent or invention, the royalties, amortization of the cost of purchased patents or other purchased patent rights applicable to contract products or processes are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the contracting officer. Charges for the use of patents, where the Government has a license or the right to free use of the patent are unallowable. (1526) Charges for the use of patents where a patent has been adjudicated to be invalid are unallowable unless otherwise provided in the contract. (NOTE: This provision, upon reconsideration by the ASPR Committee, was changed from the manner in which it is shown in the minutes of the 6 Dec. 1955 meeting (which are correct) to the form shown above.)

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15-204.36 SERVICE AND INSTALLATION EXPENSES. This item includes ... vicing the product installation, and training personnel in the use, maintenance and operation of the product. Such costs are allowable.

15-204.37 SEVERANCE PAY. Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated.

The cost of severance pay is allowable only to the extent that, in each case, it is required by (1) law, (2) employer-employee agreements, (3) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (4) the circumstances of the particular employment.

For contract costing purposes severance pay is divided into two categories as follows:

a. Normal Turnover Severance Pay. The cost of severance payments is allowable and must be allocated to all classes of work being performed in the contractor's plant at the time of payment. However, 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.

b. Mass Severance Pay. The cost of abnormal or mass severance pay actually made upon cessation of work when there is no reasonable prospect of

* Army wants consideration given to inserting "consumer"

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 entire period of employment with the contractor and equitably apportioning such cost to all business of the contractor performed during that period.

A reservation in the final release of claims (See ASPR 7-203.4) may be made in the case of completed cost-reimbursement type contracts when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

Does this conform with latest XIII definition

15-204.38 SPECIAL TOOLING. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or to the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. The cost of special tooling, when acquired for and its usefulness is limited to government contracts, is allowable and will be charged directly to the government contracts. When such special tooling is acquired it shall be subject to the provisions of the contract clause set forth in ASPR 13-503 entitled, "Government Property".

15-204.39 TAXES. Taxes are charges levied by a government unit. They do not include fines and penalties except as otherwise provided herein.

a. In general, taxes (including state and local income taxes) which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for (1) Federal income and excess profits taxes; (2) taxes in connection with financing, refinancing or refunding operations (see paragraph 15-204.16); (3) taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government; and (4) special assessments on land which represent capital improvements.

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except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the Government

b. Taxes otherwise allowable under a. above, but which may be illegally or erroneously assessed may be allowed as a cost of work performed, provided that the contractor, prior to payment of such taxes, (1) promptly requests instructions from the contracting officer concerning such taxes; (2) agrees to comply with such instructions; and (3) if so directed by the contracting officer also agrees to take all necessary action in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refun of such taxes and any interest of penalties thereon. Interest and penalties incurr by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer, shall be allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs.

c. Any refund of taxes, penalties or interest thereon shall be credited to contract costs in the proportion in which contract costs absorbed the costs of taxes, interest or penalties. If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

15-204.40 TRADE, BUSINESS, TECHNICAL AND PROFESSIONAL ACTIVITIES.

a. Memberships. This item includes costs of membership in trade, business, technical and professional organizations and such costs are allowable.

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

c. Meetings and Conferences. Expenses representing the purchase of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such expenses is the dissemination of technical information or the stimulation of production, are allowable.

15-204.41 TRAINING EXPENSES.

a. This item includes the costs of preparing and maintaining a program of instruction designed to increase the over-all effectiveness of employees. Included are the costs of the director of training and staff, training materials and text books when the training program is controlled by the contractor, and tuition, fees, training materials and text books when the training is in educational institutions.

b. Such costs which are limited to on the job training are allowable when properly allocated.

c. Costs of training in educational institutions are not allowable, except to the extent specifically provided in the contract.

15-204.42 TRANSPORTATION EXPENSES. Transportation expenses include the cost of freight, express, cartage and postage relating either to goods purchased, in process, or delivered.

When such costs can readily be identified with the items involved, they may be direct costed or added to the cost of such items. (See paragraph 15-204.21) Where identification with the materials received cannot readily be made, inbound transportation expense may be charged to the appropriate indirect expense accounts, provided the contractor follows a consistent procedure* in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as direct charges.

15-204.43 TRAVEL EXPENSES. This includes costs of transportation, lodging, subsistence and incidental expenses incurred by contractor personnel in a travel status while on official company business.

a. Travel expenses incurred in the normal course of over-all administration of the business and applicable to the entire business are allowable when properly allocated.

* Army wants insert considered "which provides for equitable results

b. Travel expenses directly attributable to contract performance may be charged to the contract in accordance with the principle of direct costing.

c. Subsistence and lodging including tips or similar incidental expenses may be reimbursed either on an actual or per diem basis. The basis selected should be consistently followed.

d. Entertainment expenses are not allowable.

e. Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the Contracting Officer.

15-204.2 (aa) Training and Educational Costs. (1) Costs of preparation and maintenance of a program of instruction at non-college level, designed to increase the vocational effectiveness of bona fide employees, including training materials, textbooks, salaries or wages of trainees during regular working hours, and

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

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

are allowable.

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

(i) training materials;

(ii) textbooks;

(iii) fees charged by the educational institution;

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

(v) (A) tuition charged by the educational institution; or

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

are allowable.

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

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

(5) Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships, are considered contributions (see ASPR 15-204.3(c)).

Part 2 - Supply, Service, and Research and Development Contracts, with Commercial Organizations

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.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (1) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

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

15-201.3 Credits. The applicable portion of income, rebates, allowances, and other credits received by or accruing to the contractor which is related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

15-202 Direct Costs.

15-202.1 General. Items of cost which are readily identifiable with (i) a contract, or (ii) other work of the contractor, should be charged directly to the contract or other work with which identified. This principle may be applied to items of cost, such as freight, travel, communications, and engineering services, as well as materials and productive labor, but when used must be applied consistently to all work of the contractor. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, which otherwise would be treated as direct costs, may be treated as indirect costs. Each element of direct cost is subject to the limitations of this Part as to allowability.

15-202.2 Direct Material Costs. Direct material costs include the cost of raw materials, purchased items, and items supplied from stock, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically identifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable.

Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable only to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

15-203 Indirect Costs.

15-203.1 General. (a) Items of cost which are incurred for common or joint objectives, and which are not readily subject to treatment as direct costs in accordance with ASPR 15-202, should be accumulated for accounting purposes by logical cost groupings and charged by a process of allocation. Each element of indirect cost is subject to the limitations of this Part as to allowability.

(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.

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

15-203.2 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 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. 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(v)(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. 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.

15-203.5 General and Administrative Costs. General and administrative costs consist of items of cost attributable to the over-all 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. Methods acceptable where the circumstances are appropriate include allocation on such basis as:

(i) allocation of general and administrative costs on a total cost incurred basis (exclusive of general and administrative costs);

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

(iii) factory input costs (processing costs plus direct material);

(iv) cost of goods completed;

(v) cost of sales; and

(vi) sales (where no more satisfactory method is available).

15-204 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below. These applications govern whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

15-204.2 Costs Allowable in Whole or in Part.

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

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

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

All other advertising costs are unallowable.

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

(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 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 (f) below. Contributions to local civil defense funds, or to projects not on the contractor's premises, are allowable. (See (e) below).

(d) Compensation for Personal Services. (1) Compensation is allowable subject to the specific limitations set forth hereunder. 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. Subject to specific limitations set forth hereunder, 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.

(2) Generally, the amount of compensation established by the contractor will be considered commensurate with the services rendered. However, compensation of individuals such as corporate officials, directors, executives, department heads, may be subject to special consideration and limitation as to allowability for contract cost purposes where amounts appear excessive. Some situations which may give rise to excessive compensation are where (i) the individual or member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization; or (ii) ownership of the contractor is limited to a small cohesive group; or (iii) the volume of Government contracts when related to the contractor's total business is such as to influence the amount of compensation.

(3) The cost of options to purchase stock of the contractor corporation granted to employees is not allowable as an item of cost.

(4) Subject to the provisions of (5) below, bonuses to employees, such as production incentives and suggestion or safety awards, represent a part of their total compensation and are allowable when appropriately allocated, if they are:

(i) Incurred pursuant to an arms length understanding between the contractor and the employees before the services are rendered or pursuant to an established plan consistently followed by the contractor.

(ii) Reasonable in amount when considered in the light of total compensation for work done.

(iii) Incurred for current services actually rendered by employees.

(iv) Available to all employees of the contractor or to all employees within a group or salary classification which is not unreasonably restricted.

(v) Allowable as an ordinary or necessary business expense for tax purposes.

(vi) Not restricted to officer or other employee stockholders or are not distributed on the basis of stockholdings.

(5) Profit Sharing Plans.

(i) As used herein profit sharing is construed to be any plan (immediate or deferred-regardless of method of payment or participation)which includes, in whole or in part, a formal sharing of profits or is in any manner measured by dependent upon or contingent upon profit.

(ii) The cost of profit-sharing plans shall be treated as follows:

(A) Compensation payable under immediate distribution plans is allowable if the plans meet the criteria set forth in (4) above.

(B) Employer contributions incurred under deferred distribution profit-sharing plans other than pension plans (see (q) below) are allowable costs if the plans meet the requirements of the applicable provisions of the Internal Revenue Code and the regulations of the Internal Revenue Service.

(6) Stock Bonus Plans. Stock bonuses which are not disallowed by the provisions of (5) above are acceptable as a form of compensation, and the costs thereof are allowable subject to all conditions pertinent under subparagraph (4) above and meet the following requirements:

(i) The valuation placed on the stock for the purpose of calculating such cost must be computed on a sound basis.

(ii) In the case of unlisted stock having no current market, the contractor must demonstrate the values ascribed thereto are fair and reasonable.

(iii) Bonuses paid in the form of previously unissued stock of an affiliate will not ordinarily be allowed unless it can be demonstrated that there exists a bona fide arms-length agreement and the values ascribed to such stock are fair and reasonable.

(iv) Claims for accruals of compensation under a stock bonus arrangement prior to acquisition of stock by employees will not be allowable unless arrangements are made for appropriate credit adjustment of costs in the event such stock is not acquired by employees.

(7) The determination of allowability of the cost of pension plans, training and education, overtime, extra pay and multi-shift premiums and other fringe benefits will be in accordance with paragraphs (q), (bb), (o), and (i) respectively.

(e) Contributions and Donations. Reasonable contributions and donations to established non-profit charitable, scientific, educational and civil defense organizations are allowable provided they (i) may reasonably be expected to result in future benefits to the contractor through advancing, directly or indirectly, the technology of his industry or increasing the supply of trained manpower available to it, (ii) are in lieu of the cost of similar facilities which the contractor would have to provide, such as employee medical or recreational facilities, or (iii) are expected of the contractor by the community and it can reasonably be expected that the prestige of the contractor in the community would suffer through the lack of such contributions.

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

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

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

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

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

(iii) by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954.

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

(3) Where a contractor has received a determination of "true depreciation" from an Emergency Facilities Depreciation Board relating to an emergency facility covered by a certificate of necessity, it may elect to use either normal or "true" depreciation. However, the method elected must be followed consistently throughout the life of the emergency facility. Where an election is made to use normal depreciation, the amount thereof shall be computed in accordance with (2) above. Where an election is made to use "true depreciation," the amount allowable as depreciation:

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

(ii) after the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life (but see (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.

(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. Use charges for assets not fully depreciated on the contractor's books are unallowable.

(g) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred, in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(h) 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 or facilities controlled by the contractor. 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.

(i) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor (but see (d) above, and (j)(3)(v), (o) and (x) below).

(j) Insurance and Indemnification.

(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes securing the contractor against liabilities to third persons not compensated by insurance or otherwise.

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

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

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

(ii) costs allowed for use and occupancy insurance shall be limited to exclude coverage of profit, interest, Federal income taxes, and 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 unallowable except to the extent that the Government shall have approved or required such insurance or reserve;

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

(v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(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.

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

(l) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable (but see ASPR 15-204.3(d)). Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis.

(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) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

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

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

are allowable.

(n) Material Costs.

(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.

(5) Reasonable charges or credits arising from a difference 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 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 sales price to its most favored customer.

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise approved by the Government and may be classified as either direct or indirect labor costs. When direct labor cost is the base for distribution of overhead, such premiums shall not be included in that base. When such premiums are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work.

(p) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. 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 (v) and (w) below.)

(q) Pension Plans.

(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, either the 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 (q).).

(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 plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P. L. 591, 83rd Cong., 2d 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 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-emempt 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) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall 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) in determining the net 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 —

(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 adjustment 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.

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

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

(1) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(f)).

(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 a continuing nature and have little relationship to work under Government contracts.

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

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

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

(u) 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 agreement.

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

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

(v) Research and Development Costs.

(1) Research and development costs (sometimes referred to as general

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

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable to the extent specifically provided in the contract.

(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 (m) 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.

(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 allowable as precontract costs (see ASPR 15-204.3(k)).

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

(x) Severance Pay.

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

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

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

(ii) abnormal or mass severance payments actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of the 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.

(y) Special Tooling Costs. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling acquired for performance of the contract are allowable and shall be charged directly thereto.

(z) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(f));

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

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

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

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

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

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

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

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

(1) Memberships. Costs of membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(bb) Training and Educational Costs.

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

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

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

are allowable.

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

(i) training materials;

(ii) textbooks;

(iii) fees charged by the educational institution;

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

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

are allowable.

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

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

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

(cc) Transportation Costs. Transportation costs include freight, express, cartage, and postage charges relating either to goods purchased, in process, or delivered. When such costs can readily be identified with the items involved, they may be direct costed as transportation costs or added to the cost of such items (see (n) above). Where identification with the materials

received cannot readily be made, inbound transportation costs may be charged to the appropriate indirect cost accounts if the contractor follows a consistent equitable procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as a direct cost.

(dd) Travel Costs.

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

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

(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.

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

(ee) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

(i) ASPR 15-204.3(e)

(ii) ASPR 15-204.3(i)

(iii) ASPR 15-204.3(k)

15-204.3 Unallowable Costs.

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

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs, see ASPR 15-204.2(j)).

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

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

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

(f) Interest and Other Financial Costs. Interest (however represented), bond discounts, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of the prospectus, costs of preparation and issuance of stock rights, and costs related thereto are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in ASPR 15-204.2(z) (but see ASPR 15-204.2(ee)(1)).

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

(h) Organization Costs. Expenditures, such as incorporation fees, attorney's fees, accountants fees, brokers fees, fees to promotors and organizers, in connection with (i) organization or reorganization of a business, or (ii) raising capital, are unallowable (see (f) above).

(i) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract.

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments, shall be excluded in computing contract costs (but see ASPR 15-204.2(f)(2) as to basis for depreciation).

(k) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately

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 unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(1) General.

(1) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

(i) Advertising Costs, ASPR 15-204.2(a), last sentence;

(ii) Compensation for Personal Services, ASPR 15-204.2(d)(3)

(iii) Depreciation, ASPR 15-204.2(f)(4), and (5), last sentence;

(iv) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), first sentence;

(v) Recruiting Costs, ASPR 15-204.2(t), last sentence;

(vi) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w), both provisos; and

(vii) Taxes, ASPR 15-204.2(z)(1)(i) through (iv).

(2) Certain other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

(i) Depreciation, ASPR 15-204.2(f)(5), first sentence;

(ii) Food Service Costs and Credits, ASPR 15-204.2(h), last sentence;

(iii) Insurance and Indemnification, ASPR 15-204.2(j)(3)(iii) and (iv), and (4);

(iv) Maintenance and Repair Costs, ASPR 15-204.2(l)(2);

(v) Overtime, Extra-Pay Shift, and Multi-Shift Premiums, ASPR 15-204.2(o), second sentence;

(vi) Patent Costs, ASPR 15-204.2(p), second sentence;

(vii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), last sentence;

(viii) Rental Costs (Including Sale and Leaseback of Facilities), ASPR 15-204.2(u)(3);

(ix) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w);

(x) Taxes, ASPR 15-204.2(z)(2); and

(xi) Travel Costs, ASPR 15-204.2(dd)(4).

OGC/GWM:lwt

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Part 2 - Supply, Service, and Research and Development Contracts, with Organizations Having Commercial Type Accounting Systems

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 having commercial type accounting systems. However, this Part does not apply to contracts for facilities, construction, or architect-engineer services related to construction. It also does not apply to clauses in supply or service contracts which provide for the furnishing of industrial facilities.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (i) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

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

15-201.3 Credits. The applicable portion of income, rebates, allowances, and other credits received by or accruing to the contractor which is related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

15-202 Direct Costs.

15-202.1 General. Items of cost which are readily identifiable with (i) a contract, or (ii) other work of the contractor, should be charged directly

to the contract or other work with which identified. This principle may be applied to items of cost such as freight, travel, communications, and engineering services, as well as materials and productive labor, but when used must be applied consistently to all work of the contractor. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, which otherwise would be treated as direct costs, may be treated as indirect costs. Each element of direct cost is subject to the limitations of this Part as to allowability.

15-202.2 Direct Material Costs. Direct material costs include the cost of raw materials, purchased items, and items supplied from stock, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically identifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable. Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable only to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

15-203 Indirect Costs.

15-203.1 General. (a) Items of cost which are incurred for common or joint objectives, and which are not readily subject to treatment as direct costs in accordance with ASPR 15-202, should be accumulated for accounting purposes by logical cost groupings and charged by a process of allocation. Each element of indirect cost is subject to the limitations of this Part as to allowability.

(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, be applied consistently, and produce equitable results. Any significant change in the nature of the business, the extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, the contractor's products, or other factors may require reconsideration of the method previously used. Individual categories of indirect cost are discussed in ASPR 15-203.2 through 15-203.5.

(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 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.

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 manhours 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 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. 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(v)(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. 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.

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. Factors to be considered in determining whether the results are equitable include:

(i) the ultimate objective of allocating general and administrative costs to the various activities of the contractor's business in proportion to the general and administrative effort involved;

(ii) the results obtainable by using the input cost method (as used herein the input cost method means the total costs incurred during the period, exclusive of general and administrative costs; however, inventories acquired for use under the contract shall be treated in the same manner as inventories acquired for other work of the contractor and facilities purchased under the contract shall not become part of input cost unless facilities acquired by the contractor for its own use are included therein);

(iii) the ratio of each of the several cost components to the total cost of the contract (exclusive of general and administrative costs) compared to the corresponding ratios for the contractor's plant or activity as a whole; and

(iv) other revelant factors including those mentioned in ASPR 15-203.1(b).

15-204 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below. These applications govern whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

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 (t) below.

All other advertising costs are unallowable.

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

(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 (f) 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.

(d) Compensation for Personal Services. (Reserved)

(e) Contributions and Donations. Reasonable contributions and donations to established nonprofit charitable, scientific, and educational organizations are allowable if they are deductible for Federal income tax purposes; however, such deductibility does not in itself justify allowance as a contract cost. The reasonableness 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. Allowable contributions and donations shall be allocated to all work of the contractor.

(f) Depreciation.

(1) Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the

estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

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

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

(ii) is computed by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954.

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

(3) Where a contractor has received a determination of "true depreciation" from an Emergency Facilities Depreciation Board relating to an emergency facility covered by a certificate of necessity, it may elect to use either normal or "true" depreciation. However, the method elected must be followed consistently throughout the life of the emergency facility. Where an election is made to use normal depreciation, the amount thereof shall be computed in accordance with (2) above. Where an election is made to use "true depreciation," the amount allowable as depreciation:

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

(ii) after the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life (but see (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.

(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. Use charges for assets not fully depreciated on the contractor's books are unallowable.

(g) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred, in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(h) 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.

(i) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor which constitutes, in effect, an implied agreement on the contractor's part (but see (d) above, and (j)(3)(v), (q) and (x) below).

(j) Insurance and Indemnification.

(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes liabilities to third persons not compensated by insurance or otherwise.

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

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

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

(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 unallowable except to the extent that the Government shall have approved or required such insurance or reserve;

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

(v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(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.

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

(l) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable (but see ASPR 15-204.3(d)). Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis.

(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) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

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

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

are allowable.

(n) Material Costs.

(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.

(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.

(5) Reasonable charges or credits arising from a difference 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 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 the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is lower;

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 either (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.

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government and may be classified as either direct or indirect labor costs. When direct labor cost is the base for distribution of overhead, such premiums shall not be included in that base. When such premiums are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work.

(p) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. 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 by the Government, are allowable. (See also (v) and (w) below.)

(q) Pension Plans.

(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, either the 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 (q).)

(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 plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P.L. 591, 83rd Cong., 2d 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 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)(i)(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) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall 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) in determining the net 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 —

(A) when all 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 adjustment 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 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.

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

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

(1) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(f)).

(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 organization; and

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

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

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

(t) Recruiting Costs. Costs of "help wanted" advertising, operating costs of an employment office necessary to secure and maintain an adequate labor force, costs of operating an aptitude and educational testing program, travel costs of employees while engaged in recruiting personnel, and travel costs of applicants for interviews for prospective employment are

allowable. Where the contractor uses employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are unallowable.

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

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

(v) Research and Development Costs.

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

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject

under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable to the extent specifically provided in the contract. /Generally, the contractor shall be required to disclose to the Government the purposes and results of such independent general research. In specifically providing for such costs, factors to be considered include:

(i) scope, nature, and quality of the contractor's independent general research program;

(ii) capability of the contractor in the particular research field;

(iii) benefits which may accrue to the Government;

(iv) comparison of size and cost of contractor's previous years' independent research programs; and

(v) proportion of Government business to contractor's total business./

(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 (m) 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.

(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 allowable as precontract costs (see ASPR 15-204.3(i)).

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

(x) Severance Pay.

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

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

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

(ii) abnormal or mass severance payments actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of the 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.

(y) Special Tooling Costs. The term special tooling means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling acquired for performance of the contract, are allowable and shall be charged directly thereto.

(z) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(f));

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

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

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

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

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

Reasonable costs of any such proceeding instituted by the contractor at the direction of the contracting officer are allowable. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are also allowable.

(3) Any refund of taxes, interest, or penalties, and any payment to the contractor of interest thereon, attributable to taxes, interest, or penalties which were allowed as contract costs, shall be credited or paid to the Government in the manner directed by the Government.

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

(1) Memberships. Costs of contractor's membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(bb) Training Costs. Costs of preparing and maintaining a program of instruction designed to increase the overall effectiveness of employees, including costs of the director of training and staff, training materials, and text books, and tuition and fees when part-time training is conducted by educational institutions, are allowable when limited to on-the-job type training and when properly allocated. Costs of training in educational institutions are unallowable, except to the extent specifically provided for in the contract in accordance with Departmental instructions.

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

(dd) Travel Costs.

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

(2) Travel costs incurred in the normal course of overall administration of the business and applicable to the entire business are allowable. Such costs shall be equitabl 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.

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

(ee) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

(i) ASPR 15-204.3(e);

(ii) ASPR 15-204.3(i); and

(iii) ASPR 15-204.3(k).

15-204.3 Unallowable Costs.

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

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs see ASPR 15-204.2(j).)

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

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

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

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

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

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

(i) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract. (See ASPR 15-1xx.)

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange or either short or long term investments, shall be excluded in computing contract costs (but see ASPR 15-204.2(f)(2) as to basis for depreciation).

(k) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitiation of the contractor's facilities to approximately 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 unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(l) General.

(1) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

(i) Advertising Costs, ASPR 15-204.2(a), last sentence;

(ii) Depreciation, ASPR 15-204.2(f)(4), and (5) last sentence;

(iii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), first sentence;

(iv) Recruiting Costs, ASPR 15-204.2(t), last sentence;

(v) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w), both provisos; and

(vi) Taxes, ASPR 15-204.2(z)(1)(i) through (iv).

(2) Certain Other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

(i) Civil Defense Costs, ASPR 15-204.2(c), last sentence;

(ii) Depreciation, ASPR 15-204.2(f)(5), first sentence;

(iii) Food Service Costs and Credits, ASPR 15-204.2(h), last sentence;

(iv) Insurance and Indemnification, ASPR 15-204.2(j)(3)(iii) and (iv), and (4);

(v) Maintenance and Repair Costs, ASPR 15-204.2(l)(2);

(vi) Overtime, Extra-Pay Shift, and Multi-Shift Premiums, ASPR 15-204.2(o), second sentence;

(vii) Patent Costs, ASPR 15-204.2(p), second sentence;

(viii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), last sentence;

(ix) Rental Costs (Including Sale and Leaseback of Facilities), ASPR 15-204.2(u)(3);

(x) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w);

(xi) Special Tooling Costs, ASPR 15-204.2(z)(2);

(xii) Training Costs, ASPR 15-204.2(bb), last sentence; and

(xiii) Travel Costs, ASPR 15-204.2(dd)(4).

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SECTION XV SUBCOMMITTEE

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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 contract and cost-reimbursement type subcontracts thereunder for procurement of supplies, services, and research and development work with organizations having commercial type accounting systems. However, this part does not apply to contracts for facilities,* construction and architect-engineer services related to construction.

15-201 BASIC PRINCIPLES AND STANDARDS.

a. Composition of Total Cost. The total cost of a cost-reimbursement type contract is the net sum of (i) the allowable direct costs, (ii) the properly allocable portion of allowable indirect costs and (iii) applicable income and other credits.

b. Factors Affecting Allowability of Costs. The factors to be considered in determining the allowability of costs include (i) reasonableness, (ii) application of generally accepted accounting principles and practices, (iii) significant deviations in the established practices of the contractor which substantially increase the contract costs, and (iv) any limitations as to types or amounts of cost items set forth in this Part 2 of Section XV or otherwise included in the contract.

c. Credits. The applicable portion of income and other credits, rebates, and allowances, received by or accruing to the contractor and which are related to any allowed cost will be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

d. 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).

15-202 DIRECT COSTS. Subject to the provisions of paragraph 15-201, allowable direct costs are those items of cost, or aggregate thereof, which can be identified specifically with any objective, service, program or project under the contract and

* Notes and Filing Instructions. This Part may be used for "facilities" pending publication of a Part for this purpose

are chargeable directly thereto. Major items of cost readily identifiable with the contract or with other work of the contractor should be charged directly thereto. This principle may often be applicable to such elements of expense as freight, travel, communications, engineering services, etc., as well as the normal items of materials and productive labor. However, when the contractor is engaged in mixed production, this principle must be applied consistently to the costing of both defense and non-defense products or services, in order to produce equitable results. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect expenses.

15-202.1 DIRECT MATERIALS. The cost of direct materials includes 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 furnishing such product. Costs of reasonable overruns, spoilage, and defective work may also be included (as to defective work, see paragraph 7-203.5(c)).

15-202.2 DIRECT LABOR. The cost of direct labor includes salaries and wages specifically identifiable with and properly chargeable directly to the performance of contract or other work of the contractor. Average rates may be used where it is demonstrated by the contractor that the results are equitable. Direct labor may also include other associated costs such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.3 OTHER DIRECT COSTS. Where other items of cost are charged directly to the contract consistent with paragraph 15-202 above, the contractor must demonstrate that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of like items applicable to other work of the contractor must be eliminated from indirect costs allocated to the contract.

15-203 INDIRECT COSTS.

(a) Indirect costs are expenses which are incurred for common or joint objectives, are accumulated for accounting purposes by departmental activity or other logical cost grouping and are charged to the contract and other work of the contractor by a process of allocation. Each element thereof is subject to the limitations of this part as to allowability.

(b) No specific rules can be stated as to the method of allocation of indirect costs because the actual condition in each instance must be taken into accour in determining the most suitable method or methods. The objective should be the selection of a method or methods which will distribute the indirect costs in a fair and equitable manner. The method used in connection with Government contracts must, in order to be acceptable, conform with generally accepted accounting practices, be applied consistently, and produce equitable results. Any significant change, such as in the nature of the business, extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, or the products being produced, may require reconsideration of the methods previously in use to determine whether they continue to be equitable. Further discussion relative to allocation of the individual categories of indirect costs will be found in the subparagraphs below.

15-203.1 INDIRECT MANUFACTURING AND PRODUCTION EXPENSES. Indirect manufacturing and production expenses consist of costs which are incurred in the productive process as a whole and are not readily subject to treatment as direct costs in accordance with paragraph 15-202. Allocation of indirect manufacturing and production expenses on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable bases, in appropriate circumstances, include direct labor dollars (exclusive of overtime premium), units processed and prime costs of units processed. The contractor may departmentalize or establish cost centers in order to distribute equitably the

indirect costs. The factors to be considered in determining the extent of departmentalization or establishment of cost centers include variety of products, complexity of processes and relative labor and facility requirements for the various products.

15-203.2 INDIRECT ENGINEERING EXPENSES. Indirect engineering expenses include engineering supervision, engineering administrative expense, engineering general supplies, and other related expenses. These expenses arise out of engineering activities which 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 expenses should be allocated to the benefited activities, i.e., contract and other work of the contractor (~~including independent research projects~~ see also paragraphs 15-204.3(c)) on the basis of direct engineering man-hours expended, direct engineering labor dollars, extra pay shift and multi-shift (exclusive of overtime premium), or other equitable basis. Direct costs of engineering activities should be charged directly to the benefited activities, i.e., contract and other work of the contractor in accordance with paragraph 15-202.

15-203.3 SELLING AND DISTRIBUTION EXPENSES. The expenses in this group consist of items which represent the cost of marketing the contractor's products and include sales promotion, advertising, distribution costs and other related items. Generally, such expenses are not considered to be allowable as a charge to Government cost-reimbursement type contracts for the reason that marketing, in the ordinary commercial sense, is not necessary for doing business with the Government. However, dependent upon a reasonable demonstration of benefits to Government contracts and subject to the other provisions of this part, there may be an allocation to government work of those expenses in this category which consist of technical, consulting and such other beneficial services (including related supervision and clerical expenses) which are for purposes such as application and adaptation of the

contractor's products rather than pure selling. Such costs should first be allocated between the contractor's commercial line and its Government contracts. The amount allocated to the latter should then be charged to the individual contracts on any equitable basis. Because of the special problems that arise in this area, it is usually desirable for the contractor to identify in its records by means of sub-accounts or otherwise, the items of these expenses considered properly allocable to Government contracts.

15-203.4 GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses consist of costs incurred in the over-all management, supervision and conduct of the business. Any recognized method of allocating general and administrative expense is acceptable provided equitable results are thereby obtained. Some of the factors that should receive consideration in determining whether the results are equitable are (i) the cost pattern of the Government contracts (that is, the percentage of the total cost of the contract, exclusive of general and administrative expenses, represented by each of the several cost components thereof) in relation to the cost pattern for the plant or activity as a whole, and (ii) the ultimate objective of distribution of these expenses in approximate ratio to the general and administrative effort involved in the two categories of work. In addition, consideration should be given to any significant variations of inventories between accounting periods, variations in the ratio of contract inventory levels to all other inventory levels, and other relevant factors including those mentioned in para. 15-203(b).

15-203.5 BASE PERIOD FOR ALLOCATION OF INDIRECT EXPENSES. The base period for allocation of indirect expenses should ~~approximate~~ be representative of the period of contract performance ~~or should be representative of that period. The base period~~ and should be sufficiently long to avoid inequities in the allocation of costs, but in no event longer than the contractor's fiscal year.

15-204 APPLICATIONS OF BASIC COST PRINCIPLES AND STANDARDS TO SELECTED ITEMS OF COST. This paragraph states, in some detail, applications of the basic cost principles and standards set forth in the preceding paragraphs of this part to certain selected

items of cost. The statements herein apply irrespective of whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost herein is not intended to imply that it is either allowable or unallowable. With respect to those items not specifically covered, as well as all the subparagraphs below, determination as to allowability will be made in the light of the basic principles and standards herein and, where appropriate, the treatment of similar or related items in this Part.

15-204.1 ADVERTISING. Advertising expenses include the costs of advertising media and corollary administrative expenses. Advertising media include magazines, newspapers, radio and television programs, direct mail, trade papers, outdoor advertising, dealer cards and window displays, conventions, and exhibits, free goods and samples, and sales literature.

a. The following advertising costs only are allowable:

(1) 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.

(2) Help wanted advertising, as set forth in paragraph 15-204.32.

15-204.2 BAD DEBTS. Bad debt expenses consist of losses (whether actual or estimated) arising from uncollectible customers' accounts and other claims, and include related collection expenses and related legal expenses. These costs are unallowable.

15-204.3 BIDDING EXPENSE. Bidding expenses are the costs of preparing bid estimates on potential contracts or projects, including the development of engineering and cost data necessary to support the contractor's price proposal or estimated cost of work performance. Bidding expenses of the current accounting period of both successful and unsuccessful bids normally will be treated as indirect expenses and allocated currently to all business of the contractor, in which event no

bidding expenses of past accounting periods will be allocable in the current period to the Government contract. However, the contractor's established practice may be to treat bidding expenses by some other recognized method. Regardless of the method used, the results obtained may be accepted only if found to be reasonable and equitable.

15-204.4 CAFETERIAS, DINING ROOMS, AND OTHER FOOD SERVICES. This class of expenses consists of cost, less revenue, of operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, or other types of services for contractors employees at the contractor's facilities. Profits accruing to the contractor from the operation of these services whether operated by the contractor or by a concessionaire, will be treated as a credit to costs of all production within the contractor's plant in which the services are furnished, except for services from which the profits are 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. Reasonable losses of operation from such services are allowable when it is the policy of the contractor to operate such services at no loss or profit; provided, however, that any gains or losses from these services must be appropriately allocated to all activities benefited including Government contracts. When it is the policy of the contractor to furnish such services at a loss, losses on such operation will not be allowed as a cost, unless authorized by special contract provision.

15-204.5 CIVIL DEFENSE. Civil defense costs are those incurred in the planning for and the protection of life and property against the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by local and state civil defense authorities. Examples of civil defense costs include cost in excess of normal plant protection expenses and may consist of first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions and other approved civil defense measures. Reasonable costs of 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. In the case of capital assets, acquired for civil defense purposes the costs thereof will be depreciated over a reasonable number of years in conformity with generally accepted accounting principles. Except as specifically provided in the contract, contributions to local/civil defense funds or projects not on the contractor's premises are unallowable.

15-204.6 COMPENSATION FOR PERSONAL SERVICES. (To be inserted later on this page and pages 1509, 1510 and 1511).

15-204.7 CONTINGENCIES. This type of charge results from the creation and maintenance of reserves to provide for an event whose occurrence cannot be foretold with certainty as to time, intensity or even an assurance of its happening. These costs are not allowable. (For self-insurance programs see paragraph 15-204.15).

15-204.8 CONTRIBUTIONS AND DONATIONS. 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.

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15-204.9 DEPRECIATION.

a. Depreciation as described herein is a charge to current operations intended to distribute the cost of tangible capital assets, less estimated residual value, over their estimated useful life in a systematic and logical manner. It involves a process of allocation, not of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

b. Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, provided the amount thereof is based upon original acquisition cost. Depreciation will be accounted for by consistent application to the asset(s) concerned of any generally accepted accounting principles, including those recognized by Section 167 of the Internal Revenue Code of 1954, and should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation charged in any accounting period may vary with volume of production or use of multishift operations, provided the method

followed is consistent with basic objectives set forth in subparagraph a. above.

c. Charges for depreciation on idle or excess facilities will not be allowed except on such facilities as are reasonably necessary for standby purposes.

d. Unless otherwise provided in the contract, no use charge will be allowed for assets still in use which have been, in accordance with the contractor's consistent accounting practice, fully depreciated on the contractor's books of account.

e. Where the contractor has applied for, received, and accepted a determination of "true depreciation" from an Emergency Facilities Board covering an emergency facility acquired under a certificate of necessity, the amounts so determined for "true depreciation" over the emergency period (5 years) will be recognized in lieu of normal depreciation. After the expiration of the emergency period for the facility concerned where a determination of "true depreciation" has been made, the remaining undepreciated portion of the cost of such facility will be depreciated over its remaining useful life and will be the only amount recognized as allowable cost, subject to paragraph 15-204.12. (INSERT) The contractor may elect to use normal depreciation rather than the "true depreciation" as determined by the Emergency Facilities Board. However, the method chosen after such determination of "true depreciation" must be followed consistently throughout the life of the emergency facility.

The remaining undepreciated amount shall be only the normal depreciation remaining after the end of the 'true depreciation' period and shall not include any amount of unrecovered normal or 'true depreciation' allowable during the 'true depreciation' period.

15-204.10 EMPLOYEE MORALE, HEALTH AND WELFARE. Included in this category are expenses of health and welfare activities incurred for the improvement of working conditions and the improvement of employer-employee relations, employee morale, and employee performance. Examples of these activities are house publications, health or first-aid clinics, and employee counselling services. These costs are allowable when incurred in accordance with the contractor's established practice or custom in the industry or area and are reasonable and equitably allocated to all classes of work performed in the contractor's plant. Income generated from any of these

activities will be credi[illegible]o the costs thereof unless s[illegible]ncome has been irrevocably set over to employee welfare organizations.

15-204.11 ENTERTAINMENT EXPENSE. This item includes the cost of amusement, diversion, social activities and incidental costs relating thereto, such as meals, lodging, rentals, transportation and gratuities. These costs are unallowable.

15-204.12 EXCESS FACILITIES. This item includes the cost of maintaining and housing idle and excess facilities, except those reasonably necessary for standby purposes. These costs are unallowable. The costs of additional plant capacity reserved for defense production shall be the subject of a separate contract.

15-204.13 FINES AND PENALTIES. Included in this item are those costs resulting from violations of, or failure of the contractor to comply with, local, state and Federal laws and regulations. These expenses are not allowable except when incurred as a result of compliance with specific provisions of the contract or instructions in writing from the contracting officer.

15-204.14 FRINGE BENEFITS. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries.

a. The determination as to the allowability of the cost of pension and retirement plans, profit sharing and other bonuses, and severance pay will be in accordance with sub-paragraphs 15-204.26, 15-204.6 and 15-204.37 respectively.

b. The cost of other fringe benefits such as pay for vacations, holidays, sick leave, military leave and employee insurance (but see subparagraph 204.15e) is allowable to the extent required by law, employer-employee agreement, or established policy of the contractor that constitutes, in effect, an implicit agreement on the contractor's part.

15-204.15 INSURANCE AND INDEMNIFICATION.

a. Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative, and

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15-204.15 INSURANCE AND INDEMNIFICATION.

a. Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative (see ASPR 10-501 for kinds of insurance ordinarily required), (2) any other insurance for which the contractor seeks reimbursement under the contract, and (3) liabilities to third persons not compensated by insurance or otherwise.

b. The contractor shall be reimbursed for (1) insurance required to be submitted for approval or required to be procured and maintained pursuant to ASPR 7-203.22 and (2) other insurance maintained by the contractor in connection with the performance of this contract if the types and extent of coverage are in accord with sound business practice and the rates are reasonable under the circumstances, subject to the following limitations or restrictions:

(i) Costs allowed for use and occupancy insurance will ~~be~~ be limited so as to exclude coverage of profit, interest, federal income taxes, and any other items of expense unallowable under this part.

(ii) ~~The~~ Costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are not allowable except to the extent that the Government may have approved or required such insurance or reserve.

(iii) ~~Provision for losses under~~ Cost of a reserve for a self insurance program are allowable provided the program has been approved by the Military Departments concerned.

(iv) ~~The~~ Costs of insurance on the lives of officers, partners or proprietors, are not allowable except where such insurance is part of an employee plan which is not unduly restricted.

c. The obligation of the Government to indemnify the contractor will be allowable only to the extent expressly provided for in the contract (For

Except as otherwise expressly provided in the contract,

example, see ASPR 7-203.22). ~~When the costs of insurance would have been allowable under paragraph b. above,~~ actual losses not reimbursed by insurance ~~because of failure to insure~~ (through an approved self insurance program or otherwise), are not allowable.

(2) any other insurance for which the contractor seeks reimbursement under the contract. The kinds of insurance ordinarily included in the first category are set out in ASPR 10-501.

b. Costs of Government required insurance are allowable within the limitations as to the extent of coverage and premium rates approved by the Government. Costs of other insurance, except that applicable to Government-owned property, are allowable provided (1) the insurance has been approved by the military department concerned or (2) in the absence of such approval requirement, the types of coverage, extent of coverage, and rates are reasonable under the circumstances. Costs allowed for use and occupancy insurance, however, will in principle be limited so as to exclude coverage of profit, interest, federal income taxes, and any other items of expense unallowable under this part.

c. The costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are not allowable except to the extent that the Government may have required the contractor to carry such insurance.

d. Provision for losses under a self insurance program are allowable provided the program has been approved by the Military Departments concerned. Actual losses sustained under such a self-insurance program are not allowable.

e. The costs of insurance on the lives of officers, partners or proprietors, are not allowable except where such insurance is part of an employee plan which is not unduly restricted.

f. Losses resulting from failure to insure (through self insurance or otherwise) are not allowable unless approved by the Department concerned.

g. Cost of indemnification will be allowable only to the extent expressly provided for in the contract.

15-204.16 INTEREST AND OTHER FINANCIAL EXPENSES. This item includes interest (however represented), bond discount and expenses, and the cost of financing and refinancing operations as well as legal and professional fees paid in connection

with the preparation of a prospectus, cost of preparation and issuance of stock rights and expenses related thereto. (See also 15-204.23). These costs are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in subparagraph 15-204.39.

15-204.17 LABOR RELATIONS. This item covers expenses incurred in maintaining satisfactory relations between the contractor and his employees. It includes the cost of shop stewards, labor management committees, employee publications and other related activities. Costs incurred for these purposes are allowable.

15-204.18 LOSSES ON OTHER CONTRACTS. This item covers any excess of costs over income under any and all other contracts, whether such other contracts are of a supply, research and development or other nature (including the contractor's contributed portion under cost sharing R+D contracts). Costs of this nature are not allowable as a cost of performance of the Government contract.

15-204.19 MAINTENANCE AND REPAIRS.

a. This item includes those costs necessary for the upkeep of property (including Government property unless otherwise provided for) which neither adds to the permanent value of the property nor appreciably prolongs its intended life but keeps it in an efficient operating condition. These costs are allowable. Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation will be allowable only on a depreciation basis. Cost of maintenance and repairs of excess facilities and of idle facilities (other than reasonable standby facilities) are not allowable.

b. Deferred maintenance is defined as maintenance and repairs which for some reason such as abnormal operating conditions or lack of funds, is delayed to a future period. The cost of maintenance and repairs which has been deferred from a period prior to the contract is not allowable unless specifically provided for in the contract. Likewise, the estimated cost of maintenance and repairs normally required but not accomplished during the period of the contract will not be allowed as a cost unless specifically provided for in the contract.

15-204.20 MANUFACTURING AND PRODUCTION ENGINEERING. Manufacturing and production engineering includes the cost of engineering activities in connection with (1) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement and (2) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production. These costs are allowable.

15-204.21 MATERIALS AND SUPPLIES.

a. This item includes the net costs of such items as raw materials, parts, sub-assemblies, components, and manufacturing supplies, whether purchased outside or manufactured by the contractor, and may include such collateral items as inbound transportation and intransit insurance. In computing materials costs consideration will be given to reasonable overruns, spoilage, or defective work (as to defective work, see paragraph 7-203.5(c)). These costs are allowable subject, however, to the provisions of subparagraphs b. through f. below.

b. Costs of materials and supplies shall be suitably adjusted for applicable portions of income and other credits. Such income and other credits include trade discounts, refunds, rebates and allowances, cash discounts available, credits for scrap and salvage and materials returned to vendors. Such discounts, rebates, allowances and credits, may be applied directly to the charges for materials involved or may be apportioned through credits to indirect costs. However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond his control, such lost discounts will be allowed.

c. When materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to the contract.

d. If materials are issued from stock, any generally recognized method of pricing such materials will be acceptable, provided the 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 and the Government may, by contract provision, agree upon the use of a method of pricing based upon the fair value of the materials as of the date of the contract, but not in excess of replacement cost on such date. Such agreement should include identification of the types or kinds of materials involved and should be made at the time the contract is entered into and provided for therein.

e. Reasonable charges arising from difference between periodic physical inventory quantities and related material control records will be included in arriving at the cost of materials, provided that such charges (1) do not include "write-downs" of values, and (2) relate to the period of performance of the contract. All credits arising from differences between periodic physical inventory quantities and related material control records shall be taken into account.

f. Ordinarily sales or transfers of materials, services and supplies between plants, divisions, or organizations, under a common control, shall be stated on the basis of cost to the transferor. 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, provided that the price charged to the contract does not exceed the lower of (1) the transferor's sales price to its most favored customer for the same item in like quantity, or (2) the prices of other suppliers for the same or substantially similar items.

15-204.22 ORGANIZATION EXPENSES. This item consists of expenditures in connection with organization or reorganization of a business. Examples of such costs are incorporation fee, attorneys fee, accountants fees, fees to promoters and organizers and costs of raising capital. These costs are unallowable. (See paragraph 15-204.16).

15-204.23 OTHER BUSINESS EXPENSES. Included in this item are such recurring expenses as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy

solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies and incidental costs of directors and committee meetings. The above and similar costs are allowable when allocated on an equitable basis to all classes of work.

15-204.24 OVERTIME, EXTRA PAY SHIFT AND MULTI-SHIFT PREMIUMS. ~~This item consists~~

"This item consists of the premium portion of overtime, extra pay shift and multi-shift payments to employees. Such premiums on direct labor may be classified as either direct or indirect labor costs, but the amount of such premiums should be separately identified. When direct labor cost is the base for distribution of overhead, such premiums shall not be included therein. Cost of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government. Cost of such premiums for indirect labor is allowable without prior approval, if reasonable, and the cost is allocated on a pro rata basis to commercial as well as Government work. See ASPR 12-102 for further information concerning the policy regarding such authorization. The amount of such premium cost charged on Government contracts shall be equitable in relation to the amount of such premium costs charged on non-Government work being concurrently performed in the Contractor's plant and the factors which necessitate the incurrence of the cost."

"15-204.25 PATENT EXPENSES. This item relates to such expenses as costs leading to the issuance of patents, costs required to search the art and costs necessary to comply with invention disclosure provisions of the contract. The costs of searching the art in order to make invention disclosures, and of preparing disclosures and other reports, as required by the contract are allowable. The costs of preparing assignment and other papers in connection with the filing of a patent application by the Government and any other such costs are allowable, upon the written authorization of the contracting officer. The cost of research and development work is treated in 15-204.34. (See also paragraph 15-204.35)."

~~tization of the cost of purchased patents applicable to contract products or pro-~~

cesses is allowable. The cost of preparing disclosures and other reports as required by the contract and of preparing assignment and other papers in connection with the filing of a patent application by or for the Government, and any expenses ~~incident to patents incurred upon the written authorization of the contracting officer, are allowable. All other patent expenses and charges for the use of~~

~~patents where the Government has a license or the right to free use thereof, are unallowable unless otherwise provided in the contract. The cost of research and development work leading to patents is treated in subparagraph 15-204.34.~~

15-204.26 PENSION PLANS.

a. A pension plan as used herein is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to his 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 will be considered a pension plan, if, under the plan, either the 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 be subject to paragraph 15-204.6e).

b. Pension plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the Military Department; however, approval of the plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such plan by the Military Department. Consideration of a plan and the method of determination of cost thereof will be the responsibility of the Department to which audit cognizance is assigned and the subsequent action taken by that Department will generally be accepted by the

other Departments. Where pension and retirement plans of non-profit or other tax exempt organizations are not required to be reviewed and approved by the Internal Revenue Service, it will be the responsibility of the Department to which audit cognizance is assigned to give consideration to the acceptability of such plans.

c. The costs of a pension plan approved by the Military Department concerned, to the extent such costs are claimed and deductible for income tax purposes (or are determined to be reasonable in the case of non-profit or tax exempt organizations), are allowable except as otherwise determined unallowable under this paragraph. Such costs may include excess contributions ~~of previous years~~ Federal income to the extent such contributions are claimed and allowed for tax purposes in the current taxable period. In cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract cost will be made for contributions disallowed for tax purposes which previously had been allocated to and allowed as contract costs.

d. In determining the net costs allocable to military contracts, consideration will be given to the possibility of future abnormal termination credits or gains and the effect such credits or gains would have upon current costs. These termination credits or gains will arise with respect to individuals for whom current costs are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits purchased or funded by current costs. When such credits or gains are foreseeable and their worth can be evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to the anticipated future credits or gains will be made. Such equitable adjustment can be accomplished either by discounting 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 discount for the abnormal termination credits or gains which are anticipated. However, most often such abnormal credits or gains, if foreseeable at all, are not susceptible of being evaluated at

the time of contracting because neither the timing nor the severity of the termination actions will be known. Under these circumstances, the Government's interest in such abnormal credits or gains will be preserved for retrospective evaluation and accounting. If a contractor has but one or relatively few Government contracts, an appropriate contractual provision may be used to preserve the Government's interest ~~and~~ by provide ~~for the~~ and any necessary adjustment to pension plan cost incurred under the contra retrospective accounting. In other cases, where a contractor is not limited to one or few Government contracts or there is reasonable probability he will receive follow-on contracts, a separate contractual "side" agreement will be negotiated having application to all pension costs allowed under contracts with the particular contractor and provide for an accounting of abnormal credits or gains, as that term is defined in the agreement, arising by reason of a cutback or cessation of Government contract work.

e. 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 incurred under approved pension plans will be subject to consideration on an individual case basis.

15-204.27 PLANT PROTECTION EXPENSES. This item includes the cost of wages, uniforms and equipment of personnel engaged in plant protection, supplies, depreciation on plant protection capital assets, and necessary expenses to comply with military security requirements. These costs are allowable.

15-204.28 PRECONTRACT COSTS. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs will not be allowed unless specifically set forth in the contract ~~and may be limited to a period of time as well as to the type and amount of such costs.~~

15-204.29 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER.

a. This item includes the cost of professional services rendered by the members of the particular profession separately engaged. These costs generally

rable when reasonable in relation to the services rendered and are not
it upon recovery of the costs from the Government.

b. Factors to be considered (among others) in determining the allowa-
costs in a particular case are: (1) past pattern of such costs, partic-
the years prior to the award of Government contracts; (2) the impact of
t contracts on the contractor's business; (3) the nature and scope of
l services expected of the contractor's own organization; and (4) whether
e proportion of Government work to the contractor's total business is
o influence the contractor in favor of incurring the cost, particularly
services rendered are not of a continuing nature and have little rela-
to work under Government contracts. Retainer fees to be allowable must
ably supported by evidence of services rendered.

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

O PROFITS AND LOSSES ON DISPOSITION OF PLANT, EQUIPMENT OR OTHER CAPITAL

Included herein are gains or losses of any nature arising from the sale or
of plant, equipment, or other capital assets, including sale or exchange
r short or long term investments. Profits or losses on sale or exchange
al assets, including investments, will be excluded in computing contract

I RECONVERSION EXPENSES. Reconversion expenses are those incurred in the
ion of the contractor's facilities to approximately the same physical
ent and condition existing immediately prior to commencement of the mili-
tract work and include the cost of removal of Government property. Recon-
expenses are not allowable except that the cost of removing Government
and the restoration costs caused by such removal are allowable if specifi-
ovided for in the contract.

15-204.32 RECRUITING EXPENSE. This item includes the costs of "help wanted" advertising and the operating costs of an employment office necessary to secure and maintain an adequate labor force. It further includes the costs of operating an ~~educational and~~ and educational aptitude testing program, travel expenses of employees while engaged in recruiting personnel, and travel expenses of applicants for interviews for prospective employment. These costs are allowable. Where the contractor uses private employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are not allowable.

15-204.33 RENTALS OF PLANT AND EQUIPMENT. (Including sale and leaseback of facilities.) This item includes expenses for (1) use of land, buildings, and equipment or other personal property, and (2) rental expenses under sale and lease-back agreements incurred by contractors through sale of plant facilities to investment organizations (such as insurance companies) or to private investors and concurrently leasing back the same facilities.

a. Rentals of plant and equipment under (1) above are allowable if the rates are reasonable in light of the type, condition and value of the facilities leased, options available and other provisions of the rental agreement.

b. Unless specifically provided for otherwise in the contract, rentals specified in sale and lease-back agreements under (2) above are allowable only to the extent that such rentals do not exceed normal costs (such as depreciation, taxes, insurance and maintenance expenses borne by the lessor) which would have been incurred had the contractor retained legal title to the facilities.

15-204.34 RESEARCH AND DEVELOPMENT. Research and development expenses (sometimes referred to as general engineering expenses) for the purpose of contract costing are divided into two major categories, namely:

a. General research, also referred to as basic research, fundamental research, pure research and blue-sky research.

b. Related research or development, also referred to as applied research, product research and product line research.

> "(i) General research is that type of research which is directed towards increase of knowledge in science. It is research where the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. The cost of Independent General Research (that which is not sponsored by a contract or grant or other arrangement) shall be allowed to the extent specifically provided in the contract.
>
> (A) To the extent such costs are allowed, they will be equitably allocated to all work of the contractor other than its independent general and related research.
>
> (B) Generally, the contractor shall be required to disclose to the Government the purposes and results of such independent general research.
>
> In specially providing for such cost, consideration shall be given to the following factors among others:
>
> a. Scope, nature and quality of the contractor's independent general research program.
> b. The capability of the contractor in the particular research field.
> c. Benefits which may accrue to the Government.
> d. Comparison of size and cost of contractor's previous years' research programs.
> e. The proportion of the Government business to the contractor's total business."

development (that which is not sponsored by a contract or grant or ~~is not otherwise reimbursed to a contractor~~ other arrangement) may, if allocated on the basis of all production, be allowed as a cost under any cost type production contract if the research is related to the contract product or product line. No portion of such research will be allowable under cost-type research and development contracts.

c. Independent research projects will absorb their appropriate share of the indirect expenses of the department where the research work is performed.

d. Research and development costs (including amounts capitalized), regardless of the nature, which were incurred in accounting periods prior to the award of a particular military contract, will not be allocated to that contract unless allowable as pre-contract costs (Paragraph 15-204.28)."

"15-204.35 ROYALTIES AND OTHER COSTS FOR USE OF PATENTS.

This item covers amounts paid or payable for the right to use patents or inventions. Where the use of such a patent or invention is necessary for the proper performance of the contract and where the Government does not already have a license or other right to use such a patent or invention, the royalties, amortization of the cost of purchased patents or other purchased patent rights applicable to contract products or processes are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the contracting officer. Charges for the use of patents, where the Government has a license or the right to free use of the patent are unallowable. (1526) Charges for the use of patents where a patent has been adjudicated to be invalid are unallowable unless otherwise provided in the contract. (NOTE: This provision, upon reconsideration by the ASPR Committee, was changed from the manner in which it is shown in the minutes of the 6 Dec. 1955 meeting (which are correct) to the form shown above.)

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15-204.36 SERVICE AND INSTALLATION EXPENSES. This item includes ... vicing the product installation, and training personnel in the use, maintenance and operation of the product. Such costs are allowable.

15-204.37 SEVERANCE PAY. Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated.

The cost of severance pay is allowable only to the extent that, in each case, it is required by (1) law, (2) employer-employee agreements, (3) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (4) the circumstances of the particular employment.

For contract costing purposes severance pay is divided into two categories as follows:

a. Normal Turnover Severance Pay. The cost of severance payments is allowable and must be allocated to all classes of work being performed in the contractor's plant at the time of payment. However, 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.

b. Mass Severance Pay. The cost of abnormal or mass severance pay actually made upon cessation of work when there is no reasonable prospect of

* Army wants consideration given to inserting "consumer"

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 entire period of employment with the contractor and equitably apportioning such cost to all business of the contractor performed during that period.

A reservation in the final release of claims (See ASPR 7-203.4) may be made in the case of completed cost-reimbursement type contracts when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

Does this conform with latest XIII definition

15-204.38 SPECIAL TOOLING. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or to the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. The cost of special tooling, when acquired for and its usefulness is limited to government contracts, is allowable and will be charged directly to the government contracts. When such special tooling is acquired it shall be subject to the provisions of the contract clause set forth in ASPR 13-503 entitled, "Government Property".

15-204.39 TAXES. Taxes are charges levied by a government unit. They do not include fines and penalties except as otherwise provided herein.

a. In general, taxes (including state and local income taxes) which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for (1) Federal income and excess profits taxes; (2) taxes in connection with financing, refinancing or refunding operations (see paragraph 15-204.16); (3) taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government; and (4) special assessments on land which represent capital improvements.

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except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the Government

b. Taxes otherwise allowable under a. above, but which may be illegally or erroneously assessed may be allowed as a cost of work performed, provided that the contractor, prior to payment of such taxes, (1) promptly requests instructions from the contracting officer concerning such taxes; (2) agrees to comply with such instructions; and (3) if so directed by the contracting officer also agrees to take all necessary action in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refun of such taxes and any interest of penalties thereon. Interest and penalties incurr by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer, shall be allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs.

c. Any refund of taxes, penalties or interest thereon shall be credited to contract costs in the proportion in which contract costs absorbed the costs of taxes, interest or penalties. If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

15-204.40 TRADE, BUSINESS, TECHNICAL AND PROFESSIONAL ACTIVITIES.

a. Memberships. This item includes costs of membership in trade, business, technical and professional organizations and such costs are allowable.

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

c. Meetings and Conferences. Expenses representing the purchase of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such expenses is the dissemination of technical information or the stimulation of production, are allowable.

15-204.41 TRAINING EXPENSES.

a. This item includes the costs of preparing and maintaining a program of instruction designed to increase the over-all effectiveness of employees. Included are the costs of the director of training and staff, training materials and text books when the training program is controlled by the contractor, and tuition, fees, training materials and text books when the training is in educational institutions.

b. Such costs which are limited to on the job training are allowable when properly allocated.

c. Costs of training in educational institutions are not allowable, except to the extent specifically provided in the contract.

15-204.42 TRANSPORTATION EXPENSES. Transportation expenses include the cost of freight, express, cartage and postage relating either to goods purchased, in process, or delivered.

When such costs can readily be identified with the items involved, they may be direct costed or added to the cost of such items. (See paragraph 15-204.21) Where identification with the materials received cannot readily be made, inbound transportation expense may be charged to the appropriate indirect expense accounts, provided the contractor follows a consistent procedure* in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as direct charges.

15-204.43 TRAVEL EXPENSES. This includes costs of transportation, lodging, subsistence and incidental expenses incurred by contractor personnel in a travel status while on official company business.

a. Travel expenses incurred in the normal course of over-all administration of the business and applicable to the entire business are allowable when properly allocated.

* Army wants insert considered "which provides for equitable results

b. Travel expenses directly attributable to contract performance may be charged to the contract in accordance with the principle of direct costing.

c. Subsistence and lodging including tips or similar incidental expenses may be reimbursed either on an actual or per diem basis. The basis selected should be consistently followed.

d. Entertainment expenses are not allowable.

e. Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the Contracting Officer.

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Index #2.

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9/27/56

STATEMENT TO ACCOMPANY PUBLICATION
OF REVISED CONTRACT COST PRINCIPLES
IN ASPR FILING INSTRUCTIONS

The revision of Section XV, Part 2, of the Armed Services Procurement Regulation has been undertaken to provide a more equitable statement of cost principles to reflect the reasonable and allocable costs of performing defense cost reimbursement type contracts and to reflect a contractor's normal cost of doing business. It is the intent that generally accepted and approved methods of accounting, as presently practices by contractors, which fairly and equitably reflect and distribute the cost of doing business are acceptable. Only where the determination of allowability requires a particular accounting treatment to obtain equitable results will specific accounting methods be selected. Items of cost listed as unallowable reflect national or Department of Defense policy. In subsequent revisions, it is the intent that certain procedural requirements relating to accounting methods will be separated from the cost principle treatment and be included elsewhere in the Armed Services Procurement Regulation. In addition, the revised principles, which formerly were a mere listing of named items of cost as either allowable or unallowable, contain a definition for each item, a statement as to the extent of allowability or unallowability, and in many instances provide criteria for determining the reasonableness of a particular item of cost.

Furthermore, this revision has been developed (1) to provide policy guidance to prospective contractors and subcontractors, contracting officers, contract negotiators and auditors in areas in which such guidance has been lacking, including in many instances, criteria for determining the reasonableness of a particular item of cost, or which were subject to special consideration; (2) to accommodate changes in Department of Defense policy in regard to contributions; and (3) to make improvements of an editorial nature.

These regulations should materially assist contractors and contracting officers to recognize and provide treatment which protects their respective interests.

(a) Competitive price proposals.
(b) Published market prices.
(c) Catalog prices (including discounts).
(d) Previous procurement experience on the same or similar items, with computed adjustments of the prices paid where appropriate to make allowance for changes in specification or quantities, or changes in labor, material and other cost indices.

15-102.1 Examples Where Required. Examples of situations where cost estimates shall ordinarily be required are as follows:

(a) Negotiation of fixed-price contracts where there is an absence of adequate competition, sufficient prior experience, or other adequate valid pricing criteria.

(b) In connection with fixed-price contracts containing price-redetermination or incentive provisions:

(i) Negotiation of tentative or target prices.

(ii) Negotiation of firm prices on a forward basis.

(iii) In combination with historical costs, negotiation of firm prices for retroactive and prospective application.

(iv) In the case of incentive contracts, negotiation of target costs.

(c) In connection with cost, cost sharing and cost- plus-a-fixed-fee contracts:

(i) Determination of the estimated cost of the contract, and in the case of cost-plus-a-fixed-fee contract, the negotiation of the fixed fee.

(ii) Negotiation of fixed overhead rates.

(d) In connection with all types of contracts, negotiation of contract changes affecting the contract consideration.

15-103 Use of Historical (Actual) Cost. Historical (actual) cost shall be used for the following purposes under the below listed types of contracts, and may be used where appropriate in other situations:

(a) Under all cost-reimbursement type contracts (including cost-reimbursement subcontracts thereunder), for the determination of the reimbursability of cost, except to the extent predetermined overhead rates are provided for in such contracts (see paragraph 15-105). The term "cost-reimbursement type contract", as used

throughout this section, includes cost or cost-sharing contracts, cost-plus-a-fixed-fee contracts, and the cost reimbursement portion of time-and materials contracts.

(b) Under all fixed-price contracts containing price-redetermination or incentive provisions, for the determination, to the extent required by such contracts, of historical (actual) costs of performance thereof.

(c) Under all types of contracts, for the settlement, to the extent required by Section VIII hereof, of contracts terminated in whole or in part for the convenience of the Government.

15-104 Contract Provisions. The cost principles and standards set forth in Part 2, as implemented by Part 3, Part 4, Part 5 or Part 6 (whichever implementing part is applicable) shall be made a part of every cost-reimbursement type contract, executed as of a date on or after , (and every cost reimbursement subcontract thereunder), for the purpose of determining of reimbursability of costs except that such contract may treat any element of cost thereunder more specifically than provided by the aforesaid cost principles and standards so long as not inconsistent therewith. In addition, these cost principles and standards may be made a part of any other contract for the purpose of determination of historical (actual) cost orfor the purpose of preparation of estimates of cost.

15-105 Use of Predetermined Rates in Cost-Reimbursement Type Contracts. The use of a fixed indirect expense rate negotiated prior to the expiration of a significant portion of the period to which such rate applies may be provided for in cost-reimbursement type contracts in lieu of the determination of historical (actual) indirect expense provided that the results will reasonably approximate the actual rates. Consideration of cost elements in negotiating such rates must be consistent with the provisions of this section concerning cost allowability and allocability. When predetermined rates are used, the contract shall specifically state the types of items which are to be treated as direct costs. Care should be exercised in negotiating these rates to exclude from the listing of direct costs any cost element included in predetermined expense rates in order to avoid duplicate charges.

15-106 Encouragement of Use of Standard Cost Method of Accounting. Contractors are encouraged to use, where economically feasible, modern standard cost methods because they provide an excellent means of cost estimating and cost analysis, as well as enable more effective control of actual costs during contract performance. Such methods provide for pricing material costs on the basis of bills of materials, labor costs on the basis of studies of time requirements, and overhead costs on the basis of budgeted expenses for the expected volume and types of production, with reasonable allowances for cost variances indicated by experience to be expected for defective work and failure to achieve full efficiency. Such methods generally provide the assurance of accuracy of cost estimates, as well as the means of more effective cost control, when variances of actual costs from standards are measured frequently and recorded in the formal accounts.

PART 2 - GENERAL PRINCIPLES AND STANDARDS FOR DETERMINATION OF COSTS

15-200 Scope of Part. This part sets forth general principles and standards for determination of costs.

15-201 Composition of Total Cost. The total cost of work performed or to be performed under a contract or subcontract to which these principles are applicable is the net sum of (i) the allowable direct costs reasonably incident to the performance of the contract or subcontract, (ii) the properly allocable portion of allowable indirect costs, and (iii) less applicable income and other credits. This composition of cost shall be followed whether the total costs are stated for an entire contract or for individual units of products or services covered by the contract.

15-202 Factors in Determining Costs. Factors to be considered in determining costs include (a) conformity with the composition of total cost outlined in paragraph 15-201; (b) reasonableness in the amounts of particular elements of costs; (c) application of generally accepted accounting principles and practices; (d) customary practices of absorbing certain costs in profit; (e) exclusions of specific elements of costs as a matter of public or business policy, as set forth in this section; and (f) exercise of good business judgment in incurrence of the cost.

15-203 Contractor's Accounting System. Subject to the observance of the cost principles set forth in this section, any system of accounts and any method of cost accounting or estimating will be acceptable, if they are in accordance with generally accepted accounting principles and practices and if they produce equitable results under the particular circumstances.

15-204 Direct vs. Indirect Costs. Every acceptable method of cost accounting or estimating embodies the principle of direct costing of certain materials and subcontract work. Direct costing of productive labor is general practice. Other expenses may be costed directly, but generally are allocated to products, job orders, or contracts, etc. on an arithmetical basis in ratio to appropriate measures of performance. Such allocated expenses are termed "indirect costs."

15-205 Direct Costs. There are no absolute rules to determine which items or elements of cost should be direct costs. However, direct costs should, in general, comprise every major item of cost (actual or estimated) which can be identified with the unit being costed, whether the unit is product, job order or contract, unless such item of cost, in fact, has substantial proportionate applicability to more than one class of work. When of major consequence, travel, commissions, advertising, engineering services and other expenses should also be so treated. Unless inequitable, the contractor must follow a consistent pattern of costing, and must follow the same pattern in costing both defense and non defense products and services when engaged in mixed production.

15-206 Indirect Costs. Indirect costs, which have the character of common or joint costs, usually consist of indirect materials, indirect labor, and other items of indirect expense. These costs generally are grouped in classes as follows:

(a) Manufacturing (shop, laboratory) expenses (often termed "manufacturing overhead" or "burden"), which are incurred in fabricating the article or service rendered;
(b) Engineering expenses to extent not included in (a) or (c);
(c) Selling and distribution expenses, incurred in marketing the products manufactured;
(d) General and administrative expenses incurred in the overall management, supervision, and conduct of the business;
(e) Financial and other expenses.

15-206.1 Methods of Allocation. No general rules regarding allocation of indirect costs to products, job orders, or contracts can be stated for all cases, because the nature of the particular operations and the actual conditions in each instance determine the most suitable method or methods to be employed. Any method of allocation of indirect costs will be acceptable if it is in accord with generally accepted accounting principles and practices and if it produces equitable results under the particular circumstances.

15-207 Use of Standard Costs in Determining Historical (Actual) Costs. Where contractors have satisfactory cost systems, standard costs of products, or parts thereof, with appropriate adjustments for variances from actual costs, may be considered to represent historical (actual) costs, provided such costs reasonably reflect the application of the principles and standards set forth in this section.

15-208 Cost Estimates

15-208.1 Use of Historical Costs. Regardless of the method used (standard, job-order or process), unmodified historical cost data, when used in the preparation of cost estimates, do not provide a satisfactory standard of future performance and should not be used. Where no more satisfactory cost data are available, historical costs may be used in the preparation of estimates provided they are adjusted to eliminate nonrecurring costs and to reflect new conditions, if any, which may be applicable to future production.

15-208.2 Use of Predetermined Rates for Indirect Expenses (Overhead Costs). Indirect expenses must always be predicted for purposes of cost estimates. This involves determination of expense rates in accordance with whatever reasonable method or methods of expense allocation are followed by the contractor. Where budgeting based upon distinguishing between fixed and variable expenses and upon estimating variable expenses in proportion to anticipated levels of production or work loads are used, such budgets provide the best means for estimating expense rates. Historical indirect expenses, or expense rates, are not to be used as the equivalent of budgeted rates for this prupose.

15-204.2 (aa) Training and Educational Costs. (1) Costs of preparation and maintenance of a program of instruction at non-college level, designed to increase the vocational effectiveness of bona fide employees, including training materials, textbooks, salaries or wages of trainees during regular working hours, and

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

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

are allowable.

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

(i) training materials;

(ii) textbooks;

(iii) fees charged by the educational institution;

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

(v) (A) tuition charged by the educational institution; or

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

are allowable.

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

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

(5) Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships, are considered contributions (see ASPR 15-204.3(c)).

Part 2 - Supply, Service, and Research and Development Contracts, with Commercial Organizations

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.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (1) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

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

15-201.3 Credits. The applicable portion of income, rebates, allowances, and other credits received by or accruing to the contractor which is related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

15-202 Direct Costs.

15-202.1 General. Items of cost which are readily identifiable with (i) a contract, or (ii) other work of the contractor, should be charged directly to the contract or other work with which identified. This principle may be applied to items of cost, such as freight, travel, communications, and engineering services, as well as materials and productive labor, but when used must be applied consistently to all work of the contractor. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, which otherwise would be treated as direct costs, may be treated as indirect costs. Each element of direct cost is subject to the limitations of this Part as to allowability.

15-202.2 Direct Material Costs. Direct material costs include the cost of raw materials, purchased items, and items supplied from stock, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically identifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable.

Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable only to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

15-203 Indirect Costs.

15-203.1 General. (a) Items of cost which are incurred for common or joint objectives, and which are not readily subject to treatment as direct costs in accordance with ASPR 15-202, should be accumulated for accounting purposes by logical cost groupings and charged by a process of allocation. Each element of indirect cost is subject to the limitations of this Part as to allowability.

(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.

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

15-203.2 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 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. 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(v)(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. 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.

15-203.5 General and Administrative Costs. General and administrative costs consist of items of cost attributable to the over-all 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. Methods acceptable where the circumstances are appropriate include allocation on such basis as:

(i) allocation of general and administrative costs on a total cost incurred basis (exclusive of general and administrative costs);

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

(iii) factory input costs (processing costs plus direct material);

(iv) cost of goods completed;

(v) cost of sales; and

(vi) sales (where no more satisfactory method is available).

15-204 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below. These applications govern whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

15-204.2 Costs Allowable in Whole or in Part.

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

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

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

All other advertising costs are unallowable.

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

(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 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 (f) below. Contributions to local civil defense funds, or to projects not on the contractor's premises, are allowable. (See (e) below).

(d) Compensation for Personal Services. (1) Compensation is allowable subject to the specific limitations set forth hereunder. 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. Subject to specific limitations set forth hereunder, 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.

(2) Generally, the amount of compensation established by the contractor will be considered commensurate with the services rendered. However, compensation of individuals such as corporate officials, directors, executives, department heads, may be subject to special consideration and limitation as to allowability for contract cost purposes where amounts appear excessive. Some situations which may give rise to excessive compensation are where (i) the individual or member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization; or (ii) ownership of the contractor is limited to a small cohesive group; or (iii) the volume of Government contracts when related to the contractor's total business is such as to influence the amount of compensation.

(3) The cost of options to purchase stock of the contractor corporation granted to employees is not allowable as an item of cost.

(4) Subject to the provisions of (5) below, bonuses to employees, such as production incentives and suggestion or safety awards, represent a part of their total compensation and are allowable when appropriately allocated, if they are:

(i) Incurred pursuant to an arms length understanding between the contractor and the employees before the services are rendered or pursuant to an established plan consistently followed by the contractor.

(ii) Reasonable in amount when considered in the light of total compensation for work done.

(iii) Incurred for current services actually rendered by employees.

(iv) Available to all employees of the contractor or to all employees within a group or salary classification which is not unreasonably restricted.

(v) Allowable as an ordinary or necessary business expense for tax purposes.

(vi) Not restricted to officer or other employee stockholders or are not distributed on the basis of stockholdings.

(5) Profit Sharing Plans.

(i) As used herein profit sharing is construed to be any plan (immediate or deferred-regardless of method of payment or participation)which includes, in whole or in part, a formal sharing of profits or is in any manner measured by dependent upon or contingent upon profit.

(ii) The cost of profit-sharing plans shall be treated as follows:

(A) Compensation payable under immediate distribution plans is allowable if the plans meet the criteria set forth in (4) above.

(B) Employer contributions incurred under deferred distribution profit-sharing plans other than pension plans (see (q) below) are allowable costs if the plans meet the requirements of the applicable provisions of the Internal Revenue Code and the regulations of the Internal Revenue Service.

(6) Stock Bonus Plans. Stock bonuses which are not disallowed by the provisions of (5) above are acceptable as a form of compensation, and the costs thereof are allowable subject to all conditions pertinent under subparagraph (4) above and meet the following requirements:

(i) The valuation placed on the stock for the purpose of calculating such cost must be computed on a sound basis.

(ii) In the case of unlisted stock having no current market, the contractor must demonstrate the values ascribed thereto are fair and reasonable.

(iii) Bonuses paid in the form of previously unissued stock of an affiliate will not ordinarily be allowed unless it can be demonstrated that there exists a bona fide arms-length agreement and the values ascribed to such stock are fair and reasonable.

(iv) Claims for accruals of compensation under a stock bonus arrangement prior to acquisition of stock by employees will not be allowable unless arrangements are made for appropriate credit adjustment of costs in the event such stock is not acquired by employees.

(7) The determination of allowability of the cost of pension plans, training and education, overtime, extra pay and multi-shift premiums and other fringe benefits will be in accordance with paragraphs (q), (bb), (o), and (i) respectively.

(e) Contributions and Donations. Reasonable contributions and donations to established non-profit charitable, scientific, educational and civil defense organizations are allowable provided they (i) may reasonably be expected to result in future benefits to the contractor through advancing, directly or indirectly, the technology of his industry or increasing the supply of trained manpower available to it, (ii) are in lieu of the cost of similar facilities which the contractor would have to provide, such as employee medical or recreational facilities, or (iii) are expected of the contractor by the community and it can reasonably be expected that the prestige of the contractor in the community would suffer through the lack of such contributions.

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

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

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

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

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

(iii) by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954.

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

(3) Where a contractor has received a determination of "true depreciation" from an Emergency Facilities Depreciation Board relating to an emergency facility covered by a certificate of necessity, it may elect to use either normal or "true" depreciation. However, the method elected must be followed consistently throughout the life of the emergency facility. Where an election is made to use normal depreciation, the amount thereof shall be computed in accordance with (2) above. Where an election is made to use "true depreciation," the amount allowable as depreciation:

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

(ii) after the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life (but see (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.

(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. Use charges for assets not fully depreciated on the contractor's books are unallowable.

(g) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred, in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(h) 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 or facilities controlled by the contractor. 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.

(i) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor (but see (d) above, and (j)(3)(v), (o) and (x) below).

(j) Insurance and Indemnification.

(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes securing the contractor against liabilities to third persons not compensated by insurance or otherwise.

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

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

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

(ii) costs allowed for use and occupancy insurance shall be limited to exclude coverage of profit, interest, Federal income taxes, and 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 unallowable except to the extent that the Government shall have approved or required such insurance or reserve;

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

(v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(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.

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

(l) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable (but see ASPR 15-204.3(d)). Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis.

(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) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

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

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

are allowable.

(n) Material Costs.

(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.

(5) Reasonable charges or credits arising from a difference 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 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 sales price to its most favored customer.

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise approved by the Government and may be classified as either direct or indirect labor costs. When direct labor cost is the base for distribution of overhead, such premiums shall not be included in that base. When such premiums are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work.

(p) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. 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 (v) and (w) below.)

(q) Pension Plans.

(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, either the 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 (q).).

(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 plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P. L. 591, 83rd Cong., 2d 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 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-emempt 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) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall 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) in determining the net 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 —

(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 adjustment 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.

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

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

(1) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(f)).

(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 a continuing nature and have little relationship to work under Government contracts.

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

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

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

(u) 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 agreement.

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

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

(v) Research and Development Costs.

(1) Research and development costs (sometimes referred to as general

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

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable to the extent specifically provided in the contract.

(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 (m) 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.

(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 allowable as precontract costs (see ASPR 15-204.3(k)).

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

(x) Severance Pay.

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

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

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

(ii) abnormal or mass severance payments actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of the 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.

(y) Special Tooling Costs. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling acquired for performance of the contract are allowable and shall be charged directly thereto.

(z) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(f));

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

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

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

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

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

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

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

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

(1) Memberships. Costs of membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(bb) Training and Educational Costs.

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

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

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

are allowable.

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

(i) training materials;

(ii) textbooks;

(iii) fees charged by the educational institution;

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

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

are allowable.

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

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

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

(cc) Transportation Costs. Transportation costs include freight, express, cartage, and postage charges relating either to goods purchased, in process, or delivered. When such costs can readily be identified with the items involved, they may be direct costed as transportation costs or added to the cost of such items (see (n) above). Where identification with the materials

received cannot readily be made, inbound transportation costs may be charged to the appropriate indirect cost accounts if the contractor follows a consistent equitable procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as a direct cost.

(dd) Travel Costs.

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

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

(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.

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

(ee) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

(i) ASPR 15-204.3(e)

(ii) ASPR 15-204.3(i)

(iii) ASPR 15-204.3(k)

15-204.3 Unallowable Costs.

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

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs, see ASPR 15-204.2(j)).

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

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

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

(f) Interest and Other Financial Costs. Interest (however represented), bond discounts, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of the prospectus, costs of preparation and issuance of stock rights, and costs related thereto are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in ASPR 15-204.2(z) (but see ASPR 15-204.2(ee)(1)).

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

(h) Organization Costs. Expenditures, such as incorporation fees, attorney's fees, accountants fees, brokers fees, fees to promotors and organizers, in connection with (i) organization or reorganization of a business, or (ii) raising capital, are unallowable (see (f) above).

(i) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract.

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments, shall be excluded in computing contract costs (but see ASPR 15-204.2(f)(2) as to basis for depreciation).

(k) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately

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 unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(1) General.

(1) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

(i) Advertising Costs, ASPR 15-204.2(a), last sentence;

(ii) Compensation for Personal Services, ASPR 15-204.2(d)(3)

(iii) Depreciation, ASPR 15-204.2(f)(4), and (5), last sentence;

(iv) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), first sentence;

(v) Recruiting Costs, ASPR 15-204.2(t), last sentence;

(vi) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w), both provisos; and

(vii) Taxes, ASPR 15-204.2(z)(1)(i) through (iv).

(2) Certain other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

(i) Depreciation, ASPR 15-204.2(f)(5), first sentence;

(ii) Food Service Costs and Credits, ASPR 15-204.2(h), last sentence;

(iii) Insurance and Indemnification, ASPR 15-204.2(j)(3)(iii) and (iv), and (4);

(iv) Maintenance and Repair Costs, ASPR 15-204.2(l)(2);

(v) Overtime, Extra-Pay Shift, and Multi-Shift Premiums, ASPR 15-204.2(o), second sentence;

(vi) Patent Costs, ASPR 15-204.2(p), second sentence;

(vii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), last sentence;

(viii) Rental Costs (Including Sale and Leaseback of Facilities), ASPR 15-204.2(u)(3);

(ix) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w);

(x) Taxes, ASPR 15-204.2(z)(2); and

(xi) Travel Costs, ASPR 15-204.2(dd)(4).

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Part 2 - Supply, Service, and Research and Development Contracts, with Organizations Having Commercial Type Accounting Systems

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 having commercial type accounting systems. However, this Part does not apply to contracts for facilities, construction, or architect-engineer services related to construction. It also does not apply to clauses in supply or service contracts which provide for the furnishing of industrial facilities.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a cost-reimbursement type contract is (i) the allowable direct costs, plus (ii) the allocable portion of allowable indirect costs, less (iii) any applicable credits.

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

15-201.3 Credits. The applicable portion of income, rebates, allowances, and other credits received by or accruing to the contractor which is related to any allowed cost shall be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

15-202 Direct Costs.

15-202.1 General. Items of cost which are readily identifiable with (i) a contract, or (ii) other work of the contractor, should be charged directly

to the contract or other work with which identified. This principle may be applied to items of cost such as freight, travel, communications, and engineering services, as well as materials and productive labor, but when used must be applied consistently to all work of the contractor. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, which otherwise would be treated as direct costs, may be treated as indirect costs. Each element of direct cost is subject to the limitations of this Part as to allowability.

15-202.2 Direct Material Costs. Direct material costs include the cost of raw materials, purchased items, and items supplied from stock, which are directly incorporated into or attached to the end product or which are directly consumed or expended in the performance of a contract.

15-202.3 Direct Labor Costs. Direct labor costs include salaries and wages specifically identifiable with and properly chargeable directly to the performance of a contract or other work of the contractor. Average rates may be used where the contractor demonstrates that the results are equitable. Direct labor costs may also include other associated costs, such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.4 Other Direct Costs. Other items of cost may, in particular cases, be charged directly to the contract where the contractor demonstrates that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable only to other work of the contractor must be eliminated from indirect costs allocated to the Government contract.

15-203 Indirect Costs.

15-203.1 General. (a) Items of cost which are incurred for common or joint objectives, and which are not readily subject to treatment as direct costs in accordance with ASPR 15-202, should be accumulated for accounting purposes by logical cost groupings and charged by a process of allocation. Each element of indirect cost is subject to the limitations of this Part as to allowability.

(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, be applied consistently, and produce equitable results. Any significant change in the nature of the business, the extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, the contractor's products, or other factors may require reconsideration of the method previously used. Individual categories of indirect cost are discussed in ASPR 15-203.2 through 15-203.5.

(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 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.

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 manhours 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 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. 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(v)(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. 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.

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. Factors to be considered in determining whether the results are equitable include:

(i) the ultimate objective of allocating general and administrative costs to the various activities of the contractor's business in proportion to the general and administrative effort involved;

(ii) the results obtainable by using the input cost method (as used herein the input cost method means the total costs incurred during the period, exclusive of general and administrative costs; however, inventories acquired for use under the contract shall be treated in the same manner as inventories acquired for other work of the contractor and facilities purchased under the contract shall not become part of input cost unless facilities acquired by the contractor for its own use are included therein);

(iii) the ratio of each of the several cost components to the total cost of the contract (exclusive of general and administrative costs) compared to the corresponding ratios for the contractor's plant or activity as a whole; and

(iv) other revelant factors including those mentioned in ASPR 15-203.1(b).

15-204 Principles and Standards for Selected Items of Cost.

15-204.1 General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below. These applications govern whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost does not imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related items.

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 (t) below.

All other advertising costs are unallowable.

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

(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 (f) 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.

(d) Compensation for Personal Services. (Reserved)

(e) Contributions and Donations. Reasonable contributions and donations to established nonprofit charitable, scientific, and educational organizations are allowable if they are deductible for Federal income tax purposes; however, such deductibility does not in itself justify allowance as a contract cost. The reasonableness 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. Allowable contributions and donations shall be allocated to all work of the contractor.

(f) Depreciation.

(1) Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the

estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

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

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

(ii) is computed by the consistent application to the assets concerned of any generally accepted accounting method, including those recognized by Section 167 of the Internal Revenue Code of 1954.

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

(3) Where a contractor has received a determination of "true depreciation" from an Emergency Facilities Depreciation Board relating to an emergency facility covered by a certificate of necessity, it may elect to use either normal or "true" depreciation. However, the method elected must be followed consistently throughout the life of the emergency facility. Where an election is made to use normal depreciation, the amount thereof shall be computed in accordance with (2) above. Where an election is made to use "true depreciation," the amount allowable as depreciation:

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

(ii) after the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life (but see (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.

(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. Use charges for assets not fully depreciated on the contractor's books are unallowable.

(g) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, and employee counselling services, incurred, in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(h) 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.

(i) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor which constitutes, in effect, an implied agreement on the contractor's part (but see (d) above, and (j)(3)(v), (q) and (x) below).

(j) Insurance and Indemnification.

(1) Insurance includes (i) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of an authorized representative of the Government, and (ii) any other insurance for which the contractor seeks reimbursement under the contract. Indemnification includes liabilities to third persons not compensated by insurance or otherwise.

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

(3) Costs of other insurance, not required to be submitted for approval but maintained by the contractor in connection with the performance of the contract, are allowable subject to the following limitations:

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

(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 unallowable except to the extent that the Government shall have approved or required such insurance or reserve;

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

(v) costs of insurance on the lives of officers, partners, or proprietors, are unallowable except where such insurance is part of an employee plan which is not unduly restricted.

(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.

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

(l) Maintenance and Repair Costs.

(1) Costs, necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable (but see ASPR 15-204.3(d)). Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation are allowable only on a depreciation basis.

(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) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with:

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

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

are allowable.

(n) Material Costs.

(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.

(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.

(5) Reasonable charges or credits arising from a difference 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 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 the cost to the transferor, or the prices of other suppliers for the same or substantially similar items, whichever is lower;

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 either (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.

(o) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. The premium portion of overtime, extra-pay shift, and multi-shift payments to direct labor employees shall be separately identified. Costs of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government and may be classified as either direct or indirect labor costs. When direct labor cost is the base for distribution of overhead, such premiums shall not be included in that base. When such premiums are charged as indirect costs, the amount allocated to Government contracts shall be equitable in relation to (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs. The premium portion of overtime, extra-pay shift, and multi-shift payments to indirect labor employees is allowable without prior approval, if reasonable, and if allocated on a pro rata basis to commercial as well as Government work.

(p) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. 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 by the Government, are allowable. (See also (v) and (w) below.)

(q) Pension Plans.

(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, either the 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 (q).)

(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 plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P.L. 591, 83rd Cong., 2d 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 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)(i)(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) in cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract costs shall 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) in determining the net 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 —

(A) when all 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 adjustment 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 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.

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

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

(1) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(f)).

(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 organization; and

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

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

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

(t) Recruiting Costs. Costs of "help wanted" advertising, operating costs of an employment office necessary to secure and maintain an adequate labor force, costs of operating an aptitude and educational testing program, travel costs of employees while engaged in recruiting personnel, and travel costs of applicants for interviews for prospective employment are

allowable. Where the contractor uses employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are unallowable.

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

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

(v) Research and Development Costs.

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

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject

under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable to the extent specifically provided in the contract. /Generally, the contractor shall be required to disclose to the Government the purposes and results of such independent general research. In specifically providing for such costs, factors to be considered include:

(i) scope, nature, and quality of the contractor's independent general research program;

(ii) capability of the contractor in the particular research field;

(iii) benefits which may accrue to the Government;

(iv) comparison of size and cost of contractor's previous years' independent research programs; and

(v) proportion of Government business to contractor's total business./

(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 (m) 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.

(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 allowable as precontract costs (see ASPR 15-204.3(i)).

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

(x) Severance Pay.

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

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

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

(ii) abnormal or mass severance payments actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the contractor shall be assigned to the entire period of the 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.

(y) Special Tooling Costs. The term special tooling means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. Costs of special tooling acquired for performance of the contract, are allowable and shall be charged directly thereto.

(z) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see ASPR 15-204.3(f));

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

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

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

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

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

Reasonable costs of any such proceeding instituted by the contractor at the direction of the contracting officer are allowable. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer are also allowable.

(3) Any refund of taxes, interest, or penalties, and any payment to the contractor of interest thereon, attributable to taxes, interest, or penalties which were allowed as contract costs, shall be credited or paid to the Government in the manner directed by the Government.

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

(1) Memberships. Costs of contractor's membership in trade, business, technical, and professional organizations are allowable.

(2) Subscriptions. Costs of subscriptions to trade, business, professional, and technical periodicals are allowable.

(3) Meetings and Conferences. Costs of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or the stimulation of production, are allowable.

(bb) Training Costs. Costs of preparing and maintaining a program of instruction designed to increase the overall effectiveness of employees, including costs of the director of training and staff, training materials, and text books, and tuition and fees when part-time training is conducted by educational institutions, are allowable when limited to on-the-job type training and when properly allocated. Costs of training in educational institutions are unallowable, except to the extent specifically provided for in the contract in accordance with Departmental instructions.

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

(dd) Travel Costs.

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

(2) Travel costs incurred in the normal course of overall administration of the business and applicable to the entire business are allowable. Such costs shall be equitabl 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.

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

(ee) General.

(1) Such recurring costs as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies, and incidental costs of directors and committee meetings are allowable. Such costs shall be equitably allocated to all work of the contractor.

(2) Certain costs discussed in ASPR 15-204.3 are allowable if expressly provided for in the contract, or, in some cases, if approved in writing by the contracting officer. See for example:

(i) ASPR 15-204.3(e);

(ii) ASPR 15-204.3(i); and

(iii) ASPR 15-204.3(k).

15-204.3 Unallowable Costs.

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

(b) Contingency Reserves. Contingency reserves, created and maintained to provide for events the occurrence of which cannot be foretold with certainty as to time, intensity, or even with an assurance of their happening, are unallowable. (For self-insurance programs see ASPR 15-204.2(j).)

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

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

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

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

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

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

(i) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs are unallowable unless specifically set forth and identified in the contract. (See ASPR 15-1xx.)

(j) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange or either short or long term investments, shall be excluded in computing contract costs (but see ASPR 15-204.2(f)(2) as to basis for depreciation).

(k) Reconversion Costs. Reconversion costs are those incurred in the restoration or rehabilitiation of the contractor's facilities to approximately 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 unallowable except that the cost of removing Government property and the restoration or rehabilitation costs caused by such removal are allowable if specifically provided for in the contract.

(l) General.

(1) In addition, certain costs discussed in ASPR 15-204.2 are stated to be unallowable. See for example:

(i) Advertising Costs, ASPR 15-204.2(a), last sentence;

(ii) Depreciation, ASPR 15-204.2(f)(4), and (5) last sentence;

(iii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), first sentence;

(iv) Recruiting Costs, ASPR 15-204.2(t), last sentence;

(v) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w), both provisos; and

(vi) Taxes, ASPR 15-204.2(z)(1)(i) through (iv).

(2) Certain Other costs discussed in ASPR 15-204.2 are unallowable unless expressly provided for in the contract, or, in some cases, if authorized or approved by the Government. See for example:

(i) Civil Defense Costs, ASPR 15-204.2(c), last sentence;

(ii) Depreciation, ASPR 15-204.2(f)(5), first sentence;

(iii) Food Service Costs and Credits, ASPR 15-204.2(h), last sentence;

(iv) Insurance and Indemnification, ASPR 15-204.2(j)(3)(iii) and (iv), and (4);

(v) Maintenance and Repair Costs, ASPR 15-204.2(l)(2);

(vi) Overtime, Extra-Pay Shift, and Multi-Shift Premiums, ASPR 15-204.2(o), second sentence;

(vii) Patent Costs, ASPR 15-204.2(p), second sentence;

(viii) Professional Service Costs - Legal, Accounting, Engineering, and Other, ASPR 15-204.2(s)(3), last sentence;

(ix) Rental Costs (Including Sale and Leaseback of Facilities), ASPR 15-204.2(u)(3);

(x) Royalties and Other Costs for Use of Patents, ASPR 15-204.2(w);

(xi) Special Tooling Costs, ASPR 15-204.2(z)(2);

(xii) Training Costs, ASPR 15-204.2(bb), last sentence; and

(xiii) Travel Costs, ASPR 15-204.2(dd)(4).

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DRAFT 11/1/55
SECTION XV SUBCOMMITTEE

Return to A.B. Carter. - 3-D-781

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 contract and cost-reimbursement type subcontracts thereunder for procurement of supplies, services, and research and development work with organizations having commercial type accounting systems. However, this part does not apply to contracts for facilities,* construction and architect-engineer services related to construction.

15-201 BASIC PRINCIPLES AND STANDARDS.

a. Composition of Total Cost. The total cost of a cost-reimbursement type contract is the net sum of (i) the allowable direct costs, (ii) the properly allocable portion of allowable indirect costs and (iii) applicable income and other credits.

b. Factors Affecting Allowability of Costs. The factors to be considered in determining the allowability of costs include (i) reasonableness, (ii) application of generally accepted accounting principles and practices, (iii) significant deviations in the established practices of the contractor which substantially increase the contract costs, and (iv) any limitations as to types or amounts of cost items set forth in this Part 2 of Section XV or otherwise included in the contract.

c. Credits. The applicable portion of income and other credits, rebates, and allowances, received by or accruing to the contractor and which are related to any allowed cost will be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

d. 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).

15-202 DIRECT COSTS. Subject to the provisions of paragraph 15-201, allowable direct costs are those items of cost, or aggregate thereof, which can be identified specifically with any objective, service, program or project under the contract and

* Notes and Filing Instructions. This Part may be used for "facilities" pending publication of a Part for this purpose

are chargeable directly thereto. Major items of cost readily identifiable with the contract or with other work of the contractor should be charged directly thereto. This principle may often be applicable to such elements of expense as freight, travel, communications, engineering services, etc., as well as the normal items of materials and productive labor. However, when the contractor is engaged in mixed production, this principle must be applied consistently to the costing of both defense and non-defense products or services, in order to produce equitable results. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect expenses.

15-202.1 DIRECT MATERIALS. The cost of direct materials includes 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 furnishing such product. Costs of reasonable overruns, spoilage, and defective work may also be included (as to defective work, see paragraph 7-203.5(c)).

15-202.2 DIRECT LABOR. The cost of direct labor includes salaries and wages specifically identifiable with and properly chargeable directly to the performance of contract or other work of the contractor. Average rates may be used where it is demonstrated by the contractor that the results are equitable. Direct labor may also include other associated costs such as payroll taxes and workmen's compensation insurance, where it is the established practice of the contractor to treat these items as a part of direct labor costs.

15-202.3 OTHER DIRECT COSTS. Where other items of cost are charged directly to the contract consistent with paragraph 15-202 above, the contractor must demonstrate that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of like items applicable to other work of the contractor must be eliminated from indirect costs allocated to the contract.

15-203 INDIRECT COSTS.

(a) Indirect costs are expenses which are incurred for common or joint objectives, are accumulated for accounting purposes by departmental activity or other logical cost grouping and are charged to the contract and other work of the contractor by a process of allocation. Each element thereof is subject to the limitations of this part as to allowability.

(b) No specific rules can be stated as to the method of allocation of indirect costs because the actual condition in each instance must be taken into accour in determining the most suitable method or methods. The objective should be the selection of a method or methods which will distribute the indirect costs in a fair and equitable manner. The method used in connection with Government contracts must, in order to be acceptable, conform with generally accepted accounting practices, be applied consistently, and produce equitable results. Any significant change, such as in the nature of the business, extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, or the products being produced, may require reconsideration of the methods previously in use to determine whether they continue to be equitable. Further discussion relative to allocation of the individual categories of indirect costs will be found in the subparagraphs below.

15-203.1 INDIRECT MANUFACTURING AND PRODUCTION EXPENSES. Indirect manufacturing and production expenses consist of costs which are incurred in the productive process as a whole and are not readily subject to treatment as direct costs in accordance with paragraph 15-202. Allocation of indirect manufacturing and production expenses on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable bases, in appropriate circumstances, include direct labor dollars (exclusive of overtime premium), units processed and prime costs of units processed. The contractor may departmentalize or establish cost centers in order to distribute equitably the

indirect costs. The factors to be considered in determining the extent of departmentalization or establishment of cost centers include variety of products, complexity of processes and relative labor and facility requirements for the various products.

15-203.2 INDIRECT ENGINEERING EXPENSES. Indirect engineering expenses include engineering supervision, engineering administrative expense, engineering general supplies, and other related expenses. These expenses arise out of engineering activities which 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 expenses should be allocated to the benefited activities, i.e., contract and other work of the contractor (~~including independent research projects~~ see also paragraphs 15-204.3(c)) on the basis of direct engineering man-hours expended, direct engineering labor dollars, extra pay shift and multi-shift (exclusive of overtime premium), or other equitable basis. Direct costs of engineering activities should be charged directly to the benefited activities, i.e., contract and other work of the contractor in accordance with paragraph 15-202.

15-203.3 SELLING AND DISTRIBUTION EXPENSES. The expenses in this group consist of items which represent the cost of marketing the contractor's products and include sales promotion, advertising, distribution costs and other related items. Generally, such expenses are not considered to be allowable as a charge to Government cost-reimbursement type contracts for the reason that marketing, in the ordinary commercial sense, is not necessary for doing business with the Government. However, dependent upon a reasonable demonstration of benefits to Government contracts and subject to the other provisions of this part, there may be an allocation to government work of those expenses in this category which consist of technical, consulting and such other beneficial services (including related supervision and clerical expenses) which are for purposes such as application and adaptation of the

contractor's products rather than pure selling. Such costs should first be allocated between the contractor's commercial line and its Government contracts. The amount allocated to the latter should then be charged to the individual contracts on any equitable basis. Because of the special problems that arise in this area, it is usually desirable for the contractor to identify in its records by means of sub-accounts or otherwise, the items of these expenses considered properly allocable to Government contracts.

15-203.4 GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses consist of costs incurred in the over-all management, supervision and conduct of the business. Any recognized method of allocating general and administrative expense is acceptable provided equitable results are thereby obtained. Some of the factors that should receive consideration in determining whether the results are equitable are (i) the cost pattern of the Government contracts (that is, the percentage of the total cost of the contract, exclusive of general and administrative expenses, represented by each of the several cost components thereof) in relation to the cost pattern for the plant or activity as a whole, and (ii) the ultimate objective of distribution of these expenses in approximate ratio to the general and administrative effort involved in the two categories of work. In addition, consideration should be given to any significant variations of inventories between accounting periods, variations in the ratio of contract inventory levels to all other inventory levels, and other relevant factors including those mentioned in para. 15-203(b).

15-203.5 BASE PERIOD FOR ALLOCATION OF INDIRECT EXPENSES. The base period for allocation of indirect expenses should ~~approximate~~ be representative of the period of contract performance ~~or should be representative of that period. The base period~~ and should be sufficiently long to avoid inequities in the allocation of costs, but in no event longer than the contractor's fiscal year.

15-204 APPLICATIONS OF BASIC COST PRINCIPLES AND STANDARDS TO SELECTED ITEMS OF COST. This paragraph states, in some detail, applications of the basic cost principles and standards set forth in the preceding paragraphs of this part to certain selected

items of cost. The statements herein apply irrespective of whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost herein is not intended to imply that it is either allowable or unallowable. With respect to those items not specifically covered, as well as all the subparagraphs below, determination as to allowability will be made in the light of the basic principles and standards herein and, where appropriate, the treatment of similar or related items in this Part.

15-204.1 ADVERTISING. Advertising expenses include the costs of advertising media and corollary administrative expenses. Advertising media include magazines, newspapers, radio and television programs, direct mail, trade papers, outdoor advertising, dealer cards and window displays, conventions, and exhibits, free goods and samples, and sales literature.

a. The following advertising costs only are allowable:

(1) 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.

(2) Help wanted advertising, as set forth in paragraph 15-204.32.

15-204.2 BAD DEBTS. Bad debt expenses consist of losses (whether actual or estimated) arising from uncollectible customers' accounts and other claims, and include related collection expenses and related legal expenses. These costs are unallowable.

15-204.3 BIDDING EXPENSE. Bidding expenses are the costs of preparing bid estimates on potential contracts or projects, including the development of engineering and cost data necessary to support the contractor's price proposal or estimated cost of work performance. Bidding expenses of the current accounting period of both successful and unsuccessful bids normally will be treated as indirect expenses and allocated currently to all business of the contractor, in which event no

bidding expenses of past accounting periods will be allocable in the current period to the Government contract. However, the contractor's established practice may be to treat bidding expenses by some other recognized method. Regardless of the method used, the results obtained may be accepted only if found to be reasonable and equitable.

15-204.4 CAFETERIAS, DINING ROOMS, AND OTHER FOOD SERVICES. This class of expenses consists of cost, less revenue, of operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, or other types of services for contractors employees at the contractor's facilities. Profits accruing to the contractor from the operation of these services whether operated by the contractor or by a concessionaire, will be treated as a credit to costs of all production within the contractor's plant in which the services are furnished, except for services from which the profits are 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. Reasonable losses of operation from such services are allowable when it is the policy of the contractor to operate such services at no loss or profit; provided, however, that any gains or losses from these services must be appropriately allocated to all activities benefited including Government contracts. When it is the policy of the contractor to furnish such services at a loss, losses on such operation will not be allowed as a cost, unless authorized by special contract provision.

15-204.5 CIVIL DEFENSE. Civil defense costs are those incurred in the planning for and the protection of life and property against the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by local and state civil defense authorities. Examples of civil defense costs include cost in excess of normal plant protection expenses and may consist of first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions and other approved civil defense measures. Reasonable costs of 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. In the case of capital assets, acquired for civil defense purposes the costs thereof will be depreciated over a reasonable number of years in conformity with generally accepted accounting principles. Except as specifically provided in the contract, contributions to local/civil defense funds or projects not on the contractor's premises are unallowable.

15-204.6 COMPENSATION FOR PERSONAL SERVICES. (To be inserted later on this page and pages 1509, 1510 and 1511).

15-204.7 CONTINGENCIES. This type of charge results from the creation and maintenance of reserves to provide for an event whose occurrence cannot be foretold with certainty as to time, intensity or even an assurance of its happening. These costs are not allowable. (For self-insurance programs see paragraph 15-204.15).

15-204.8 CONTRIBUTIONS AND DONATIONS. 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.

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15-204.9 DEPRECIATION.

a. Depreciation as described herein is a charge to current operations intended to distribute the cost of tangible capital assets, less estimated residual value, over their estimated useful life in a systematic and logical manner. It involves a process of allocation, not of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

b. Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, provided the amount thereof is based upon original acquisition cost. Depreciation will be accounted for by consistent application to the asset(s) concerned of any generally accepted accounting principles, including those recognized by Section 167 of the Internal Revenue Code of 1954, and should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation charged in any accounting period may vary with volume of production or use of multishift operations, provided the method

followed is consistent with basic objectives set forth in subparagraph a. above.

c. Charges for depreciation on idle or excess facilities will not be allowed except on such facilities as are reasonably necessary for standby purposes.

d. Unless otherwise provided in the contract, no use charge will be allowed for assets still in use which have been, in accordance with the contractor's consistent accounting practice, fully depreciated on the contractor's books of account.

e. Where the contractor has applied for, received, and accepted a determination of "true depreciation" from an Emergency Facilities Board covering an emergency facility acquired under a certificate of necessity, the amounts so determined for "true depreciation" over the emergency period (5 years) will be recognized in lieu of normal depreciation. After the expiration of the emergency period for the facility concerned where a determination of "true depreciation" has been made, the remaining undepreciated portion of the cost of such facility will be depreciated over its remaining useful life and will be the only amount recognized as allowable cost, subject to paragraph 15-204.12. (INSERT) The contractor may elect to use normal depreciation rather than the "true depreciation" as determined by the Emergency Facilities Board. However, the method chosen after such determination of "true depreciation" must be followed consistently throughout the life of the emergency facility.

The remaining undepreciated amount shall be only the normal depreciation remaining after the end of the 'true depreciation' period and shall not include any amount of unrecovered normal or 'true depreciation' allowable during the 'true depreciation' period.

15-204.10 EMPLOYEE MORALE, HEALTH AND WELFARE. Included in this category are expenses of health and welfare activities incurred for the improvement of working conditions and the improvement of employer-employee relations, employee morale, and employee performance. Examples of these activities are house publications, health or first-aid clinics, and employee counselling services. These costs are allowable when incurred in accordance with the contractor's established practice or custom in the industry or area and are reasonable and equitably allocated to all classes of work performed in the contractor's plant. Income generated from any of these

activities will be credi[illegible]o the costs thereof unless s[illegible]ncome has been irrevocably set over to employee welfare organizations.

15-204.11 ENTERTAINMENT EXPENSE. This item includes the cost of amusement, diversion, social activities and incidental costs relating thereto, such as meals, lodging, rentals, transportation and gratuities. These costs are unallowable.

15-204.12 EXCESS FACILITIES. This item includes the cost of maintaining and housing idle and excess facilities, except those reasonably necessary for standby purposes. These costs are unallowable. The costs of additional plant capacity reserved for defense production shall be the subject of a separate contract.

15-204.13 FINES AND PENALTIES. Included in this item are those costs resulting from violations of, or failure of the contractor to comply with, local, state and Federal laws and regulations. These expenses are not allowable except when incurred as a result of compliance with specific provisions of the contract or instructions in writing from the contracting officer.

15-204.14 FRINGE BENEFITS. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries.

a. The determination as to the allowability of the cost of pension and retirement plans, profit sharing and other bonuses, and severance pay will be in accordance with sub-paragraphs 15-204.26, 15-204.6 and 15-204.37 respectively.

b. The cost of other fringe benefits such as pay for vacations, holidays, sick leave, military leave and employee insurance (but see subparagraph 204.15e) is allowable to the extent required by law, employer-employee agreement, or established policy of the contractor that constitutes, in effect, an implicit agreement on the contractor's part.

15-204.15 INSURANCE AND INDEMNIFICATION.

a. Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative, and

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15-204.15 INSURANCE AND INDEMNIFICATION.

a. Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative (see ASPR 10-501 for kinds of insurance ordinarily required), (2) any other insurance for which the contractor seeks reimbursement under the contract, and (3) liabilities to third persons not compensated by insurance or otherwise.

b. The contractor shall be reimbursed for (1) insurance required to be submitted for approval or required to be procured and maintained pursuant to ASPR 7-203.22 and (2) other insurance maintained by the contractor in connection with the performance of this contract if the types and extent of coverage are in accord with sound business practice and the rates are reasonable under the circumstances, subject to the following limitations or restrictions:

(i) Costs allowed for use and occupancy insurance will ~~be~~ be limited so as to exclude coverage of profit, interest, federal income taxes, and any other items of expense unallowable under this part.

(ii) ~~The~~ Costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are not allowable except to the extent that the Government may have approved or required such insurance or reserve.

(iii) ~~Provision for losses under~~ Cost of a reserve for a self insurance program are allowable provided the program has been approved by the Military Departments concerned.

(iv) ~~The~~ Costs of insurance on the lives of officers, partners or proprietors, are not allowable except where such insurance is part of an employee plan which is not unduly restricted.

c. The obligation of the Government to indemnify the contractor will be allowable only to the extent expressly provided for in the contract (For

Except as otherwise expressly provided in the contract,

example, see ASPR 7-203.22). ~~When the costs of insurance would have been allowable under paragraph b. above,~~ actual losses not reimbursed by insurance ~~because of failure to insure~~ (through an approved self insurance program or otherwise), are not allowable.

(2) any other insurance for which the contractor seeks reimbursement under the contract. The kinds of insurance ordinarily included in the first category are set out in ASPR 10-501.

b. Costs of Government required insurance are allowable within the limitations as to the extent of coverage and premium rates approved by the Government. Costs of other insurance, except that applicable to Government-owned property, are allowable provided (1) the insurance has been approved by the military department concerned or (2) in the absence of such approval requirement, the types of coverage, extent of coverage, and rates are reasonable under the circumstances. Costs allowed for use and occupancy insurance, however, will in principle be limited so as to exclude coverage of profit, interest, federal income taxes, and any other items of expense unallowable under this part.

c. The costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are not allowable except to the extent that the Government may have required the contractor to carry such insurance.

d. Provision for losses under a self insurance program are allowable provided the program has been approved by the Military Departments concerned. Actual losses sustained under such a self-insurance program are not allowable.

e. The costs of insurance on the lives of officers, partners or proprietors, are not allowable except where such insurance is part of an employee plan which is not unduly restricted.

f. Losses resulting from failure to insure (through self insurance or otherwise) are not allowable unless approved by the Department concerned.

g. Cost of indemnification will be allowable only to the extent expressly provided for in the contract.

15-204.16 INTEREST AND OTHER FINANCIAL EXPENSES. This item includes interest (however represented), bond discount and expenses, and the cost of financing and refinancing operations as well as legal and professional fees paid in connection

with the preparation of a prospectus, cost of preparation and issuance of stock rights and expenses related thereto. (See also 15-204.23). These costs are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in subparagraph 15-204.39.

15-204.17 LABOR RELATIONS. This item covers expenses incurred in maintaining satisfactory relations between the contractor and his employees. It includes the cost of shop stewards, labor management committees, employee publications and other related activities. Costs incurred for these purposes are allowable.

15-204.18 LOSSES ON OTHER CONTRACTS. This item covers any excess of costs over income under any and all other contracts, whether such other contracts are of a supply, research and development or other nature (including the contractor's contributed portion under cost sharing R+D contracts). Costs of this nature are not allowable as a cost of performance of the Government contract.

15-204.19 MAINTENANCE AND REPAIRS.

a. This item includes those costs necessary for the upkeep of property (including Government property unless otherwise provided for) which neither adds to the permanent value of the property nor appreciably prolongs its intended life but keeps it in an efficient operating condition. These costs are allowable. Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation will be allowable only on a depreciation basis. Cost of maintenance and repairs of excess facilities and of idle facilities (other than reasonable standby facilities) are not allowable.

b. Deferred maintenance is defined as maintenance and repairs which for some reason such as abnormal operating conditions or lack of funds, is delayed to a future period. The cost of maintenance and repairs which has been deferred from a period prior to the contract is not allowable unless specifically provided for in the contract. Likewise, the estimated cost of maintenance and repairs normally required but not accomplished during the period of the contract will not be allowed as a cost unless specifically provided for in the contract.

15-204.20 MANUFACTURING AND PRODUCTION ENGINEERING. Manufacturing and production engineering includes the cost of engineering activities in connection with (1) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement and (2) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production. These costs are allowable.

15-204.21 MATERIALS AND SUPPLIES.

a. This item includes the net costs of such items as raw materials, parts, sub-assemblies, components, and manufacturing supplies, whether purchased outside or manufactured by the contractor, and may include such collateral items as inbound transportation and intransit insurance. In computing materials costs consideration will be given to reasonable overruns, spoilage, or defective work (as to defective work, see paragraph 7-203.5(c)). These costs are allowable subject, however, to the provisions of subparagraphs b. through f. below.

b. Costs of materials and supplies shall be suitably adjusted for applicable portions of income and other credits. Such income and other credits include trade discounts, refunds, rebates and allowances, cash discounts available, credits for scrap and salvage and materials returned to vendors. Such discounts, rebates, allowances and credits, may be applied directly to the charges for materials involved or may be apportioned through credits to indirect costs. However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond his control, such lost discounts will be allowed.

c. When materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to the contract.

d. If materials are issued from stock, any generally recognized method of pricing such materials will be acceptable, provided the 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 and the Government may, by contract provision, agree upon the use of a method of pricing based upon the fair value of the materials as of the date of the contract, but not in excess of replacement cost on such date. Such agreement should include identification of the types or kinds of materials involved and should be made at the time the contract is entered into and provided for therein.

e. Reasonable charges arising from difference between periodic physical inventory quantities and related material control records will be included in arriving at the cost of materials, provided that such charges (1) do not include "write-downs" of values, and (2) relate to the period of performance of the contract. All credits arising from differences between periodic physical inventory quantities and related material control records shall be taken into account.

f. Ordinarily sales or transfers of materials, services and supplies between plants, divisions, or organizations, under a common control, shall be stated on the basis of cost to the transferor. 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, provided that the price charged to the contract does not exceed the lower of (1) the transferor's sales price to its most favored customer for the same item in like quantity, or (2) the prices of other suppliers for the same or substantially similar items.

15-204.22 ORGANIZATION EXPENSES. This item consists of expenditures in connection with organization or reorganization of a business. Examples of such costs are incorporation fee, attorneys fee, accountants fees, fees to promoters and organizers and costs of raising capital. These costs are unallowable. (See paragraph 15-204.16).

15-204.23 OTHER BUSINESS EXPENSES. Included in this item are such recurring expenses as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy

solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies and incidental costs of directors and committee meetings. The above and similar costs are allowable when allocated on an equitable basis to all classes of work.

15-204.24 OVERTIME, EXTRA PAY SHIFT AND MULTI-SHIFT PREMIUMS. ~~This item consists~~

"This item consists of the premium portion of overtime, extra pay shift and multi-shift payments to employees. Such premiums on direct labor may be classified as either direct or indirect labor costs, but the amount of such premiums should be separately identified. When direct labor cost is the base for distribution of overhead, such premiums shall not be included therein. Cost of such premiums on direct labor are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government. Cost of such premiums for indirect labor is allowable without prior approval, if reasonable, and the cost is allocated on a pro rata basis to commercial as well as Government work. See ASPR 12-102 for further information concerning the policy regarding such authorization. The amount of such premium cost charged on Government contracts shall be equitable in relation to the amount of such premium costs charged on non-Government work being concurrently performed in the Contractor's plant and the factors which necessitate the incurrence of the cost."

"15-204.25 PATENT EXPENSES. This item relates to such expenses as costs leading to the issuance of patents, costs required to search the art and costs necessary to comply with invention disclosure provisions of the contract. The costs of searching the art in order to make invention disclosures, and of preparing disclosures and other reports, as required by the contract are allowable. The costs of preparing assignment and other papers in connection with the filing of a patent application by the Government and any other such costs are allowable, upon the written authorization of the contracting officer. The cost of research and development work is treated in 15-204.34. (See also paragraph 15-204.35)."

~~tization of the cost of purchased patents applicable to contract products or pro-~~

cesses is allowable. The cost of preparing disclosures and other reports as required by the contract and of preparing assignment and other papers in connection with the filing of a patent application by or for the Government, and any expenses ~~incident to patents incurred upon the written authorization of the contracting officer, are allowable. All other patent expenses and charges for the use of~~

~~patents where the Government has a license or the right to free use thereof, are unallowable unless otherwise provided in the contract. The cost of research and development work leading to patents is treated in subparagraph 15-204.34.~~

15-204.26 PENSION PLANS.

a. A pension plan as used herein is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to his 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 will be considered a pension plan, if, under the plan, either the 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 be subject to paragraph 15-204.6e).

b. Pension plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the Military Department; however, approval of the plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such plan by the Military Department. Consideration of a plan and the method of determination of cost thereof will be the responsibility of the Department to which audit cognizance is assigned and the subsequent action taken by that Department will generally be accepted by the

other Departments. Where pension and retirement plans of non-profit or other tax exempt organizations are not required to be reviewed and approved by the Internal Revenue Service, it will be the responsibility of the Department to which audit cognizance is assigned to give consideration to the acceptability of such plans.

c. The costs of a pension plan approved by the Military Department concerned, to the extent such costs are claimed and deductible for income tax purposes (or are determined to be reasonable in the case of non-profit or tax exempt organizations), are allowable except as otherwise determined unallowable under this paragraph. Such costs may include excess contributions ~~of previous years~~ Federal income to the extent such contributions are claimed and allowed for tax purposes in the current taxable period. In cases where the Internal Revenue Service withdraws approval of a plan, an appropriate adjustment of contract cost will be made for contributions disallowed for tax purposes which previously had been allocated to and allowed as contract costs.

d. In determining the net costs allocable to military contracts, consideration will be given to the possibility of future abnormal termination credits or gains and the effect such credits or gains would have upon current costs. These termination credits or gains will arise with respect to individuals for whom current costs are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits purchased or funded by current costs. When such credits or gains are foreseeable and their worth can be evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to the anticipated future credits or gains will be made. Such equitable adjustment can be accomplished either by discounting 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 discount for the abnormal termination credits or gains which are anticipated. However, most often such abnormal credits or gains, if foreseeable at all, are not susceptible of being evaluated at

the time of contracting because neither the timing nor the severity of the termination actions will be known. Under these circumstances, the Government's interest in such abnormal credits or gains will be preserved for retrospective evaluation and accounting. If a contractor has but one or relatively few Government contracts, an appropriate contractual provision may be used to preserve the Government's interest ~~and~~ by provide ~~for the~~ and any necessary adjustment to pension plan cost incurred under the contra retrospective accounting. In other cases, where a contractor is not limited to one or few Government contracts or there is reasonable probability he will receive follow-on contracts, a separate contractual "side" agreement will be negotiated having application to all pension costs allowed under contracts with the particular contractor and provide for an accounting of abnormal credits or gains, as that term is defined in the agreement, arising by reason of a cutback or cessation of Government contract work.

e. 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 incurred under approved pension plans will be subject to consideration on an individual case basis.

15-204.27 PLANT PROTECTION EXPENSES. This item includes the cost of wages, uniforms and equipment of personnel engaged in plant protection, supplies, depreciation on plant protection capital assets, and necessary expenses to comply with military security requirements. These costs are allowable.

15-204.28 PRECONTRACT COSTS. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs will not be allowed unless specifically set forth in the contract ~~and may be limited to a period of time as well as to the type and amount of such costs.~~

15-204.29 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER.

a. This item includes the cost of professional services rendered by the members of the particular profession separately engaged. These costs generally

rable when reasonable in relation to the services rendered and are not
it upon recovery of the costs from the Government.

b. Factors to be considered (among others) in determining the allowa-
costs in a particular case are: (1) past pattern of such costs, partic-
the years prior to the award of Government contracts; (2) the impact of
t contracts on the contractor's business; (3) the nature and scope of
l services expected of the contractor's own organization; and (4) whether
e proportion of Government work to the contractor's total business is
o influence the contractor in favor of incurring the cost, particularly
services rendered are not of a continuing nature and have little rela-
to work under Government contracts. Retainer fees to be allowable must
ably supported by evidence of services rendered.

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

O PROFITS AND LOSSES ON DISPOSITION OF PLANT, EQUIPMENT OR OTHER CAPITAL

Included herein are gains or losses of any nature arising from the sale or
of plant, equipment, or other capital assets, including sale or exchange
r short or long term investments. Profits or losses on sale or exchange
al assets, including investments, will be excluded in computing contract

I RECONVERSION EXPENSES. Reconversion expenses are those incurred in the
ion of the contractor's facilities to approximately the same physical
ent and condition existing immediately prior to commencement of the mili-
tract work and include the cost of removal of Government property. Recon-
expenses are not allowable except that the cost of removing Government
and the restoration costs caused by such removal are allowable if specifi-
ovided for in the contract.

15-204.32 RECRUITING EXPENSE. This item includes the costs of "help wanted" advertising and the operating costs of an employment office necessary to secure and maintain an adequate labor force. It further includes the costs of operating an ~~educational and~~ and educational aptitude testing program, travel expenses of employees while engaged in recruiting personnel, and travel expenses of applicants for interviews for prospective employment. These costs are allowable. Where the contractor uses private employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are not allowable.

15-204.33 RENTALS OF PLANT AND EQUIPMENT. (Including sale and leaseback of facilities.) This item includes expenses for (1) use of land, buildings, and equipment or other personal property, and (2) rental expenses under sale and lease-back agreements incurred by contractors through sale of plant facilities to investment organizations (such as insurance companies) or to private investors and concurrently leasing back the same facilities.

a. Rentals of plant and equipment under (1) above are allowable if the rates are reasonable in light of the type, condition and value of the facilities leased, options available and other provisions of the rental agreement.

b. Unless specifically provided for otherwise in the contract, rentals specified in sale and lease-back agreements under (2) above are allowable only to the extent that such rentals do not exceed normal costs (such as depreciation, taxes, insurance and maintenance expenses borne by the lessor) which would have been incurred had the contractor retained legal title to the facilities.

15-204.34 RESEARCH AND DEVELOPMENT. Research and development expenses (sometimes referred to as general engineering expenses) for the purpose of contract costing are divided into two major categories, namely:

a. General research, also referred to as basic research, fundamental research, pure research and blue-sky research.

b. Related research or development, also referred to as applied research, product research and product line research.

> "(i) General research is that type of research which is directed towards increase of knowledge in science. It is research where the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. The cost of Independent General Research (that which is not sponsored by a contract or grant or other arrangement) shall be allowed to the extent specifically provided in the contract.
>
> (A) To the extent such costs are allowed, they will be equitably allocated to all work of the contractor other than its independent general and related research.
>
> (B) Generally, the contractor shall be required to disclose to the Government the purposes and results of such independent general research.
>
> In specially providing for such cost, consideration shall be given to the following factors among others:
>
> a. Scope, nature and quality of the contractor's independent general research program.
> b. The capability of the contractor in the particular research field.
> c. Benefits which may accrue to the Government.
> d. Comparison of size and cost of contractor's previous years' research programs.
> e. The proportion of the Government business to the contractor's total business."

development (that which is not sponsored by a contract or grant or ~~is not otherwise reimbursed to a contractor~~ other arrangement) may, if allocated on the basis of all production, be allowed as a cost under any cost type production contract if the research is related to the contract product or product line. No portion of such research will be allowable under cost-type research and development contracts.

c. Independent research projects will absorb their appropriate share of the indirect expenses of the department where the research work is performed.

d. Research and development costs (including amounts capitalized), regardless of the nature, which were incurred in accounting periods prior to the award of a particular military contract, will not be allocated to that contract unless allowable as pre-contract costs (Paragraph 15-204.28)."

"15-204.35 ROYALTIES AND OTHER COSTS FOR USE OF PATENTS.

This item covers amounts paid or payable for the right to use patents or inventions. Where the use of such a patent or invention is necessary for the proper performance of the contract and where the Government does not already have a license or other right to use such a patent or invention, the royalties, amortization of the cost of purchased patents or other purchased patent rights applicable to contract products or processes are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the contracting officer. Charges for the use of patents, where the Government has a license or the right to free use of the patent are unallowable. (1526) Charges for the use of patents where a patent has been adjudicated to be invalid are unallowable unless otherwise provided in the contract. (NOTE: This provision, upon reconsideration by the ASPR Committee, was changed from the manner in which it is shown in the minutes of the 6 Dec. 1955 meeting (which are correct) to the form shown above.)

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15-204.36 SERVICE AND INSTALLATION EXPENSES. This item includes ... vicing the product installation, and training personnel in the use, maintenance and operation of the product. Such costs are allowable.

15-204.37 SEVERANCE PAY. Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated.

The cost of severance pay is allowable only to the extent that, in each case, it is required by (1) law, (2) employer-employee agreements, (3) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (4) the circumstances of the particular employment.

For contract costing purposes severance pay is divided into two categories as follows:

a. Normal Turnover Severance Pay. The cost of severance payments is allowable and must be allocated to all classes of work being performed in the contractor's plant at the time of payment. However, 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.

b. Mass Severance Pay. The cost of abnormal or mass severance pay actually made upon cessation of work when there is no reasonable prospect of

* Army wants consideration given to inserting "consumer"

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 entire period of employment with the contractor and equitably apportioning such cost to all business of the contractor performed during that period.

A reservation in the final release of claims (See ASPR 7-203.4) may be made in the case of completed cost-reimbursement type contracts when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

Does this conform with latest XIII definition

15-204.38 SPECIAL TOOLING. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or to the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. The cost of special tooling, when acquired for and its usefulness is limited to government contracts, is allowable and will be charged directly to the government contracts. When such special tooling is acquired it shall be subject to the provisions of the contract clause set forth in ASPR 13-503 entitled, "Government Property".

15-204.39 TAXES. Taxes are charges levied by a government unit. They do not include fines and penalties except as otherwise provided herein.

a. In general, taxes (including state and local income taxes) which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for (1) Federal income and excess profits taxes; (2) taxes in connection with financing, refinancing or refunding operations (see paragraph 15-204.16); (3) taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government; and (4) special assessments on land which represent capital improvements.

insert

except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the Government

b. Taxes otherwise allowable under a. above, but which may be illegally or erroneously assessed may be allowed as a cost of work performed, provided that the contractor, prior to payment of such taxes, (1) promptly requests instructions from the contracting officer concerning such taxes; (2) agrees to comply with such instructions; and (3) if so directed by the contracting officer also agrees to take all necessary action in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refun of such taxes and any interest of penalties thereon. Interest and penalties incurr by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer, shall be allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs.

c. Any refund of taxes, penalties or interest thereon shall be credited to contract costs in the proportion in which contract costs absorbed the costs of taxes, interest or penalties. If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

15-204.40 TRADE, BUSINESS, TECHNICAL AND PROFESSIONAL ACTIVITIES.

a. Memberships. This item includes costs of membership in trade, business, technical and professional organizations and such costs are allowable.

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

c. Meetings and Conferences. Expenses representing the purchase of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrence of such expenses is the dissemination of technical information or the stimulation of production, are allowable.

15-204.41 TRAINING EXPENSES.

a. This item includes the costs of preparing and maintaining a program of instruction designed to increase the over-all effectiveness of employees. Included are the costs of the director of training and staff, training materials and text books when the training program is controlled by the contractor, and tuition, fees, training materials and text books when the training is in educational institutions.

b. Such costs which are limited to on the job training are allowable when properly allocated.

c. Costs of training in educational institutions are not allowable, except to the extent specifically provided in the contract.

15-204.42 TRANSPORTATION EXPENSES. Transportation expenses include the cost of freight, express, cartage and postage relating either to goods purchased, in process, or delivered.

When such costs can readily be identified with the items involved, they may be direct costed or added to the cost of such items. (See paragraph 15-204.21) Where identification with the materials received cannot readily be made, inbound transportation expense may be charged to the appropriate indirect expense accounts, provided the contractor follows a consistent procedure* in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as direct charges.

15-204.43 TRAVEL EXPENSES. This includes costs of transportation, lodging, subsistence and incidental expenses incurred by contractor personnel in a travel status while on official company business.

a. Travel expenses incurred in the normal course of over-all administration of the business and applicable to the entire business are allowable when properly allocated.

* Army wants insert considered "which provides for equitable results

b. Travel expenses directly attributable to contract performance may be charged to the contract in accordance with the principle of direct costing.

c. Subsistence and lodging including tips or similar incidental expenses may be reimbursed either on an actual or per diem basis. The basis selected should be consistently followed.

d. Entertainment expenses are not allowable.

e. Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the Contracting Officer.

Case 53-44
ASPR-Record Copy

Index #2.

DRAFT
9/27/56

STATEMENT TO ACCOMPANY PUBLICATION
OF REVISED CONTRACT COST PRINCIPLES
IN ASPR FILING INSTRUCTIONS

The revision of Section XV, Part 2, of the Armed Services Procurement Regulation has been undertaken to provide a more equitable statement of cost principles to reflect the reasonable and allocable costs of performing defense cost reimbursement type contracts and to reflect a contractor's normal cost of doing business. It is the intent that generally accepted and approved methods of accounting, as presently practices by contractors, which fairly and equitably reflect and distribute the cost of doing business are acceptable. Only where the determination of allowability requires a particular accounting treatment to obtain equitable results will specific accounting methods be selected. Items of cost listed as unallowable reflect national or Department of Defense policy. In subsequent revisions, it is the intent that certain procedural requirements relating to accounting methods will be separated from the cost principle treatment and be included elsewhere in the Armed Services Procurement Regulation. In addition, the revised principles, which formerly were a mere listing of named items of cost as either allowable or unallowable, contain a definition for each item, a statement as to the extent of allowability or unallowability, and in many instances provide criteria for determining the reasonableness of a particular item of cost.

Furthermore, this revision has been developed (1) to provide policy guidance to prospective contractors and subcontractors, contracting officers, contract negotiators and auditors in areas in which such guidance has been lacking, including in many instances, criteria for determining the reasonableness of a particular item of cost, or which were subject to special consideration; (2) to accommodate changes in Department of Defense policy in regard to contributions; and (3) to make improvements of an editorial nature.

These regulations should materially assist contractors and contracting officers to recognize and provide treatment which protects their respective interests.

(a) Competitive price proposals.
(b) Published market prices.
(c) Catalog prices (including discounts).
(d) Previous procurement experience on the same or similar items, with computed adjustments of the prices paid where appropriate to make allowance for changes in specification or quantities, or changes in labor, material and other cost indices.

15-102.1 Examples Where Required. Examples of situations where cost estimates shall ordinarily be required are as follows:

(a) Negotiation of fixed-price contracts where there is an absence of adequate competition, sufficient prior experience, or other adequate valid pricing criteria.

(b) In connection with fixed-price contracts containing price-redetermination or incentive provisions:

(i) Negotiation of tentative or target prices.

(ii) Negotiation of firm prices on a forward basis.

(iii) In combination with historical costs, negotiation of firm prices for retroactive and prospective application.

(iv) In the case of incentive contracts, negotiation of target costs.

(c) In connection with cost, cost sharing and cost- plus-a-fixed-fee contracts:

(i) Determination of the estimated cost of the contract, and in the case of cost-plus-a-fixed-fee contract, the negotiation of the fixed fee.

(ii) Negotiation of fixed overhead rates.

(d) In connection with all types of contracts, negotiation of contract changes affecting the contract consideration.

15-103 Use of Historical (Actual) Cost. Historical (actual) cost shall be used for the following purposes under the below listed types of contracts, and may be used where appropriate in other situations:

(a) Under all cost-reimbursement type contracts (including cost-reimbursement subcontracts thereunder), for the determination of the reimbursability of cost, except to the extent predetermined overhead rates are provided for in such contracts (see paragraph 15-105). The term "cost-reimbursement type contract", as used

throughout this section, includes cost or cost-sharing contracts, cost-plus-a-fixed-fee contracts, and the cost reimbursement portion of time-and materials contracts.

(b) Under all fixed-price contracts containing price-redetermination or incentive provisions, for the determination, to the extent required by such contracts, of historical (actual) costs of performance thereof.

(c) Under all types of contracts, for the settlement, to the extent required by Section VIII hereof, of contracts terminated in whole or in part for the convenience of the Government.

15-104 Contract Provisions. The cost principles and standards set forth in Part 2, as implemented by Part 3, Part 4, Part 5 or Part 6 (whichever implementing part is applicable) shall be made a part of every cost-reimbursement type contract, executed as of a date on or after , (and every cost reimbursement subcontract thereunder), for the purpose of determining of reimbursability of costs except that such contract may treat any element of cost thereunder more specifically than provided by the aforesaid cost principles and standards so long as not inconsistent therewith. In addition, these cost principles and standards may be made a part of any other contract for the purpose of determination of historical (actual) cost orfor the purpose of preparation of estimates of cost.

15-105 Use of Predetermined Rates in Cost-Reimbursement Type Contracts. The use of a fixed indirect expense rate negotiated prior to the expiration of a significant portion of the period to which such rate applies may be provided for in cost-reimbursement type contracts in lieu of the determination of historical (actual) indirect expense provided that the results will reasonably approximate the actual rates. Consideration of cost elements in negotiating such rates must be consistent with the provisions of this section concerning cost allowability and allocability. When predetermined rates are used, the contract shall specifically state the types of items which are to be treated as direct costs. Care should be exercised in negotiating these rates to exclude from the listing of direct costs any cost element included in predetermined expense rates in order to avoid duplicate charges.

15-106 Encouragement of Use of Standard Cost Method of Accounting. Contractors are encouraged to use, where economically feasible, modern standard cost methods because they provide an excellent means of cost estimating and cost analysis, as well as enable more effective control of actual costs during contract performance. Such methods provide for pricing material costs on the basis of bills of materials, labor costs on the basis of studies of time requirements, and overhead costs on the basis of budgeted expenses for the expected volume and types of production, with reasonable allowances for cost variances indicated by experience to be expected for defective work and failure to achieve full efficiency. Such methods generally provide the assurance of accuracy of cost estimates, as well as the means of more effective cost control, when variances of actual costs from standards are measured frequently and recorded in the formal accounts.

PART 2 - GENERAL PRINCIPLES AND STANDARDS FOR DETERMINATION OF COSTS

15-200 Scope of Part. This part sets forth general principles and standards for determination of costs.

15-201 Composition of Total Cost. The total cost of work performed or to be performed under a contract or subcontract to which these principles are applicable is the net sum of (i) the allowable direct costs reasonably incident to the performance of the contract or subcontract, (ii) the properly allocable portion of allowable indirect costs, and (iii) less applicable income and other credits. This composition of cost shall be followed whether the total costs are stated for an entire contract or for individual units of products or services covered by the contract.

15-202 Factors in Determining Costs. Factors to be considered in determining costs include (a) conformity with the composition of total cost outlined in paragraph 15-201; (b) reasonableness in the amounts of particular elements of costs; (c) application of generally accepted accounting principles and practices; (d) customary practices of absorbing certain costs in profit; (e) exclusions of specific elements of costs as a matter of public or business policy, as set forth in this section; and (f) exercise of good business judgment in incurrence of the cost.

15-203 Contractor's Accounting System. Subject to the observance of the cost principles set forth in this section, any system of accounts and any method of cost accounting or estimating will be acceptable, if they are in accordance with generally accepted accounting principles and practices and if they produce equitable results under the particular circumstances.

15-204 Direct vs. Indirect Costs. Every acceptable method of cost accounting or estimating embodies the principle of direct costing of certain materials and subcontract work. Direct costing of productive labor is general practice. Other expenses may be costed directly, but generally are allocated to products, job orders, or contracts, etc. on an arithmetical basis in ratio to appropriate measures of performance. Such allocated expenses are termed "indirect costs."

15-205 Direct Costs. There are no absolute rules to determine which items or elements of cost should be direct costs. However, direct costs should, in general, comprise every major item of cost (actual or estimated) which can be identified with the unit being costed, whether the unit is product, job order or contract, unless such item of cost, in fact, has substantial proportionate applicability to more than one class of work. When of major consequence, travel, commissions, advertising, engineering services and other expenses should also be so treated. Unless inequitable, the contractor must follow a consistent pattern of costing, and must follow the same pattern in costing both defense and non defense products and services when engaged in mixed production.

15-206 Indirect Costs. Indirect costs, which have the character of common or joint costs, usually consist of indirect materials, indirect labor, and other items of indirect expense. These costs generally are grouped in classes as follows:

(a) Manufacturing (shop, laboratory) expenses (often termed "manufacturing overhead" or "burden"), which are incurred in fabricating the article or service rendered;
(b) Engineering expenses to extent not included in (a) or (c);
(c) Selling and distribution expenses, incurred in marketing the products manufactured;
(d) General and administrative expenses incurred in the overall management, supervision, and conduct of the business;
(e) Financial and other expenses.

15-206.1 Methods of Allocation. No general rules regarding allocation of indirect costs to products, job orders, or contracts can be stated for all cases, because the nature of the particular operations and the actual conditions in each instance determine the most suitable method or methods to be employed. Any method of allocation of indirect costs will be acceptable if it is in accord with generally accepted accounting principles and practices and if it produces equitable results under the particular circumstances.

15-207 Use of Standard Costs in Determining Historical (Actual) Costs. Where contractors have satisfactory cost systems, standard costs of products, or parts thereof, with appropriate adjustments for variances from actual costs, may be considered to represent historical (actual) costs, provided such costs reasonably reflect the application of the principles and standards set forth in this section.

15-208 Cost Estimates

15-208.1 Use of Historical Costs. Regardless of the method used (standard, job-order or process), unmodified historical cost data, when used in the preparation of cost estimates, do not provide a satisfactory standard of future performance and should not be used. Where no more satisfactory cost data are available, historical costs may be used in the preparation of estimates provided they are adjusted to eliminate nonrecurring costs and to reflect new conditions, if any, which may be applicable to future production.

15-208.2 Use of Predetermined Rates for Indirect Expenses (Overhead Costs). Indirect expenses must always be predicted for purposes of cost estimates. This involves determination of expense rates in accordance with whatever reasonable method or methods of expense allocation are followed by the contractor. Where budgeting based upon distinguishing between fixed and variable expenses and upon estimating variable expenses in proportion to anticipated levels of production or work loads are used, such budgets provide the best means for estimating expense rates. Historical indirect expenses, or expense rates, are not to be used as the equivalent of budgeted rates for this prupose.

FOR DEPARTMENT OF DEFENSE USE ONLY

DRAFT
November 1953

PROPOSED REVISION
OF
SECTION XV

1501

CONTRACT COST PRINCIPLES AND STANDARDS

15-000 Scope of Section. This section sets forth, in general, principles and standards to be applied uniformly (except as expressly qualified herein) in the determination of historical costs, the preparation and presentation of cost estimates by contractors, and the review or audit, from a cost standpoint, of contractors' pricing proposals of prime contracts and those subcontracts which are subject to negotiation, approval, review or audit within the Department of Defense.

15-001 Effective Date of Section. This section shall become effective _____ 1954 with respect to contracts executed on or after that date although use is authorized from the date of issuance. Existing contracts will not be amended to incorporate this Section unless in the opinion of the Contracting Officer the interests of the Government justify a contract amendment incorporating this Section.

PART 1 - APPLICABILITY AND PURPOSE

15-101 Application.

(a) General. These cost principles are to be used by procurement and audit personnel of the Department of Defense wherever cost data are to be considered in the negotiation and administration of contracts as indicated in paragraphs (b), (c) and (d) below. [Where incorporated in a contract (as indicated below) the contract may treat any element of cost more specifically than provided in this Section, so long as there is no inconsistency therewith. Moreover, basic agreements may be negotiated with individual contractors specifying in more detail uniform procedures or practices to be followed by the contractor provided such agreement is consistent with the provisions of this Section.]

(b) Cost-Reimbursement Type Contracts. Cost estimates shall be developed and evaluated, and reimbursements to the contractor for costs incurred shall be determined, through the application of these cost principles and standards. Therefore, Part 2 and either Part 3, 4, 5, or 6 (whichever is appropriate to the type of work called for by the contract) shall be incorporated by reference in every cost-reimbursement type prime contract and every cost-reimbursement type subcontract thereunder.

[(c) Fixed-Price Type Contracts. Cost is but one of several factors to be considered in the negotiation of prices or in negotiating settlements in the event of termination for the convenience of the Government. When considering cost data as a basis for negotiation (as required by paragraphs 15-103 and 15-104), the cost principles and standards contained in this Section shall be used as criteria for the evaluation of cost data submitted by contractors.

This applies to pre-award negotiations, negotiations during or upon completion of the contract, and negotiations in the event of termination for the convenience of the Government. Accordingly, Part 2 and either Part 3, 4, 5, or 6 (whichever is appropriate to the type of work called for by the contract) will be incorporated by reference in the clause of every contract entitled Termination for the Convenience of the Government. Similarly, where future pricing actions are contemplated, the price redetermination or incentive clause shall incorporate by reference the same Parts included in the clause of the contract entitled Termination for the Convenience of the Government.7

(c) Fixed-Price Contracts. Cost is but one of several factors which which may be considered in the negotiation of price or in negotiating settlements in the event of termination for the convenience of the Government. To the extent that cost data submitted by contractors are considered in connection with such negotiations, pursuant to paragraphs 15-103 and 15-104, the cost principles and standards contained in this Section shall be used as criteria for the guidance of the Contracting Officers in the evaluation of such cost data. This applies to pre-contract negotiations, negotiations during or upon completion of the contract, and negotiations in the event of termination for the convenience of the Government. Part 2 and either Part 3, 4, 5 or 6 (whichever is appropriate to the type of work called for by the contract) will only be incorporated by reference in the clause of every contract entitled Termination for the Convenience of the Government for mandatory use in formula determinations.

(d) Time and Materials Contracts. The cost principles and standards contained in this Section shall be used as criteria to guide the contracting officer in the evaluation of cost data submitted by contractors for purposes of negotiating hourly rates and estimating costs of materials. Reimbursements to contractors for costs incurred for materials shall be determined through the applications of these cost principles and standards. Accordingly, Parts 2 and 3 of this Section shall be incorporated by reference in all time and materials contracts for the purposes of (i) requiring the submission of cost data by contractors in conformity therewith and (ii) determining the reimbursability of any items to be reimbursed on a cost basis.

15-102 Historical and Estimated Costs. Costs used in negotiating contracts, or in making settlements thereunder, may be either of a historical nature (actual costs) or may be estimates of future costs, in whole or in part, whichever is appropriate for the specific type of procurement action as indicated in paragraphs 15-103 and 15-104.

15-102.1 Applicability of Cost Principles to the Preparation of Cost Estimates as Well as to the Determination of Actual Costs. In general, the same cost principles apply to preparing cost estimates as to determination of actual costs. Therefore, this Section will consider the cost principles set forth herein as applicable interchangeably to either cost estimates or actual costs, except as may be indicated specifically to the contrary.

15-102.2 Use of Standard Costs in Cost Estimates. Wherever future cost estimates are required, the use, where economically feasible, of modern standard cost methods should be encouraged, because they provide an excellent means of cost estimating and cost analysis, as well as enable more effective control of actual costs during contract performance. Such methods provide for pricing material costs on the basis of bills of materials, labor costs on the basis of studies of time requirements, and overhead costs on the basis of budgeted expenses for the expected volume and types of production, with reasonable allowances for cost variances indicated by experience to be expected for defective work and failure to achieve full efficiency. Such methods generally provide the assurance of accuracy of cost estimates, as well as the means of more effective cost control, when variances of actual costs from standards are measured frequently and recorded in the formal accounts.

15-102.3 Use of Standard Costs in Determining Historical Costs. Wherever contract price negotiations or settlements depend upon historical costs, and contractors have satisfactory standard cost systems, standard costs of products or components appropriately adjusted for variances from actual costs, may be considered to represent actual costs, provided such costs reasonably reflect the application of the principles and standards governing the allowability and allocability of cost as set forth in this section. /Normally, where adequate standard costs are available for complete end-products, firm fixed-price contracts should be used./

15-102.4 Use of Job-Order or Process Cost-Accounting Method in Determining Historical Costs. The use of either the job-order or process cost-accounting method in determining historical costs of contract performance is acceptable. In any pricing negotiations which require consideration of work in process at an intermediate point in the period of contract performance, special care must be exercised to segregate any part of the work in process costs which is not applicable to the completed portion to the cut-off point.

15-102.5 Use of Historical Costs for Purposes of Cost Estimating. Regardless of the method used (standard, job-order or process), unmodified historical cost data, when used in the preparation of cost estimates, may not provide a satisfactory standard of future performance. In this event their use would be undesirable. Where no more satisfactory cost data are available, historical costs may be used in the preparation of estimates provided they are adjusted to eliminate nonrecurring costs and to reflect new conditions, if any, which may be applicable to future production.

15-103 Use of Cost Estimates. The proper use of cost estimates requires the exercise of judgment and discrimination. It is impractical to lay down hard and fast rules which would be completely comprehensive in this area. In general, cost estimates shall be obtained from contractors except where other valid and adequate pricing criteria exist or the estimates would not materially assist the Contracting Officer in negotiating prices.

(a) Examples of valid, but not necessarily adequate in a particular case, pricing criteria to be considered for the purpose of determining whether cost estimates will be of material assistance include, but are not limited to, the following:

(1) Competitive price proposals.

(2) Published market prices.

(3) Catalog prices, including discounts.

(4) Previous procurement price experience on the same or similar items, with computed adjustments of the prices paid where appropriate to make allowance for changes in specification or quantities, or changes in labor, material and other cost indices.

(b) Examples of situations where cost estimates should normally be utilized are as follows:

(1) Negotiation of firm fixed-price contracts when there is an absence of valid pricing criteria as illustrated above.

(2) Under fixed-price contracts containing price-redetermination provisions:

a. Negotiation of tentative initial prices.
b. Negotiation of firm prices on a forward basis.
c. In combination with historical costs to arrive at firm prices for both retroactive and prospective application.

(3) Under incentive-type contracts:

a. To establish billing prices for use until target prices are negotiated.
b. Negotiation of tentative target costs when firm targets cannot be initially determined.
c. In combination with historical costs to negotiate firm target prices and target costs, including those cases where the targets are set during the course of the contract.

(4) Under cost-reimbursement type contracts:

a. Initial estimates as a basis for negotiation of fixed fees.
b. Negotiation of fixed overhead rates. (See also paragraph 15-104(a)(2).)

(5) Under time and materials contracts:

a. Negotiation of hourly rates.
b. Estimating costs.

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

a. Contract price ceilings.

b. Contract changes affecting the contract consideration.

15-104 Use of Historical (Actual) Cost. Historical (actual) cost shall be used for the following purposes (where price is to be negotiated, cost is not a rigid measure of price):

(a) Under cost-reimbursement type contracts:

(1) Determination of allowable cost.

(2) In combination with cost estimate to negotiate fixed overhead rates (where the contract provides for use of such rates).

(b) Under fixed-price contracts, with retroactive price-redetermination: negotiation of retroactive fixed-prices.

(c) Under incentive-type contracts:

(1) In combination with cost estimates, to negotiate firm target prices and target costs.

(2) Determination of final prices after contract completion.

(d) Under contracts terminated for the convenience of the Government: as required by Section VIII hereof.

(e) Under time and materials contracts: the determination of allowable costs.

In addition to the above listing of purposes for which use of historical cost is indicated, such cost data may be useful in other circumstances and should be applied where appropriate.

15-105 Basis of Application of Principles and Standards to Pricing of Standard Commercial Products. Standard commercial products are those which are normally manufactured and sold in volume to customers who are neither prime contractors nor subcontractors for defense work, notwithstanding the fact that substantial quantities may be sold to defense contractors or the Government with relatively little or no change in specifications. /In general, it will be expected that standard commercial products will be purchased under fixed-price contracts, and that prices will be established without primary reference to the respective contractor's costs. The use of escalation clauses generally should take care of major contingencies which should not be added to estimated costs in contract pricing of such products. However,/ In those instances where cost

analyses for standard commercial products are required in firm price negotiations under fixed-price contracts, these principles and standards will be applicable to the extent appropriate. Care must be used in such cases in order not to impose impractical requirements on contractors for cost estimates — to meet which requirements might result in work entirely disproportionate to the amounts involved. [Cost analyses in such cases may sometimes be based upon other data than current cost estimates -- for example, when a manufacturer has no cost data for a specific standard commercial product, he may have available for analysis, historical sales, costs and profit data on a group of products, including the specific one subject to price negotiation.]

15-106 Application of Generally Accepted Accounting Principles. It is to be understood that generally accepted accounting principles with respect to product or contract costs are nowhere codified or reduced to rigid formulae. Such principles permit the use of alternative practices or conventions, particularly in different types of business activities; yet in the main there are generally accepted limits in principle regarding accounting practices, the violation of which would not be condoned by the accounting profession. To the extent there is a twilight zone between accepted and non-accepted practices, it is desirable that definite understandings be reached between the contracting parties. [This section covers a number of subjects of this nature, so far as they can be covered for general application. Yet inevitably there will be many occasions where specific contractual provisions or supplementary interpretations of the contract terms in the application of cost principles will be needed. (See paragraphs 15-105 and 15-110.)]

[15-106½ Relation of Generally Accepted Accounting Principles to Internal Revenue Code. Generally accepted accounting principles are observed, in the main, in the Internal Revenue Code and Treasury regulations governing deductions for business costs in determining income subject to Federal income tax. For this reason the Internal Revenue Code and Treasury regulations may provide some guidance as to whether the contractor's costs are set forth in accordance with generally accepted accounting principles. However, provisions of the Internal Revenue Code and Treasury regulations shall not be controlling for this purpose; in fact, Part 3 of this Section contains a number of examples of deviations therefrom required or permitted to be observed in determining contract costs.]

15-107 Relation of Contract Costs and Profits. The use of actual or estimated costs in procurement pricing is only one phase of establishing the total price or monetary consideration under a contract. The determination of reasonable profit (or fee) is another important phase. These two phases of pricing are mutually dependent to the extent that certain factors may be considered in determining either costs or profit (or fee). Major factors to be considered in this respect include prolonged delivery schedules, unstable market conditions for material or labor, or uncertainty as to cost of performance. Depending upon the type of contract, either the contractor or the Government may assume such risks. Where the Government

assumes all the risk of cost increases or additional unknown costs, or a substantial share thereof (as it generally does when these risks are great) through the use of cost-reimbursement type contracts, escalation or price-redetermination clauses, or incentive-type contracts, the profit allowance for contingencies should be reduced to the extent appropriate. In negotiation of prices under firm fixed-price contracts, risks of loss or other cost increases, other than those reasonably certain and determinable, should be recognized in profit margins rather than in allowances for contingent increases in cost. However, no hard and fast line may be drawn here, but it is important that such allowances not be duplicated. For example, a contractor's cost estimates may properly include reasonable estimates of cost applicable to normally experienced defective work in manufacturing processes. Where reasonably certain and determinable contingencies are recognized in cost estimates, such contingencies should not be considered as elements of risk in determining the allowable profit. There are other factors having a similar bearing on cost and profit determination; for example, in contracting for construction under cost-reimbursement type contracts, it is customary practice to exclude general, administrative and central office expenses from costs, but to allow instead for these factors as a part of the fixed fee.

15-108 Special Provisions Relating to Cost Determinations, Including Limitations. Because of the need for standards of reasonableness in determining either estimated or actual costs of performance of specific contracts, including the application of business and public policies, a considerable portion of this Section, namely Part 3, is devoted to standards of allowability of specific elements of costs under supply contracts and research and development contracts with commercial organizations. Moreover, because of unusual accounting practices or problems involved in determining costs under facilities contracts, research and development contracts with non-profit institutions and construction contracts, Parts 4, 5, and 6 respectively, are devoted thereto.

15-109 Use of Predetermined Rates for Indirect Expenses (Overhead Costs).

(a) Indirect expenses must always be predicted for purposes of cost estimates. Contractors should be encouraged to use methods of cost estimating based upon distinguishing between fixed and variable expenses and upon estimating variable expenses by cost centers in proportion to anticipated levels of production or work loads; such methods provide the best means for estimating expense rates. Historical indirect expenses, or expense rates, should not be used indiscriminately as the equivalent of budgeted rates for this purpose without adjustment for nonrecurring expenses and adjustment of the portion of the rates representing fixed expenses when substantial changes in production or work loads are expected.

(b) The use of a fixed indirect expense rate negotiated prior to the expiration of a significant portion of the period to which such rate applies in lieu of the determination of historical indirect expense is acceptable where mutually agreeable to the contracting parties provided

the contractor is able to forecast indirect expenses and levels of output within a reasonable degree of accuracy. Consideration of cost elements in negotiating such rates must be consistent with the provisions of this Section concerning cost allowability and allocability. When predetermined expense rates are used the contract should specifically state the types of items which are to be treated as direct costs. The contractor must exclude from direct costs any cost element included in predetermined expense rates in order to avoid duplicate charges.

[15-110 Modification or Expansion by the Military Departments.

[(a) This statement of contract cost principles and standards shall be followed in procurement and audit operations within the Department of Defense without modification or expansion in any way except for: (i) the more specific treatment of particular items of cost authorized in paragraph 15-101, and (ii) interim interpretations authorized by (c) of this paragraph. The cost principles and standards contained in this Section are expressed in broad terms in order that they be sufficiently flexible to meet the requirements of the wide variety of circumstances and conditions prevailing in different industries. Being expressed in broad terms there is considerable latitude for the application of good business judgment to the facts of a particular case by procurement and audit personnel. In order that this latitude not be restricted, any interpretation of those principles and standards made in the course of contract negotiation and administration shall be on a case-by-case basis in light of the specific facts thereof -- no system of written interpretations (other than authorized in (c) hereof) to be followed generally will be permitted.

[(b) It is impracticable and unnecessary to include in these cost principles and standards every element of cost or possible situations that might arise. Where specific guidance is lacking, the philosophy expressed or implied in similar or related items should be followed. Nonetheless, revisions and amendments will be necessary. Any expansion of or change in this Section deemed to be desirable by any procurement or audit activity will be forwarded through appropriate channels to the Office of the Secretary of Defense for consideration.

[(c) Where considered essential by major procurement and audit activities [1/ of the military departments, temporary interpretations of these cost principles and standards may be issued by such activities. Any such interpretation is subject to the following circumstances, conditions, and instructions:

[1/

ARMY	NAVY	AIR FORCE	
AC of S G-4	ONM	DCS-M	Director of Procurement and Production Engineering
Heads of Procuring Activities		AMC	
Hq. AAA	Busanda (CIS)	DCS-C	Auditor General

(1) Its issuance must be considered essential by the issuing authority. In other words, the problem could not have been met adequately by interpretations made on a case-by-case basis prior to consideration by the Office of the Secretary of Defense under (b) hereof.

(2) It must be consistent with these cost principles and standards.

(3) It will expire by its terms not more than six months after issuance and, in any event, upon the issuance of an amendment to these cost principles and standards covering the subject matter of the interpretation.

(4) Two copies of each interpretation will be forwarded upon issuance to the Office of the Secretary of Defense to be considered as a recommendation of the issuing authority for revision in this Section in accordance with (b) hereof. The Office of the Secretary of Defense will consider the recommendation and will take appropriate action within the six months specified in (c)(3) hereof.

(5) Any such interpretation deemed by the Office of the Secretary of Defense to be unnecessary or inconsistent with this Section will be rescinded by the issuing authority upon receipt of notice to that effect.]

[15-111 Deviations. The authority to deviate, as provided in paragraph 1-108 of this Regulation, is further restricted in respect to this Section 15, to permit such deviations only on a specific contract basis.]

PART 2 - GENERAL PRINCIPLES AND STANDARDS FOR DETERMINATION OF COSTS

15-201 Composition of Total Cost. The total cost of work performed or to be performed under a contract or subcontract to which these principles are applicable is the net sum of the allowable direct costs incident to the performance of the contract or subcontract, plus the properly allocable portion of allowable indirect costs, less applicable income and other credits. According to the circumstances, these costs may be stated either in terms of the aggregate for an entire contract or major portions thereof in terms of individual units of products or services covered by the contract with equal application of these principles and standards.

15-202 Factors Determining Allowability of Costs. Factors to be considered in determining the allowability of costs include (a) conformity with the meaning of total cost outlined in paragraph 15-201; (b) reasonableness in the amounts of particular elements of costs; (c) [Deleted]; (d) application of generally accepted accounting principles and practices; (e) avoidance of duplication of allowances for the same price component in both cost and profit; (f) exclusions of specific elements of costs as a matter of public policy, as set forth in this section; and (g) exercise of good business judgment in incurrence of the cost. However, any specific contract provision relating to cost will be controlling.

15-203 Contractor's Accounting System. Subject to the observance of the cost principles and standards set forth in this section, any system of accounts and any method of cost accounting or estimating will be acceptable, if they are in accord with generally accepted accounting principles and practices and if they produce equitable results under the particular circumstances.

15-204 Direct vs. Indirect Costs. Every acceptable method of cost accounting or estimating embodies the principle of direct costing of certain materials and subcontract work. Direct costing of productive labor is also general practice. Other expenses may be costed directly sometimes, but generally many of them are allocated to products, job orders, or contracts, etc., on an arithmetical basis in ratio to appropriate measures of performance — for this reason, such allocated expenses are termed "indirect costs."

15-205 Principle of Direct Costing. Every major item of cost (actual or estimated) should be identified with the unit being costed, whether it be the product, a job order, or a contract, when such items of cost do not, in fact, have substantially proportionate applicability to more than one class of work. This principle may often be applicable to such elements of expense (when of major consequence), as travel, commissions, advertising, engineering services, etc., as well as the normal items of materials and productive labor. This principle should be applied equally to the costing of both defense and nondefense products or services by any contractor who is engaged in mixed production. There are no absolute rules by which to determine which items or elements of cost should be direct costed. In applying the principle, any contractor must follow a

consistent pattern of costing if the results are to be equitable. In some instances, this principle may be applied by direct costing only the major items of a given cost element to all products, leaving minor items, if appropriate, subject to indirect cost allocations.

15-206 Indirect Costs. Indirect costs, which have the character of common or joint costs, usually consist of indirect materials, indirect labor, and other items. These costs generally are grouped in classes, as follows:

(a) Manufacturing (shop, laboratory) expenses (often termed "manufacturing overhead" or "burden"), which are incurred in fabricating the article or performing the service;

(b) Engineering expenses to extent not included in (a) or (c);

(c) Selling and distribution expenses incurred in marketing the products manufactured;

(d) General and administrative expenses incurred in the over-all management, supervision, and conduct of the business;

(e) Financial and other expenses.

15-207 Methods of Allocation of Indirect Costs. No general rules regarding allocation of indirect costs to products, job orders, or contracts can be stated for all individual cases, because the nature of the particular operations and the actual conditions in each instance determine the most suitable method or methods to be employed. The method of allocation of indirect costs will be acceptable if it is in accord with generally accepted accounting principles and practices and if it produces equitable results under the particular circumstances. (See also paragraphs 15-313.1, 15-313.2, 15-320.1 and 15-330.1.)

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(a) Cash discounts taken. However, if the contractor does not exercise reasonable precautions in taking advantage of cash discounts available, all cash discounts lost may be deducted in determining allowable costs;

(b) Trade discounts, rebates, refunds, and allowances on material purchased;

(c) Credits for scrap and salvage and materials returned to vendors;

(d) Credits arising from differences between book and physical inventories.

15-311.2 Pricing:

(a) In determining historical costs, any generally recognized method of pricing materials issued from stock may be employed for determining actual cost, provided it has been consistently used by the contractor, is acceptable for internal revenue purposes, and does not discriminate against the Government. When materials in inventory at the commencement date of a Government contract have a provable replacement cost significantly different from book cost, either the contractor or the Government may elect to use such replacement cost in lieu of book cost in pricing materials issued from such inventory. However, such election including identification of the types or kinds of materials involved should be made at the time the contract is entered into and provided for in the contract. When materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be changed to the contract. Costs of subcontracts for components should be determined similarly; proyided that, when subcontracts are performed under contract pricing arrangements other than firm fixed prices, the negotiation of prices or determination of costs shall conform to this section so far as considerations of costs are concerned.

(b) For purposes of estimating material cost, either current market

PART 3 - APPLICATIONS OF COST PRINCIPLES TO SUPPLY CONTRACTS AND RESEARCH AND DEVELOPMENT CONTRACTS WITH COMMERCIAL ORGANIZATIONS

15-300 Scope of Part. This part states, in some detail, applications of the general cost principles and standards set forth in Part 2 of this Section to supply contracts and research and development contracts with commercial organizations. It is impracticable and unnecessary to cover every element of cost or possible situation that might arise in a particular case. However, when this part does not furnish specific guidance, the philosophy expressed or implied in the principles and standards comprising Part 2 of this Section and the more detailed discussions of similar or related items in this Part 3 should be followed.

15-310 Manufacturing Costs:

15-311 Materials. The net costs of materials (including components), both direct and indirect, used or consumed in performance of Government contracts are allowable on the basis hereinafter outlined. Cost may include such collateral items as transportation, insurance, purchasing, receiving, storage, warehousing and adjustments of inventory accounts reasonably related to the period of contract performance resulting from variations at cost between book and physical inventories. (See paragraph 15-311.2 for basis of materials pricing.) If the cost of collateral items is included in material costs, no additional allowance therefor may be made in the determination of manufacturing burden. If such items are not included in material costs, they are properly included in overhead.

15-311.1 Material Credits. In establishing material cost, effect shall be given, as appropriate, directly, or indirectly as a reduction of total manufacturing costs, to such items as:

[(iii) The prices of other suppliers for the same or substantially similar items can be established through quotations, correspondence, or by other means.

[(2) In case the transferor is a separate corporation or partnership in which nonaffiliated parties hold a minority interest of 10 percent or more, a reasonable margin of profit on such sales in recognition of the minority interest may be permitted by agreement notwithstanding inability to determine market prices in accordance with paragraph (1) above.

[(3) Under special circumstances, inter-company or interdivisional sales or transfers may be priced to include a profit to the transferor when no evidence exists as to market prices, provided, in the opinion of the contracting officer, the total price paid by the Government for work performed under the contract of the transferee is not increased by such pricing procedures. This departure from the basis of pricing such sales or transfers at market prices determined in accordance with paragraph (1) above or cost to the transferor should be authorized only where all of the following circumstances exist:

[(i) The management of the transferring unit is significantly independent (though not necessarily autonomous) of the acquiring unit;

[(ii) It is the contractor's long established practice to price inter-company transfers at other than cost and to apply such practice to transfers of commercial work as well;

[(iii) Routing of work through the integrated unit is not affected by departure from the cost basis with consequent increase in total actual production costs of the work.

prices or anticipated acquisition cost may be used, but the basis of pricing must be disclosed. In order to avoid the allowance of contingencies in firm forward pricing actions in which the anticipated replacement cost may be expected to be substantially greater than current market, materials escalation provisions may be made a part of the contract. However, situations involving changes in material costs which are reasonably certain and determinable, or relatively minor in amount, may warrant recognition being given thereto in making estimates.

[(c) In cases in which a contractor has integrated operations involving inter-company or inter-divisional sales or transfers of materials, such materials may be priced to include a profit to the transferor company or division under appropriate circumstances outlined below. In such event, such sales or transfers shall be treated as subcontracts in determining the profit or fee for work performed under the contract of the transferee. In other cases, where the conditions outlined below do not exist, inter-company or inter-divisional sales or transfers of materials shall be stated at cost to the transferor for purposes of contract pricing of the transferee.

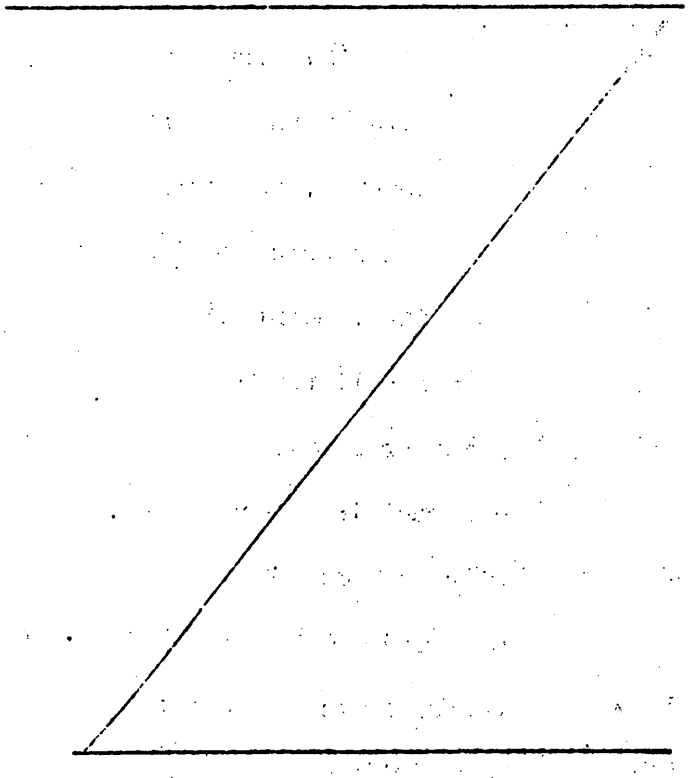
[(1) When inter-company or inter-divisional sales or transfers of materials are priced in excess of cost, they shall be priced, insofar as possible, upon the basis of the lowest market price determined in consideration of the following:

[(i) The price is the transferor's lowest sales price to nonaffiliated customers for the same or a similar item, quantity and quality considered;

[(ii) The price for the same or substantially similar items is quoted at reasonable intervals in financial or trade publications;

the basic salary or wage and all fringe benefits will be considered in determining the reasonableness of the earnings of an individual in relation to services rendered. Direct labor cost consists of salaries and wages identified specifically with the performance of a contract, job, or product. Labor services utilized for joint objectives may be treated as indirect costs if specific identification is impractical or uneconomical and the results of allocation are equitable.

(b) In determining historical costs, labor will generally be charged at actual rates paid by the contractor. However, if it is the contractor's consistent practice to charge for performance of groups of



Determination of the foregoing facts in any case may require submission of cost data of the transferor.7

(c) Inter-company or inter-divisional sales or transfers of materials shall ordinarily be stated on the basis of cost to the transferor. However, under some circumstances, departure from the cost basis may be appropriate but such departure is permissible only if specifically authorized by the contracting officer. Examples of circumstances which may justify departure from the cost basis are as follows:

(1) Cases where the transferor is an affiliated or subsidiary corporation in which non-affiliated parties hold a minority interest of 10 percent or more.

(2) Transactions involving items regularly manufactured and sold by the contractor through commercial channels. In these cases, however, the price must not exceed the lower of (i) the transferor's sales price to its most favored customer for the same or a similar item, quantity and quality considered, or (ii) the prices of other suppliers for the same or substantially similar items.

Departures pursuant to the foregoing, should be authorized at the time contract is entered into, should include identification of the types or kinds of materials involved and the names of the suppliers, and should be provided for in the contract. Also in such event where such sales or transfers are authorized they shall be treated as subcontracts in negotiating the profit or fee for work performed under the contract of the transferee.

15-312 Labor:

(a) The cost of obtaining the services of any individual includes the base salary or wage, plus the cost of all fringe benefits. Therefore, both

(a) Each class of compensation is preferably to be accrued as a cost over the period in which it is earned.

(b) Where it is the contractor's established practice to record the costs at the time of payment, such practice may be acceptable. This is the most commonly used method of accounting for "fringe benefits," but its use might result in inequities in some cases. For example, if a Government contract was performed over the summer months during which most of the contractor's employees took vacations or military leaves, recognition of the cost at time of payment would be inequitable to the Government. On the other hand, if the contract or contracts extended over approximately one year and the proportion of Government work to the contractor's commercial work remained stable, this method might be equitable.

(c) When the costs of any of the elements of fringe benefits are greater or lesser with respect to defense business as compared with non-defense business, such costs should be allocated, so far as feasible and appropriate, between the two classes of business before further allocation of such costs to individual contracts or products. If this method of cost allocation is used, it should be used consistently for all elements of fringe benefits having a different cost relationship of defense business as compared with nondefense business.

(d) It may be practicable to negotiate an equitable rate for fringe benefits based upon experience for a representative period in lieu of individual consideration for each item. Changed conditions and circumstances would have to be considered in making such a determination. The experience rate would then be applied to the more direct labor costs to determine the allowable costs. The use of such rate should be subject

labor at an average rate, or to use standard labor rates, with consequent savings in clerical expense or improvement in labor control, such methods may be used, provided labor groupings and the adjustment for cost variances result in a reasonably accurate assessment of total charges.

(c) When labor costs are required for making cost estimates, the use of standard labor rates and standard time allowances (appropriately adjusted for experience variances) or reliable engineering estimates is acceptable. Ordinarily the use of wage rates higher than current going-rates will not be permitted for estimating purposes. In order to avoid substantial allowances for labor rate contingencies, labor escalation clauses may be utilized in fixed-price type contracts. However, situations involving increases in wage rates which are reasonably certain and determinable or relatively minor in amount may warrant recognition being given thereto in making estimates.

15-312.1 Fringe Benefits—Vacations, Holidays, Sick Leave, Military Leave, and Employee Insurance. Compensation of these types is allowable to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment.

The cost of "fringe benefits" is part of the cost of the work performed by the employee while on the job, and must be considered as having a direct relationship to such work. However, in recognition of the different accounting treatments accorded fringe benefits by different contractors, the cost thereof may be allocated to Government contracts on any of the following bases, provided equitable results are achieved:

unreasonable or otherwise unallowable under this paragraph, and are allocable to all classes of work. Costs of such plans established by nonprofit or other organizations not subject to payment of Federal income taxes are also allowable except to the extent determined to be unreasonable or otherwise unallowable under this paragraph, and are allocable to all classes of work.

(b) Pension or retirement plans of a contractor which are subject to approval of the Bureau of Internal Revenue must have been so approved before costs under the plans may be allowed as charges under defense contracts. Many plans of nonprofit or other tax exempt organizations are also reviewed and approved by the Bureau of Internal Revenue - when not so reviewed and approved, each such plan will be reviewed, and approved or disapproved, by the Department to which audit cognizance is assigned, using, insofar as applicable, the criteria and standards of the Internal Revenue Code and the regulations of the Bureau of Internal Revenue. In any case where the Bureau of Internal Revenue withdraws approval of a plan, approval of amounts allocated to contract costs or estimates will be withdrawn accordingly.

(c) The approval of a pension or retirement plan by the Bureau of Internal Revenue will generally be the only approval required by the Departments; however, the right is reserved to require submission of any such plan for consideration by a Department and to disapprove such plan in its entirety or any feature thereof whenever the circumstances in a particular case are deemed to warrant such action. Such consideration will be the responsibility of the Department to which audit cognizance

to revision in light of changed conditions.

15-312.2 Fringe Benefits - Bonuses. Bonuses to employees, such as production incentives and suggestion or safety awards, represent a part of their total compensation and are an allowable cost under Government contracts when appropriately allocated to all classes of work, if they are: (1) reasonable in amount, (2) paid in connection with an established plan which was in effect before the award of the Government contract under consideration, and the plan is consistently followed by the contractor, (3) paid for current services rendered by the employee, (4) available to all employees of the contractor, or to all employees within a group or salary classification, provided such group or salary classification is not unreasonably restricted, and (5) represented by current expenditures of funds rather than by accrual of expenses or issuance of stock.

Bonuses will not be allowed as a cost on Government contracts when they are contingent upon profits and constitute a distribution of profit rather than reasonable compensation for services. Bonuses will not be allowed when they are restricted to officer or other employee stockholders or are distributed in relation to stockholdings.

15-312.3 Fringe Benefits - Pension and Retirement Plans.

(a) The costs of pension and retirement plans, including reasonable incidental benefits, such as disability, withdrawal, insurance or survivorship allowances which are deductible from taxable income in accordance with the Internal Revenue Code and the regulations of the Bureau of Internal Revenue, are allowable except to the extent determined to be

(h) Credits which arise from various sources, such as dividends and cancellation of employee benefits, which have not vested at the time of termination of their employment, must be taken into account in an equitable manner in arriving at pension and retirement costs. Special provision for these credits is usually necessary when the contractor's organization has substantially expanded for the performance of defense contracts and there is reasonable expectation that the employment of a large number of the additional employees will be terminated upon curtailment of defense work. Under these circumstances, 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. There are two general methods which may be used, individually or in combination, in making such arrangements:

(i) A lump sum or percentage discount (of current pension cost) allowance negotiated and agreed upon in advance. Determination of such allowance is not often an actuarial problem involving a calculation based upon known factors, but rather is an attempt to reach a negotiated agreement as to various uncertain or variable factors in a complex situation. Mass lay-off of employees which may result in the incurrence of severance payments costs should generally lead to a reduction in pension costs through an increase in pension credits.

(ii) A retrospective determination at some time in the future when a more accurate estimate can be made by virtue of experience which may have developed. Until such determination, current costs may be

is assigned, and the subsequent action taken by that Department will generally be accepted by the other Departments.

(d) Approval of a pension or retirement plan by the Bureau of Internal Revenue or by the Departments does not imply that the cost thereof for any particular year will be allowable for apportionment to contract costs or estimates, except to the extent costs for that year meet all other requirements of the Bureau of Internal Revenue as a deduction for income tax purposes, and are allowable under the provisions of this paragraph and the other provisions of this section.

(e) Pension and retirement costs constitute a part of the total compensation by a contractor to any individual covered by the plan, and accordingly are subject to the provisions of this section with respect to reasonableness of the total compensation paid to the individual for the services rendered (see ASPR 15-312 and ASPR 15-330.2).

(f) Where contributions to pension or retirement plans are based on profits, providing that provisions of the Internal Revenue Code and regulations of the Bureau of Internal Revenue have been met, the amount allowable for apportionment to contracts in any one year shall be the amount contributed to the pension trust(s) for that year, but not to exceed 15 percent of the total compensation otherwise paid or accrued in that year to the individuals covered under the plan(s).

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

sentative past period. In determining historical costs, such recurring nominal severance payments actually made are allowable. Where the Contractor provides for accruals of severance payments in lieu of recording the cost thereof at the time of payment, such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made over a representative past period. Generally, the cost of severance payments made during the performance of defense contracts should be allocated to all classes of work being performed at the time of payment since it is a reduction of total work which causes the severance. The following paragraphs are devoted to the treatment of severance payments anticipated to be necessary upon the completion or termination of defense production.

(b) Mass severances.

(1) Fixed-price type contracts. The considerable uncertainty as to whether mass severance payments will ever have to be made is such that no consideration will be given thereto in making cost estimates or in determining historical costs. This risk is one which the contractor must assume and for which he is compensated in the profit. However, where, because of termination of the contract for convenience of the Government, the Contractor does not have the opportunity to earn the profit contemplated by the contracting parties at the inception of the contract, costs of severance payments actually made and which are allocable to the terminated contract are allowable. In allocating costs to the terminated contract(s) the costs shall be assigned to the period in which the severance pay was actually earned and apportioned to all business of the Contractor performed during that period. The cost apportioned to the period of of production of the terminated contract(s) should then be allocated

allowed provided an appropriate contractual arrangement can be agreed upon which reserves the Government's right to these credits. Such recapture provisions will vary in the extent and duration of application and time of determination. For example, such provisions may be contract-wide or contractor-wide and the determination may be made at termination of a defense contract or defense contracts, at mass lay-off of contractor's employees or at the time of substantial decline in proportion of contractor's total sales under defense contracts.

15-312.4 Fringe Benefits - Severance Pay. The cost of severance pay will be considered only to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment. Theoretically, the right to severance pay is earned during the entire period of employment of the indivual or, when based upon specified years of service, is earned during those years. In theory, the cost of severance payments should be recorded in the contractor's accounts during the periods in which the employee earned the right to such payments. However, few contractors accrue severance payments because (1) the clerical expense involved in identifying and recording the cost for each employee is not justified; and (2) there is considerable doubt that any substantial payments will have to be made since payment is solely contingent upon future events.

(a) Recurring, nominal severance payments. The cost of severance payments arising from regular employee severances as distinct from mass layoffs may be included in cost estimates only to the extent that such estimates are based upon severance payments actually made over a repre-

15-312.5 Fringe Benefits -- Premium Payments for Overtime and Extra-Shift Work. Costs of this nature consist of only the premium portion of overtime and extra-shift payments or accruals to employees, not the straight-time portion. Thus, if the rate for overtime work is time-and-one-half of the regular rate, the premium portion is the additional one-half. Similarly, if the wage rate for a second shift is twenty cents an hour above the regular rate, this additional amount is the premium.

Overtime and shift premiums are allowable if authorized or approved pursuant to the requirements of paragraph 12-102.

Such premiums may be classified as either direct or indirect labor cost, but overtime premiums should be separately stated in either event. When treated as direct labor cost, overtime premiums should not be included in the base for distribution of overhead. The amount of overtime and shift premium cost charged on Government contracts shall not be disproportionate to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant.

15-312.6 Fringe Benefits -- Unclaimed Wages. Costs under cost-reimbursement type contracts should reflect a credit for unclaimed wages based upon agreement as to the amount thereof reasonably expected not to be paid subsequent to the date of completion or settlement. In this event, all unclaimed wage liability rests with the contractor. When such an agreement cannot be reached, the Government will assume liability for payment of unclaimed wages and eliminate all allowances therefor from reimbursement to the contractor.

between the terminated contract(s) and all other business of the Contractor. If the termination claim is prepared on the total cost basis, the amount so allocated is properly allowable. If the claim is prepared on the inventory basis, the amount allocated to the terminated contract must be further subdivided between that portion of production billed as completed units and the portion to be inventoried. Only the severance pay costs applicable to the latter portion is includible in the termination claim.

(2) Cost-reimbursement type contracts. Mass severance pay costs will not be considered in the evaluation of cost estimates; nor will any allowance be made on an estimated basis in determining historical costs. Likewise, the contingency of severance payments will not be considered to be a risk assumed by the contractor in determining the fee since the Government assumes the risk. The cost of severance payments actually made upon cessation of Government work where there is no reasonable prospect of continuing employment on other work of the Contractor are allowable. The allowable cost shall be determined by assigning the total cost to the period in which the severance pay was actually earned and apportioning such cost to cost-reimbursement type contracts and all other business of the contractor performed during that period.

A reservation in the final release of claims (see ASPR 7-203.4) may be made in the case of completed cost-reimbursement type contracts where it is reasonable to assume that severance payments allocable to the contract will have to be made at some future date.

consistent pattern of costing if the results are to be equitable. In some instances, this principle may be applied by direct costing only the major items of a given cost element to all products, leaving minor items, if appropriate, subject to indirect cost allocations.

15-206 Indirect Costs. Indirect costs, which have the character of common or joint costs, usually consist of indirect materials, indirect labor, and other items. These costs generally are grouped in classes, as follows:

(a) Manufacturing (shop, laboratory) expenses (often termed "manufacturing overhead" or "burden"), which are incurred in fabricating the article or performing the service;

(b) Engineering expenses to extent not included in (a) or (c);

(c) Selling and distribution expenses incurred in marketing the products manufactured;

(d) General and administrative expenses incurred in the over-all management, supervision, and conduct of the business;

(e) Financial and other expenses.

15-207 Methods of Allocation of Indirect Costs. No general rules regarding allocation of indirect costs to products, job orders, or contracts can be stated for all individual cases, because the nature of the particular operations and the actual conditions in each instance determine the most suitable method or methods to be employed. The method of allocation of indirect costs will be acceptable if it is in accord with generally accepted accounting principles and practices and if it produces equitable results under the particular circumstances. (See also paragraphs 15-313.1, 15-313.2, 15-320.1 and 15-330.1.)

(a) Cash discounts taken. However, if the contractor does not exercise reasonable precautions in taking advantage of cash discounts available, all cash discounts lost may be deducted in determining allowable costs;

(b) Trade discounts, rebates, refunds, and allowances on material purchased;

(c) Credits for scrap and salvage and materials returned to vendors;

(d) Credits arising from differences between book and physical inventories.

15-311.2 Pricing:

(a) In determining historical costs, any generally recognized method of pricing materials issued from stock may be employed for determining actual cost, provided it has been consistently used by the contractor, is acceptable for internal revenue purposes, and does not discriminate against the Government. When materials in inventory at the commencement date of a Government contract have a provable replacement cost significantly different from book cost, either the contractor or the Government may elect to use such replacement cost in lieu of book cost in pricing materials issued from such inventory. However, such election including identification of the types or kinds of materials involved should be made at the time the contract is entered into and provided for in the contract. When materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be changed to the contract. Costs of subcontracts for components should be determined similarly; proyided that, when subcontracts are performed under contract pricing arrangements other than firm fixed prices, the negotiation of prices or determination of costs shall conform to this section so far as considerations of costs are concerned.

(b) For purposes of estimating material cost, either current market

PART 3 - APPLICATIONS OF COST PRINCIPLES TO SUPPLY CONTRACTS AND RESEARCH AND DEVELOPMENT CONTRACTS WITH COMMERCIAL ORGANIZATIONS

15-300 Scope of Part. This part states, in some detail, applications of the general cost principles and standards set forth in Part 2 of this Section to supply contracts and research and development contracts with commercial organizations. It is impracticable and unnecessary to cover every element of cost or possible situation that might arise in a particular case. However, when this part does not furnish specific guidance, the philosophy expressed or implied in the principles and standards comprising Part 2 of this Section and the more detailed discussions of similar or related items in this Part 3 should be followed.

15-310 Manufacturing Costs:

15-311 Materials. The net costs of materials (including components), both direct and indirect, used or consumed in performance of Government contracts are allowable on the basis hereinafter outlined. Cost may include such collateral items as transportation, insurance, purchasing, receiving, storage, warehousing and adjustments of inventory accounts reasonably related to the period of contract performance resulting from variations at cost between book and physical inventories. (See paragraph 15-311.2 for basis of materials pricing.) If the cost of collateral items is included in material costs, no additional allowance therefor may be made in the determination of manufacturing burden. If such items are not included in material costs, they are properly included in overhead.

15-311.1 Material Credits. In establishing material cost, effect shall be given, as appropriate, directly, or indirectly as a reduction of total manufacturing costs, to such items as:

[(iii) The prices of other suppliers for the same or substantially similar items can be established through quotations, correspondence, or by other means.

[(2) In case the transferor is a separate corporation or partnership in which nonaffiliated parties hold a minority interest of 10 percent or more, a reasonable margin of profit on such sales in recognition of the minority interest may be permitted by agreement notwithstanding inability to determine market prices in accordance with paragraph (1) above.

[(3) Under special circumstances, inter-company or interdivisional sales or transfers may be priced to include a profit to the transferor when no evidence exists as to market prices, provided, in the opinion of the contracting officer, the total price paid by the Government for work performed under the contract of the transferee is not increased by such pricing procedures. This departure from the basis of pricing such sales or transfers at market prices determined in accordance with paragraph (1) above or cost to the transferor should be authorized only where all of the following circumstances exist:

[(i) The management of the transferring unit is significantly independent (though not necessarily autonomous) of the acquiring unit;

[(ii) It is the contractor's long established practice to price inter-company transfers at other than cost and to apply such practice to transfers of commercial work as well;

[(iii) Routing of work through the integrated unit is not affected by departure from the cost basis with consequent increase in total actual production costs of the work.

prices or anticipated acquisition cost may be used, but the basis of pricing must be disclosed. In order to avoid the allowance of contingencies in firm forward pricing actions in which the anticipated replacement cost may be expected to be substantially greater than current market, materials escalation provisions may be made a part of the contract. However, situations involving changes in material costs which are reasonably certain and determinable, or relatively minor in amount, may warrant recognition being given thereto in making estimates.

[(c) In cases in which a contractor has integrated operations involving inter-company or inter-divisional sales or transfers of materials, such materials may be priced to include a profit to the transferor company or division under appropriate circumstances outlined below. In such event, such sales or transfers shall be treated as subcontracts in determining the profit or fee for work performed under the contract of the transferee. In other cases, where the conditions outlined below do not exist, inter-company or inter-divisional sales or transfers of materials shall be stated at cost to the transferor for purposes of contract pricing of the transferee.

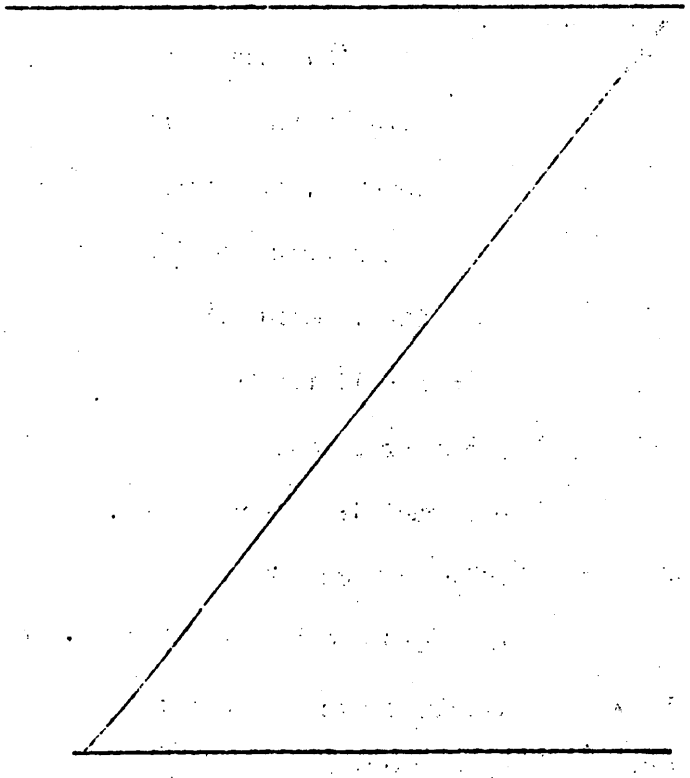
[(1) When inter-company or inter-divisional sales or transfers of materials are priced in excess of cost, they shall be priced, insofar as possible, upon the basis of the lowest market price determined in consideration of the following:

[(i) The price is the transferor's lowest sales price to nonaffiliated customers for the same or a similar item, quantity and quality considered;

[(ii) The price for the same or substantially similar items is quoted at reasonable intervals in financial or trade publications;

the basic salary or wage and all fringe benefits will be considered in determining the reasonableness of the earnings of an individual in relation to services rendered. Direct labor cost consists of salaries and wages identified specifically with the performance of a contract, job, or product. Labor services utilized for joint objectives may be treated as indirect costs if specific identification is impractical or uneconomical and the results of allocation are equitable.

(b) In determining historical costs, labor will generally be charged at actual rates paid by the contractor. However, if it is the contractor's consistent practice to charge for performance of groups of



Determination of the foregoing facts in any case may require submission of cost data of the transferor.7

(c) Inter-company or inter-divisional sales or transfers of materials shall ordinarily be stated on the basis of cost to the transferor. However, under some circumstances, departure from the cost basis may be appropriate but such departure is permissible only if specifically authorized by the contracting officer. Examples of circumstances which may justify departure from the cost basis are as follows:

(1) Cases where the transferor is an affiliated or subsidiary corporation in which non-affiliated parties hold a minority interest of 10 percent or more.

(2) Transactions involving items regularly manufactured and sold by the contractor through commercial channels. In these cases, however, the price must not exceed the lower of (i) the transferor's sales price to its most favored customer for the same or a similar item, quantity and quality considered, or (ii) the prices of other suppliers for the same or substantially similar items.

Departures pursuant to the foregoing, should be authorized at the time contract is entered into, should include identification of the types or kinds of materials involved and the names of the suppliers, and should be provided for in the contract. Also in such event where such sales or transfers are authorized they shall be treated as subcontracts in negotiating the profit or fee for work performed under the contract of the transferee.

15-312 Labor:

(a) The cost of obtaining the services of any individual includes the base salary or wage, plus the cost of all fringe benefits. Therefore, both

(a) Each class of compensation is preferably to be accrued as a cost over the period in which it is earned.

(b) Where it is the contractor's established practice to record the costs at the time of payment, such practice may be acceptable. This is the most commonly used method of accounting for "fringe benefits," but its use might result in inequities in some cases. For example, if a Government contract was performed over the summer months during which most of the contractor's employees took vacations or military leaves, recognition of the cost at time of payment would be inequitable to the Government. On the other hand, if the contract or contracts extended over approximately one year and the proportion of Government work to the contractor's commercial work remained stable, this method might be equitable.

(c) When the costs of any of the elements of fringe benefits are greater or lesser with respect to defense business as compared with non-defense business, such costs should be allocated, so far as feasible and appropriate, between the two classes of business before further allocation of such costs to individual contracts or products. If this method of cost allocation is used, it should be used consistently for all elements of fringe benefits having a different cost relationship of defense business as compared with nondefense business.

(d) It may be practicable to negotiate an equitable rate for fringe benefits based upon experience for a representative period in lieu of individual consideration for each item. Changed conditions and circumstances would have to be considered in making such a determination. The experience rate would then be applied to the more direct labor costs to determine the allowable costs. The use of such rate should be subject

labor at an average rate, or to use standard labor rates, with consequent savings in clerical expense or improvement in labor control, such methods may be used, provided labor groupings and the adjustment for cost variances result in a reasonably accurate assessment of total charges.

(c) When labor costs are required for making cost estimates, the use of standard labor rates and standard time allowances (appropriately adjusted for experience variances) or reliable engineering estimates is acceptable. Ordinarily the use of wage rates higher than current going-rates will not be permitted for estimating purposes. In order to avoid substantial allowances for labor rate contingencies, labor escalation clauses may be utilized in fixed-price type contracts. However, situations involving increases in wage rates which are reasonably certain and determinable or relatively minor in amount may warrant recognition being given thereto in making estimates.

15-312.1 Fringe Benefits—Vacations, Holidays, Sick Leave, Military Leave, and Employee Insurance. Compensation of these types is allowable to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment.

The cost of "fringe benefits" is part of the cost of the work performed by the employee while on the job, and must be considered as having a direct relationship to such work. However, in recognition of the different accounting treatments accorded fringe benefits by different contractors, the cost thereof may be allocated to Government contracts on any of the following bases, provided equitable results are achieved:

unreasonable or otherwise unallowable under this paragraph, and are allocable to all classes of work. Costs of such plans established by nonprofit or other organizations not subject to payment of Federal income taxes are also allowable except to the extent determined to be unreasonable or otherwise unallowable under this paragraph, and are allocable to all classes of work.

(b) Pension or retirement plans of a contractor which are subject to approval of the Bureau of Internal Revenue must have been so approved before costs under the plans may be allowed as charges under defense contracts. Many plans of nonprofit or other tax exempt organizations are also reviewed and approved by the Bureau of Internal Revenue - when not so reviewed and approved, each such plan will be reviewed, and approved or disapproved, by the Department to which audit cognizance is assigned, using, insofar as applicable, the criteria and standards of the Internal Revenue Code and the regulations of the Bureau of Internal Revenue. In any case where the Bureau of Internal Revenue withdraws approval of a plan, approval of amounts allocated to contract costs or estimates will be withdrawn accordingly.

(c) The approval of a pension or retirement plan by the Bureau of Internal Revenue will generally be the only approval required by the Departments; however, the right is reserved to require submission of any such plan for consideration by a Department and to disapprove such plan in its entirety or any feature thereof whenever the circumstances in a particular case are deemed to warrant such action. Such consideration will be the responsibility of the Department to which audit cognizance

to revision in light of changed conditions.

15-312.2 Fringe Benefits - Bonuses. Bonuses to employees, such as production incentives and suggestion or safety awards, represent a part of their total compensation and are an allowable cost under Government contracts when appropriately allocated to all classes of work, if they are: (1) reasonable in amount, (2) paid in connection with an established plan which was in effect before the award of the Government contract under consideration, and the plan is consistently followed by the contractor, (3) paid for current services rendered by the employee, (4) available to all employees of the contractor, or to all employees within a group or salary classification, provided such group or salary classification is not unreasonably restricted, and (5) represented by current expenditures of funds rather than by accrual of expenses or issuance of stock.

Bonuses will not be allowed as a cost on Government contracts when they are contingent upon profits and constitute a distribution of profit rather than reasonable compensation for services. Bonuses will not be allowed when they are restricted to officer or other employee stockholders or are distributed in relation to stockholdings.

15-312.3 Fringe Benefits - Pension and Retirement Plans.

(a) The costs of pension and retirement plans, including reasonable incidental benefits, such as disability, withdrawal, insurance or survivorship allowances which are deductible from taxable income in accordance with the Internal Revenue Code and the regulations of the Bureau of Internal Revenue, are allowable except to the extent determined to be

(h) Credits which arise from various sources, such as dividends and cancellation of employee benefits, which have not vested at the time of termination of their employment, must be taken into account in an equitable manner in arriving at pension and retirement costs. Special provision for these credits is usually necessary when the contractor's organization has substantially expanded for the performance of defense contracts and there is reasonable expectation that the employment of a large number of the additional employees will be terminated upon curtailment of defense work. Under these circumstances, 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. There are two general methods which may be used, individually or in combination, in making such arrangements:

(i) A lump sum or percentage discount (of current pension cost) allowance negotiated and agreed upon in advance. Determination of such allowance is not often an actuarial problem involving a calculation based upon known factors, but rather is an attempt to reach a negotiated agreement as to various uncertain or variable factors in a complex situation. Mass lay-off of employees which may result in the incurrence of severance payments costs should generally lead to a reduction in pension costs through an increase in pension credits.

(ii) A retrospective determination at some time in the future when a more accurate estimate can be made by virtue of experience which may have developed. Until such determination, current costs may be

is assigned, and the subsequent action taken by that Department will generally be accepted by the other Departments.

(d) Approval of a pension or retirement plan by the Bureau of Internal Revenue or by the Departments does not imply that the cost thereof for any particular year will be allowable for apportionment to contract costs or estimates, except to the extent costs for that year meet all other requirements of the Bureau of Internal Revenue as a deduction for income tax purposes, and are allowable under the provisions of this paragraph and the other provisions of this section.

(e) Pension and retirement costs constitute a part of the total compensation by a contractor to any individual covered by the plan, and accordingly are subject to the provisions of this section with respect to reasonableness of the total compensation paid to the individual for the services rendered (see ASPR 15-312 and ASPR 15-330.2).

(f) Where contributions to pension or retirement plans are based on profits, providing that provisions of the Internal Revenue Code and regulations of the Bureau of Internal Revenue have been met, the amount allowable for apportionment to contracts in any one year shall be the amount contributed to the pension trust(s) for that year, but not to exceed 15 percent of the total compensation otherwise paid or accrued in that year to the individuals covered under the plan(s).

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

sentative past period. In determining historical costs, such recurring nominal severance payments actually made are allowable. Where the Contractor provides for accruals of severance payments in lieu of recording the cost thereof at the time of payment, such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made over a representative past period. Generally, the cost of severance payments made during the performance of defense contracts should be allocated to all classes of work being performed at the time of payment since it is a reduction of total work which causes the severance. The following paragraphs are devoted to the treatment of severance payments anticipated to be necessary upon the completion or termination of defense production.

(b) Mass severances.

(1) Fixed-price type contracts. The considerable uncertainty as to whether mass severance payments will ever have to be made is such that no consideration will be given thereto in making cost estimates or in determining historical costs. This risk is one which the contractor must assume and for which he is compensated in the profit. However, where, because of termination of the contract for convenience of the Government, the Contractor does not have the opportunity to earn the profit contemplated by the contracting parties at the inception of the contract, costs of severance payments actually made and which are allocable to the terminated contract are allowable. In allocating costs to the terminated contract(s) the costs shall be assigned to the period in which the severance pay was actually earned and apportioned to all business of the Contractor performed during that period. The cost apportioned to the period of of production of the terminated contract(s) should then be allocated

allowed provided an appropriate contractual arrangement can be agreed upon which reserves the Government's right to these credits. Such recapture provisions will vary in the extent and duration of application and time of determination. For example, such provisions may be contract-wide or contractor-wide and the determination may be made at termination of a defense contract or defense contracts, at mass lay-off of contractor's employees or at the time of substantial decline in proportion of contractor's total sales under defense contracts.

15-312.4 Fringe Benefits - Severance Pay. The cost of severance pay will be considered only to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment. Theoretically, the right to severance pay is earned during the entire period of employment of the indivual or, when based upon specified years of service, is earned during those years. In theory, the cost of severance payments should be recorded in the contractor's accounts during the periods in which the employee earned the right to such payments. However, few contractors accrue severance payments because (1) the clerical expense involved in identifying and recording the cost for each employee is not justified; and (2) there is considerable doubt that any substantial payments will have to be made since payment is solely contingent upon future events.

(a) Recurring, nominal severance payments. The cost of severance payments arising from regular employee severances as distinct from mass layoffs may be included in cost estimates only to the extent that such estimates are based upon severance payments actually made over a repre-

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Overtime and shift premiums are allowable if authorized or approved pursuant to the requirements of paragraph 12-102.

Such premiums may be classified as either direct or indirect labor cost, but overtime premiums should be separately stated in either event. When treated as direct labor cost, overtime premiums should not be included in the base for distribution of overhead. The amount of overtime and shift premium cost charged on Government contracts shall not be disproportionate to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant.

15-312.6 Fringe Benefits -- Unclaimed Wages. Costs under cost-reimbursement type contracts should reflect a credit for unclaimed wages based upon agreement as to the amount thereof reasonably expected not to be paid subsequent to the date of completion or settlement. In this event, all unclaimed wage liability rests with the contractor. When such an agreement cannot be reached, the Government will assume liability for payment of unclaimed wages and eliminate all allowances therefor from reimbursement to the contractor.

between the terminated contract(s) and all other business of the Contractor. If the termination claim is prepared on the total cost basis, the amount so allocated is properly allowable. If the claim is prepared on the inventory basis, the amount allocated to the terminated contract must be further subdivided between that portion of production billed as completed units and the portion to be inventoried. Only the severance pay costs applicable to the latter portion is includible in the termination claim.

(2) Cost-reimbursement type contracts. Mass severance pay costs will not be considered in the evaluation of cost estimates; nor will any allowance be made on an estimated basis in determining historical costs. Likewise, the contingency of severance payments will not be considered to be a risk assumed by the contractor in determining the fee since the Government assumes the risk. The cost of severance payments actually made upon cessation of Government work where there is no reasonable prospect of continuing employment on other work of the Contractor are allowable. The allowable cost shall be determined by assigning the total cost to the period in which the severance pay was actually earned and apportioning such cost to cost-reimbursement type contracts and all other business of the contractor performed during that period.

A reservation in the final release of claims (see ASPR 7-203.4) may be made in the case of completed cost-reimbursement type contracts where it is reasonable to assume that severance payments allocable to the contract will have to be made at some future date.

15-313 Other Manufacturing Expenses:

15-313.1 Allocation of Indirect Manufacturing Expenses. Among the acceptable bases, depending upon circumstances, for allocating indirect manufacturing expenses are direct-labor-cost, direct-labor-hours, machine-hours, and units processed. In more complex manufacturing plants, it is appropriate to departmentalize the plant for purposes of accounting for manufacturing expenses when any given type of defense production is concentrated in departments having a much higher or lower expense rate than the average. Expense departmentalization is also desirable in larger and more complex plants for purposes of expense budgeting and control by the responsible foreman, regardless of the need for a more refined method of expense allocation. When manufacturing expenses are departmentalized, it is necessary to charge service-department expenses (such as the power plant) and factory general expenses (such as taxes, insurance, 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 should be selected for service-department and other expense distributions to productive departments - e.g., kilowatts of connected power load or metered power consumption, in the case of electric power.

Direct-labor-hours may be preferable for use as a basis for distribution of indirect manufacturing expenses when, for example, wage rates vary widely within a given cost center or department. When direct-labor dollars expended fairly reflect machine effort, as well as labor effort, in any productive department, it is most simple, as well as appropriate, to use that basis of expense allocation in preference to a direct-labor-hour or machine-hour basis. When there is much automatic or semiautomatic machinery in a

productive department, the use of a machine-hour-rate is generally more appropriate for expense allocation. The units-processed-basis of allocation is generally appropriate when a given productive department processes only one item, or the several items are so similar as to be susceptible to measurement of units processed in terms of a common denominator -- e.g., steel sheets of various gauges processed through a rolling mill.

15-313.2 Allocation of Engineering Expenses. Engineering expenses are included in such items as the cost of product design, tool design, experimental development, manufacturing and production development, lay-out of production lines, determination of machine methods and related blueprinting and drafting. The principle of direct costing (see paragraph 15-211) would indicate the desirability of charging directly to the benefited activities (such as production, facilities, and research and development) all engineering costs which can be directly identified with such activities. Only a relatively minor amount of engineering costs (consisting chiefly of engineering administrative expenses) should remain to be allocated to the activities on an indirect basis. All engineering costs charged directly or allocated should in turn be assigned to products, product lines, job orders, contracts, etc. For further treatment of the costing of research and development, special tooling, manufacturing and production engineering and preproduction expenses, see paragraphs 15-313.7, 15-313.10, 15-313.11 and 15-313.12; facilities contracts are included in Part 4 of this Section.

15-313.3 Depreciation.

(a) Depreciation accounting is a system of accounting which aims to distribute the cost of tangible capital assets, less estimated salvage value (if any), over their estimated useful life in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the

consistent pattern of costing if the results are to be equitable. In some instances, this principle may be applied by direct costing only the major items of a given cost element to all products, leaving minor items, if appropriate, subject to indirect cost allocations.

15-206 Indirect Costs. Indirect costs, which have the character of common or joint costs, usually consist of indirect materials, indirect labor, and other items. These costs generally are grouped in classes, as follows:

(a) Manufacturing (shop, laboratory) expenses (often termed "manufacturing overhead" or "burden"), which are incurred in fabricating the article or performing the service;

(b) Engineering expenses to extent not included in (a) or (c);

(c) Selling and distribution expenses incurred in marketing the products manufactured;

(d) General and administrative expenses incurred in the over-all management, supervision, and conduct of the business;

(e) Financial and other expenses.

15-207 Methods of Allocation of Indirect Costs. No general rules regarding allocation of indirect costs to products, job orders, or contracts can be stated for all individual cases, because the nature of the particular operations and the actual conditions in each instance determine the most suitable method or methods to be employed. The method of allocation of indirect costs will be acceptable if it is in accord with generally accepted accounting principles and practices and if it produces equitable results under the particular circumstances. (See also paragraphs 15-313.1, 15-313.2, 15-320.1 and 15-330.1.)

(a) Cash discounts taken. However, if the contractor does not exercise reasonable precautions in taking advantage of cash discounts available, all cash discounts lost may be deducted in determining allowable costs;

(b) Trade discounts, rebates, refunds, and allowances on material purchased;

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(d) Credits arising from differences between book and physical inventories.

15-311.2 Pricing:

(a) In determining historical costs, any generally recognized method of pricing materials issued from stock may be employed for determining actual cost, provided it has been consistently used by the contractor, is acceptable for internal revenue purposes, and does not discriminate against the Government. When materials in inventory at the commencement date of a Government contract have a provable replacement cost significantly different from book cost, either the contractor or the Government may elect to use such replacement cost in lieu of book cost in pricing materials issued from such inventory. However, such election including identification of the types or kinds of materials involved should be made at the time the contract is entered into and provided for in the contract. When materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be changed to the contract. Costs of subcontracts for components should be determined similarly; proyided that, when subcontracts are performed under contract pricing arrangements other than firm fixed prices, the negotiation of prices or determination of costs shall conform to this section so far as considerations of costs are concerned.

(b) For purposes of estimating material cost, either current market

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15-300 Scope of Part. This part states, in some detail, applications of the general cost principles and standards set forth in Part 2 of this Section to supply contracts and research and development contracts with commercial organizations. It is impracticable and unnecessary to cover every element of cost or possible situation that might arise in a particular case. However, when this part does not furnish specific guidance, the philosophy expressed or implied in the principles and standards comprising Part 2 of this Section and the more detailed discussions of similar or related items in this Part 3 should be followed.

15-310 Manufacturing Costs:

15-311 Materials. The net costs of materials (including components), both direct and indirect, used or consumed in performance of Government contracts are allowable on the basis hereinafter outlined. Cost may include such collateral items as transportation, insurance, purchasing, receiving, storage, warehousing and adjustments of inventory accounts reasonably related to the period of contract performance resulting from variations at cost between book and physical inventories. (See paragraph 15-311.2 for basis of materials pricing.) If the cost of collateral items is included in material costs, no additional allowance therefor may be made in the determination of manufacturing burden. If such items are not included in material costs, they are properly included in overhead.

15-311.1 Material Credits. In establishing material cost, effect shall be given, as appropriate, directly, or indirectly as a reduction of total manufacturing costs, to such items as:

[(iii) The prices of other suppliers for the same or substantially similar items can be established through quotations, correspondence, or by other means.

[(2) In case the transferor is a separate corporation or partnership in which nonaffiliated parties hold a minority interest of 10 percent or more, a reasonable margin of profit on such sales in recognition of the minority interest may be permitted by agreement notwithstanding inability to determine market prices in accordance with paragraph (1) above.

[(3) Under special circumstances, inter-company or interdivisional sales or transfers may be priced to include a profit to the transferor when no evidence exists as to market prices, provided, in the opinion of the contracting officer, the total price paid by the Government for work performed under the contract of the transferee is not increased by such pricing procedures. This departure from the basis of pricing such sales or transfers at market prices determined in accordance with paragraph (1) above or cost to the transferor should be authorized only where all of the following circumstances exist:

[(i) The management of the transferring unit is significantly independent (though not necessarily autonomous) of the acquiring unit;

[(ii) It is the contractor's long established practice to price inter-company transfers at other than cost and to apply such practice to transfers of commercial work as well;

[(iii) Routing of work through the integrated unit is not affected by departure from the cost basis with consequent increase in total actual production costs of the work.

prices or anticipated acquisition cost may be used, but the basis of pricing must be disclosed. In order to avoid the allowance of contingencies in firm forward pricing actions in which the anticipated replacement cost may be expected to be substantially greater than current market, materials escalation provisions may be made a part of the contract. However, situations involving changes in material costs which are reasonably certain and determinable, or relatively minor in amount, may warrant recognition being given thereto in making estimates.

[(c) In cases in which a contractor has integrated operations involving inter-company or inter-divisional sales or transfers of materials, such materials may be priced to include a profit to the transferor company or division under appropriate circumstances outlined below. In such event, such sales or transfers shall be treated as subcontracts in determining the profit or fee for work performed under the contract of the transferee. In other cases, where the conditions outlined below do not exist, inter-company or inter-divisional sales or transfers of materials shall be stated at cost to the transferor for purposes of contract pricing of the transferee.

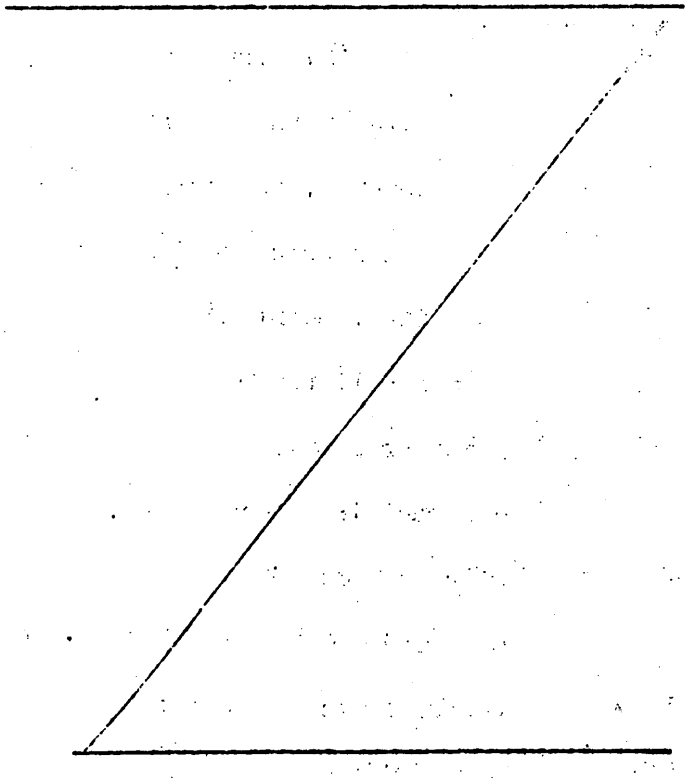
[(1) When inter-company or inter-divisional sales or transfers of materials are priced in excess of cost, they shall be priced, insofar as possible, upon the basis of the lowest market price determined in consideration of the following:

[(i) The price is the transferor's lowest sales price to nonaffiliated customers for the same or a similar item, quantity and quality considered;

[(ii) The price for the same or substantially similar items is quoted at reasonable intervals in financial or trade publications;

the basic salary or wage and all fringe benefits will be considered in determining the reasonableness of the earnings of an individual in relation to services rendered. Direct labor cost consists of salaries and wages identified specifically with the performance of a contract, job, or product. Labor services utilized for joint objectives may be treated as indirect costs if specific identification is impractical or uneconomical and the results of allocation are equitable.

(b) In determining historical costs, labor will generally be charged at actual rates paid by the contractor. However, if it is the contractor's consistent practice to charge for performance of groups of



Determination of the foregoing facts in any case may require submission of cost data of the transferor.7

(c) Inter-company or inter-divisional sales or transfers of materials shall ordinarily be stated on the basis of cost to the transferor. However, under some circumstances, departure from the cost basis may be appropriate but such departure is permissible only if specifically authorized by the contracting officer. Examples of circumstances which may justify departure from the cost basis are as follows:

(1) Cases where the transferor is an affiliated or subsidiary corporation in which non-affiliated parties hold a minority interest of 10 percent or more.

(2) Transactions involving items regularly manufactured and sold by the contractor through commercial channels. In these cases, however, the price must not exceed the lower of (i) the transferor's sales price to its most favored customer for the same or a similar item, quantity and quality considered, or (ii) the prices of other suppliers for the same or substantially similar items.

Departures pursuant to the foregoing, should be authorized at the time contract is entered into, should include identification of the types or kinds of materials involved and the names of the suppliers, and should be provided for in the contract. Also in such event where such sales or transfers are authorized they shall be treated as subcontracts in negotiating the profit or fee for work performed under the contract of the transferee.

15-312 Labor:

(a) The cost of obtaining the services of any individual includes the base salary or wage, plus the cost of all fringe benefits. Therefore, both

(a) Each class of compensation is preferably to be accrued as a cost over the period in which it is earned.

(b) Where it is the contractor's established practice to record the costs at the time of payment, such practice may be acceptable. This is the most commonly used method of accounting for "fringe benefits," but its use might result in inequities in some cases. For example, if a Government contract was performed over the summer months during which most of the contractor's employees took vacations or military leaves, recognition of the cost at time of payment would be inequitable to the Government. On the other hand, if the contract or contracts extended over approximately one year and the proportion of Government work to the contractor's commercial work remained stable, this method might be equitable.

(c) When the costs of any of the elements of fringe benefits are greater or lesser with respect to defense business as compared with non-defense business, such costs should be allocated, so far as feasible and appropriate, between the two classes of business before further allocation of such costs to individual contracts or products. If this method of cost allocation is used, it should be used consistently for all elements of fringe benefits having a different cost relationship of defense business as compared with nondefense business.

(d) It may be practicable to negotiate an equitable rate for fringe benefits based upon experience for a representative period in lieu of individual consideration for each item. Changed conditions and circumstances would have to be considered in making such a determination. The experience rate would then be applied to the more direct labor costs to determine the allowable costs. The use of such rate should be subject

labor at an average rate, or to use standard labor rates, with consequent savings in clerical expense or improvement in labor control, such methods may be used, provided labor groupings and the adjustment for cost variances result in a reasonably accurate assessment of total charges.

(c) When labor costs are required for making cost estimates, the use of standard labor rates and standard time allowances (appropriately adjusted for experience variances) or reliable engineering estimates is acceptable. Ordinarily the use of wage rates higher than current going-rates will not be permitted for estimating purposes. In order to avoid substantial allowances for labor rate contingencies, labor escalation clauses may be utilized in fixed-price type contracts. However, situations involving increases in wage rates which are reasonably certain and determinable or relatively minor in amount may warrant recognition being given thereto in making estimates.

15-312.1 Fringe Benefits—Vacations, Holidays, Sick Leave, Military Leave, and Employee Insurance. Compensation of these types is allowable to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment.

The cost of "fringe benefits" is part of the cost of the work performed by the employee while on the job, and must be considered as having a direct relationship to such work. However, in recognition of the different accounting treatments accorded fringe benefits by different contractors, the cost thereof may be allocated to Government contracts on any of the following bases, provided equitable results are achieved:

unreasonable or otherwise unallowable under this paragraph, and are allocable to all classes of work. Costs of such plans established by nonprofit or other organizations not subject to payment of Federal income taxes are also allowable except to the extent determined to be unreasonable or otherwise unallowable under this paragraph, and are allocable to all classes of work.

(b) Pension or retirement plans of a contractor which are subject to approval of the Bureau of Internal Revenue must have been so approved before costs under the plans may be allowed as charges under defense contracts. Many plans of nonprofit or other tax exempt organizations are also reviewed and approved by the Bureau of Internal Revenue - when not so reviewed and approved, each such plan will be reviewed, and approved or disapproved, by the Department to which audit cognizance is assigned, using, insofar as applicable, the criteria and standards of the Internal Revenue Code and the regulations of the Bureau of Internal Revenue. In any case where the Bureau of Internal Revenue withdraws approval of a plan, approval of amounts allocated to contract costs or estimates will be withdrawn accordingly.

(c) The approval of a pension or retirement plan by the Bureau of Internal Revenue will generally be the only approval required by the Departments; however, the right is reserved to require submission of any such plan for consideration by a Department and to disapprove such plan in its entirety or any feature thereof whenever the circumstances in a particular case are deemed to warrant such action. Such consideration will be the responsibility of the Department to which audit cognizance

to revision in light of changed conditions.

15-312.2 Fringe Benefits - Bonuses. Bonuses to employees, such as production incentives and suggestion or safety awards, represent a part of their total compensation and are an allowable cost under Government contracts when appropriately allocated to all classes of work, if they are: (1) reasonable in amount, (2) paid in connection with an established plan which was in effect before the award of the Government contract under consideration, and the plan is consistently followed by the contractor, (3) paid for current services rendered by the employee, (4) available to all employees of the contractor, or to all employees within a group or salary classification, provided such group or salary classification is not unreasonably restricted, and (5) represented by current expenditures of funds rather than by accrual of expenses or issuance of stock.

Bonuses will not be allowed as a cost on Government contracts when they are contingent upon profits and constitute a distribution of profit rather than reasonable compensation for services. Bonuses will not be allowed when they are restricted to officer or other employee stockholders or are distributed in relation to stockholdings.

15-312.3 Fringe Benefits - Pension and Retirement Plans.

(a) The costs of pension and retirement plans, including reasonable incidental benefits, such as disability, withdrawal, insurance or survivorship allowances which are deductible from taxable income in accordance with the Internal Revenue Code and the regulations of the Bureau of Internal Revenue, are allowable except to the extent determined to be

(h) Credits which arise from various sources, such as dividends and cancellation of employee benefits, which have not vested at the time of termination of their employment, must be taken into account in an equitable manner in arriving at pension and retirement costs. Special provision for these credits is usually necessary when the contractor's organization has substantially expanded for the performance of defense contracts and there is reasonable expectation that the employment of a large number of the additional employees will be terminated upon curtailment of defense work. Under these circumstances, 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. There are two general methods which may be used, individually or in combination, in making such arrangements:

(i) A lump sum or percentage discount (of current pension cost) allowance negotiated and agreed upon in advance. Determination of such allowance is not often an actuarial problem involving a calculation based upon known factors, but rather is an attempt to reach a negotiated agreement as to various uncertain or variable factors in a complex situation. Mass lay-off of employees which may result in the incurrence of severance payments costs should generally lead to a reduction in pension costs through an increase in pension credits.

(ii) A retrospective determination at some time in the future when a more accurate estimate can be made by virtue of experience which may have developed. Until such determination, current costs may be

is assigned, and the subsequent action taken by that Department will generally be accepted by the other Departments.

(d) Approval of a pension or retirement plan by the Bureau of Internal Revenue or by the Departments does not imply that the cost thereof for any particular year will be allowable for apportionment to contract costs or estimates, except to the extent costs for that year meet all other requirements of the Bureau of Internal Revenue as a deduction for income tax purposes, and are allowable under the provisions of this paragraph and the other provisions of this section.

(e) Pension and retirement costs constitute a part of the total compensation by a contractor to any individual covered by the plan, and accordingly are subject to the provisions of this section with respect to reasonableness of the total compensation paid to the individual for the services rendered (see ASPR 15-312 and ASPR 15-330.2).

(f) Where contributions to pension or retirement plans are based on profits, providing that provisions of the Internal Revenue Code and regulations of the Bureau of Internal Revenue have been met, the amount allowable for apportionment to contracts in any one year shall be the amount contributed to the pension trust(s) for that year, but not to exceed 15 percent of the total compensation otherwise paid or accrued in that year to the individuals covered under the plan(s).

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

sentative past period. In determining historical costs, such recurring nominal severance payments actually made are allowable. Where the Contractor provides for accruals of severance payments in lieu of recording the cost thereof at the time of payment, such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made over a representative past period. Generally, the cost of severance payments made during the performance of defense contracts should be allocated to all classes of work being performed at the time of payment since it is a reduction of total work which causes the severance. The following paragraphs are devoted to the treatment of severance payments anticipated to be necessary upon the completion or termination of defense production.

(b) Mass severances.

(1) Fixed-price type contracts. The considerable uncertainty as to whether mass severance payments will ever have to be made is such that no consideration will be given thereto in making cost estimates or in determining historical costs. This risk is one which the contractor must assume and for which he is compensated in the profit. However, where, because of termination of the contract for convenience of the Government, the Contractor does not have the opportunity to earn the profit contemplated by the contracting parties at the inception of the contract, costs of severance payments actually made and which are allocable to the terminated contract are allowable. In allocating costs to the terminated contract(s) the costs shall be assigned to the period in which the severance pay was actually earned and apportioned to all business of the Contractor performed during that period. The cost apportioned to the period of of production of the terminated contract(s) should then be allocated

allowed provided an appropriate contractual arrangement can be agreed upon which reserves the Government's right to these credits. Such recapture provisions will vary in the extent and duration of application and time of determination. For example, such provisions may be contract-wide or contractor-wide and the determination may be made at termination of a defense contract or defense contracts, at mass lay-off of contractor's employees or at the time of substantial decline in proportion of contractor's total sales under defense contracts.

15-312.4 Fringe Benefits - Severance Pay. The cost of severance pay will be considered only to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment. Theoretically, the right to severance pay is earned during the entire period of employment of the indivual or, when based upon specified years of service, is earned during those years. In theory, the cost of severance payments should be recorded in the contractor's accounts during the periods in which the employee earned the right to such payments. However, few contractors accrue severance payments because (1) the clerical expense involved in identifying and recording the cost for each employee is not justified; and (2) there is considerable doubt that any substantial payments will have to be made since payment is solely contingent upon future events.

(a) Recurring, nominal severance payments. The cost of severance payments arising from regular employee severances as distinct from mass layoffs may be included in cost estimates only to the extent that such estimates are based upon severance payments actually made over a repre-

15-312.5 Fringe Benefits -- Premium Payments for Overtime and Extra-Shift Work. Costs of this nature consist of only the premium portion of overtime and extra-shift payments or accruals to employees, not the straight-time portion. Thus, if the rate for overtime work is time-and-one-half of the regular rate, the premium portion is the additional one-half. Similarly, if the wage rate for a second shift is twenty cents an hour above the regular rate, this additional amount is the premium.

Overtime and shift premiums are allowable if authorized or approved pursuant to the requirements of paragraph 12-102.

Such premiums may be classified as either direct or indirect labor cost, but overtime premiums should be separately stated in either event. When treated as direct labor cost, overtime premiums should not be included in the base for distribution of overhead. The amount of overtime and shift premium cost charged on Government contracts shall not be disproportionate to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant.

15-312.6 Fringe Benefits -- Unclaimed Wages. Costs under cost-reimbursement type contracts should reflect a credit for unclaimed wages based upon agreement as to the amount thereof reasonably expected not to be paid subsequent to the date of completion or settlement. In this event, all unclaimed wage liability rests with the contractor. When such an agreement cannot be reached, the Government will assume liability for payment of unclaimed wages and eliminate all allowances therefor from reimbursement to the contractor.

between the terminated contract(s) and all other business of the Contractor. If the termination claim is prepared on the total cost basis, the amount so allocated is properly allowable. If the claim is prepared on the inventory basis, the amount allocated to the terminated contract must be further subdivided between that portion of production billed as completed units and the portion to be inventoried. Only the severance pay costs applicable to the latter portion is includible in the termination claim.

(2) Cost-reimbursement type contracts. Mass severance pay costs will not be considered in the evaluation of cost estimates; nor will any allowance be made on an estimated basis in determining historical costs. Likewise, the contingency of severance payments will not be considered to be a risk assumed by the contractor in determining the fee since the Government assumes the risk. The cost of severance payments actually made upon cessation of Government work where there is no reasonable prospect of continuing employment on other work of the Contractor are allowable. The allowable cost shall be determined by assigning the total cost to the period in which the severance pay was actually earned and apportioning such cost to cost-reimbursement type contracts and all other business of the contractor performed during that period.

A reservation in the final release of claims (see ASPR 7-203.4) may be made in the case of completed cost-reimbursement type contracts where it is reasonable to assume that severance payments allocable to the contract will have to be made at some future date.

15-313 Other Manufacturing Expenses:

15-313.1 Allocation of Indirect Manufacturing Expenses. Among the acceptable bases, depending upon circumstances, for allocating indirect manufacturing expenses are direct-labor-cost, direct-labor-hours, machine-hours, and units processed. In more complex manufacturing plants, it is appropriate to departmentalize the plant for purposes of accounting for manufacturing expenses when any given type of defense production is concentrated in departments having a much higher or lower expense rate than the average. Expense departmentalization is also desirable in larger and more complex plants for purposes of expense budgeting and control by the responsible foreman, regardless of the need for a more refined method of expense allocation. When manufacturing expenses are departmentalized, it is necessary to charge service-department expenses (such as the power plant) and factory general expenses (such as taxes, insurance, 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 should be selected for service-department and other expense distributions to productive departments - e.g., kilowatts of connected power load or metered power consumption, in the case of electric power.

Direct-labor-hours may be preferable for use as a basis for distribution of indirect manufacturing expenses when, for example, wage rates vary widely within a given cost center or department. When direct-labor dollars expended fairly reflect machine effort, as well as labor effort, in any productive department, it is most simple, as well as appropriate, to use that basis of expense allocation in preference to a direct-labor-hour or machine-hour basis. When there is much automatic or semiautomatic machinery in a

productive department, the use of a machine-hour-rate is generally more appropriate for expense allocation. The units-processed-basis of allocation is generally appropriate when a given productive department processes only one item, or the several items are so similar as to be susceptible to measurement of units processed in terms of a common denominator -- e.g., steel sheets of various gauges processed through a rolling mill.

15-313.2 Allocation of Engineering Expenses. Engineering expenses are included in such items as the cost of product design, tool design, experimental development, manufacturing and production development, lay-out of production lines, determination of machine methods and related blueprinting and drafting. The principle of direct costing (see paragraph 15-211) would indicate the desirability of charging directly to the benefited activities (such as production, facilities, and research and development) all engineering costs which can be directly identified with such activities. Only a relatively minor amount of engineering costs (consisting chiefly of engineering administrative expenses) should remain to be allocated to the activities on an indirect basis. All engineering costs charged directly or allocated should in turn be assigned to products, product lines, job orders, contracts, etc. For further treatment of the costing of research and development, special tooling, manufacturing and production engineering and preproduction expenses, see paragraphs 15-313.7, 15-313.10, 15-313.11 and 15-313.12; facilities contracts are included in Part 4 of this Section.

15-313.3 Depreciation.

(a) Depreciation accounting is a system of accounting which aims to distribute the cost of tangible capital assets, less estimated salvage value (if any), over their estimated useful life in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the

generally be determined by groups of facilities for which the factors bearing on estimated useful life are similar. The amount of depreciation written off in any fiscal period may vary with volume of production or be increased for multishift operation, provided the method followed is consistent with basic objective set forth in subparagraph (b) above. Special methods have been established for determining depreciation on emergency facilities covered by Certificates of Necessity by a special directive set forth in an appendix of this Section.

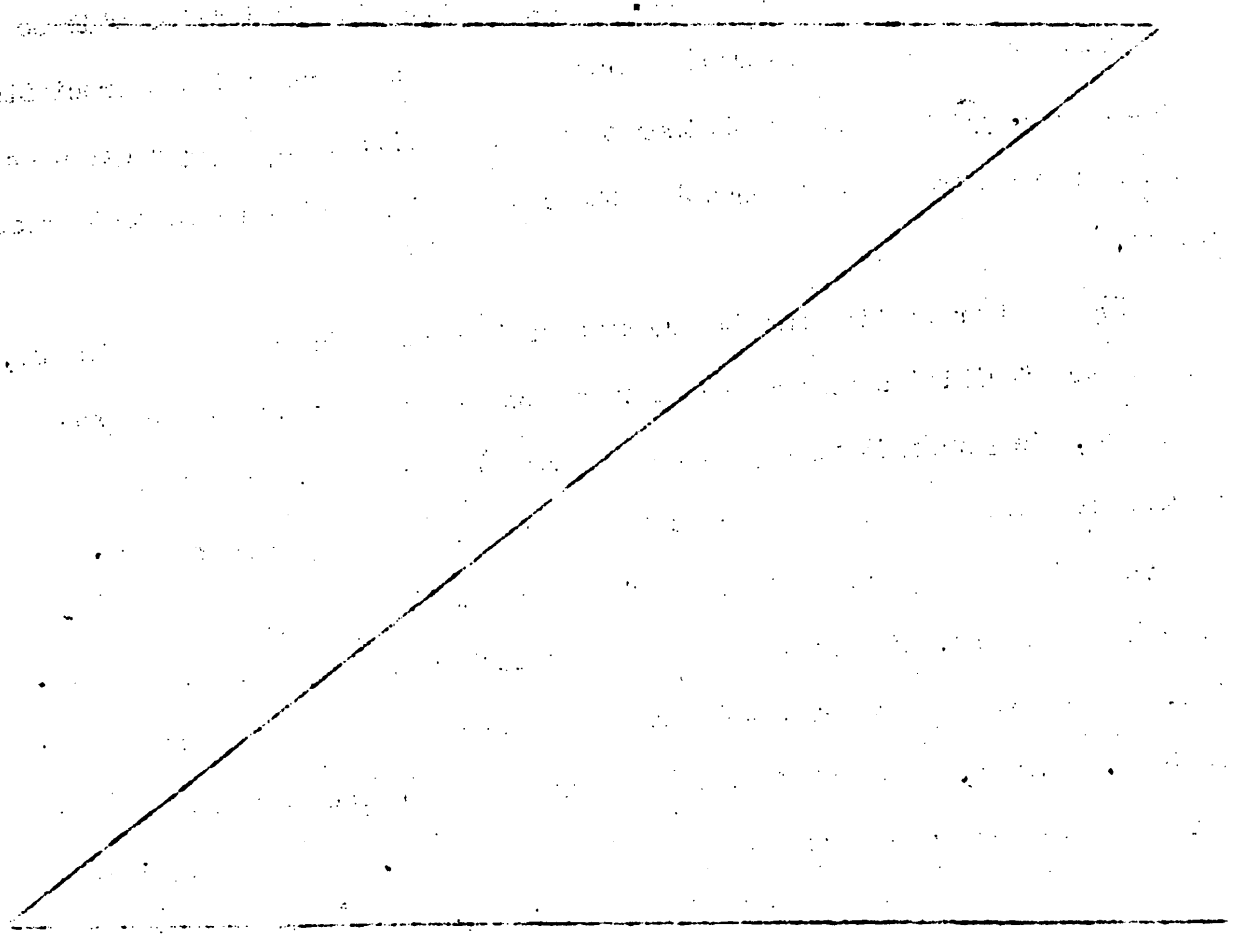
(d) Depreciation should be based upon original cost of the facilities, whether measured by purchase agreement for a cash consideration, the fair value of securities issued in exchange, or similar appropriate measures, [although it is permissible that such cost of facilities be adjusted, where desired by the contractor for purposes of depreciation computations for contract pricing, to current price levels by the use of a general price index, provided in such event that the practice will be followed consistently in the future and also provided that otherwise the charge is made at the same annual rates applied to such adjusted costs as would have been appropriately applied on original costs in view of the estimated useful life of the facilities. In other words, no deficiency in actual depreciation provisions in any prior year, based upon current price levels, should be included in the depreciation charge for the current year. No other basis of determining appreciation in value of facilities may be utilized in determining depreciation for purposes of contract costs; for this purpose the tax basis of facilities values acceptable for internal revenue purposes is applicable.]

year is the portion of the total charge under such a system that is allocated to the year. Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, usually of an indirect nature.

(b) Useful life, as above referred to, has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life. In establishing estimated useful life, consideration should be given to all of the factors of wear and tear, obsolescence (both economic and technological), and inadequacy, which are common to the depreciation problem. Of these factors, obsolescence is most often the limiting or controlling one. Obsolescence of facilities, from the standpoint of economic utility, is always a prospect or contingency to be anticipated (differing only in degree, in each instance) with respect to an entire enterprise or an individual plant, as well as groups or individual items of plant and equipment. Costs of depreciation and maintenance are mutually related. Wear and tear may be increased by lack of maintenance or may be made good by maintenance (often indefinitely, so long as it is economical to do so and provided obsolescence or inadequacy has not become preeminent). Hence, estimates of useful life of facilities in each case should take into consideration the actual maintenance policy in effect.

(c) Depreciation may be determined by application of any one of the generally accepted methods; however, the selected method and rate of depreciation used should, in the absence of compelling reasons to the contrary, consistently be applied from year to year. Generally, however, depreciation is too intangible to warrant meticulous computations by application of rates by individual items of plant and equipment, although such computations are frequent and will be recognized. Hence, depreciation will

15-313.4 Repairs and Maintenance. Repairs and maintenance of facilities (including Government-owned facilities) are allowable elements of contract costs. It is necessary that such expenses exclude expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and made the subject of depreciation. There is, of course, a twilight zone between repairs or maintenance and capital expenditures within which a contractor should be permitted to operate upon the basis of his established accounting practice, if the results are equitable. For example, certain major costs of building alterations and rebuilding or



(e) No depreciation will be allowable as such, or as a rental or use charge, on the cost of facilities which are fully depreciated but still in use when a substantial portion of such depreciation was on a basis that represented, in effect, a recovery thereof as a charge against defense contracts or subcontracts in negotiated pricing or statutory renegotiation of contracts. Otherwise, the contractor may compute normal depreciation on the cost of facilities in use without reference to previous depreciation provisions. However, if the amount of depreciation allowed on fully depreciated assets is material, this might be evidence of the application of excessive depreciation rates to assets not fully depreciated. If excessive rates are used, total depreciation claimed should be reduced so as to reflect the application of more equitable rates. Fully depreciated facilities will be determined on the basis of relating original cost to accumulated depreciation on such cost. [regardless of whether there is an adjustment of current depreciation charges based upon adjusting the cost of facilities to current price levels.]

(f) No depreciation may be allowed on facilities which are not in use, except such facilities as are held for reasonable production standby purposes and, when specifically provided by mutual agreement, on facilities representing additional plant capacity reserved for defense production.

(g) There are several methods of accounting for small tools and expendable equipment, if in accord with generally accepted accounting principles, any method consistently applied by the contractor will be acceptable; provided, however, that allowances for such items are recognized to represent depreciation allowances for the use of the items. Where acquisition costs are not capitalized, particular attention should be given to the residual value of such items upon completion or termination of the contract.

tractor, an additional cost allowance may be made in determining costs of the terminated contracts for the purpose of contract settlement, provided such facilities are transferred to the Government, if so desired, or an equitable adjustment is made in favor of the Government in recognition of any resale or salvage value estimated for such facilities.

15-313.6 Rentals of Plant and Equipment. Rentals of plant or equipment are allowable if reasonably required for the performance of the contract and if bona fide and reasonable as to rate and duration. Special care should be exercised in determining reasonableness of rentals in cases in which rates were arrived at as a result of less than arm's length bargaining. Rental costs may not be bona fide under the following circumstances:

(a) Rentals paid to persons, including corporations, affiliated with the contractor.

(b) Rentals paid to unaffiliated persons, including corporations, upon property formerly owned by the contractor when such property was fully depreciated or substantially fully depreciated before sale or transfer and Government contracts absorbed a significant portion of such depreciation. In either case (a) or (b), rentals will be limited to a reasonable amount of depreciation, as might be determined if the property were owned by the contractor, plus carrying costs which are not paid by the contractor under the terms of the lease, including maintenance, taxes, and insurance (but not interest on the investment).

15-313.7 Preparatory Costs. Preparatory costs or expenses, also known as "make-ready costs", are costs specially incurred in preparing to operate under a specific contract or contracts. They include costs of organization and planning, employee recruitment and training, engineering and development (including product design, product specifications, and

rehabilitating machinery and equipment may reasonably be treated in some instances as either repairs and maintenance expenses or capital expenditures, depending in part upon the contractor's established policy. In making decisions with respect to the alternative accounting treatment of these items, consideration should be given to the materiality of the amounts involved, and the question of the substantial enhancement in value of a contractor's facilities at the expense of the Government. In the latter case, for contract pricing purposes, the cost generally should be considered to be of a capital nature and the subject of depreciation. In those instances where it may be appropriate to charge the cost of extraordinary rehabilitation to expense, special care should be taken in equitably allocating the costs to all the benefited classes of work (see 15-313.7 "Preparatory Costs"). Repairs and maintenance costs on facilities which are not in use will not be allowed, except on individual items of machinery and equipment (as distinct from entire plants or significant portions thereof) held for reasonable standby purposes. Repairs and maintenance on additional plant capacity reserved for defense production will be allowed only if specifically provided by contractual agreement.

15-313.5 Profits or Losses on Disposition of Plant and Equipment. In determining contract costs, no recognition will be given to profits or losses on disposition of plant and equipment for reason that depreciation reasonably determined, provides the exclusive charge for the cost of using a contractor's facilities. However, when a contractor has capitalized special purpose facilities acquired solely for performance under defense contracts (rather than charge the costs thereof to specific contracts) and engineering changes or complete or partial termination of contracts finds such facilities not fully depreciated and not reasonably useful for other business of the con-

Initial production costs may consist of the excessive portion of material costs incurred in the early stages of production, on contracts requiring new products or greatly increased production, as the result of abnormal quantities of materials used or abnormal scrap losses. Initial costs may also consist of the excessive portion of direct-labor costs, plus a proper portion of the related overhead, incurred in the early stages of production due to such causes as excessive defective work resulting from inexperienced labor, idle time and subnormal production occasioned by testing and changing methods of processing, and cost of training employees. The justification for such special costs depends upon their nature and causes, and not merely upon the fact that total production costs are high.

After a reasonable volume of production has been attained and initial manufacturing difficulties have been overcome, unit cost will usually tend to level off, thereby evidencing the end of the initial period of production but not necessarily representing the lowest unit cost eventaully attainable during the operation of the entire contract. If, however, these costs continue abnormally high after a contractor has been allowed a reasonable length of time in which to learn how to make a product efficiently, the excessive costs may not properly be allowable for purposes of estimating under cost reimbursement type contracts or estimating for formal pricing purposes in fixed price type contracts, and should receive special consideration in determining historical costs under existing contracts, or in establishing costs under terminated contract settlements.

/15-313.9 Reconversion Expenses. Reconversion expenses are those connected with restoration of facilities to approximately the same physical arrangement and condition they were in immediately prior to the beginning

planning of production processes and layout) and plant alternation and rearrangement. Preparatory costs do not include initial production (starting load) costs which are treated in paragraph 15-313.8, or manufacturing and production engineering which is treated in paragraph 15-313.11 or special tooling which is treated in paragraph 15-313.10.

Preparatory costs, when incurred for the exclusive benefit of Government production, are allocable directly or indirectly to the contracts benefiting from such costs. When preparatory costs benefit other classes of work as well as Government work, an equitable allocation to all benefited classes of work is proper.

Preparatory costs (sometimes called "Anticipatory Costs") may have been incurred prior to the award of a definitive contract. The amounts of such costs, for purposes of contract cost allowances, are subject to approval of contracting officers based upon advance understandings or upon subsequent negotiation. In such case a specific provision limiting the amount, types and period of pre-award preparatory costs should be incorporated in any definitive contract. Similarly, it is desirable that prior approval of the contracting officer be obtained in the event that unusual charges of this type are to be incurred during the life of the contract. However, the absence of such provision or approval will not preclude consideration of the costs in subsequent price negotiations or determinations under such contracts.

15-313.8 Initial Production Costs. Initial Production Costs, also known as "starting-load costs", are non-recurring costs that arise in the early stages of production because of the contractor's unfamiliarity or lack of experience with the particular materials, manufacturing processes, or techniques involved. They are to be distinguished from preparatory costs or expenses (also known as "make-ready costs").

stances meeting the above conditions.7

15-313.9 Reconversion Costs. Reconversion costs are those incurred in the restoration of facilities to approximately the same physical arrangement and condition they were in immediately prior to the beginning of defense work, and includes the cost of removal of Government property. Reconversion costs, except for the removal of Government property, are incurred for the benefit of future production, and as such are properly chargeable against such production. Except for the costs of removing Government property, and the restoration and rehabilitation costs caused by such removal and specifically provided for in the contract, reconversion costs are not allowable.

15-313.10 Special Tooling. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment.

The cost of special tooling, when acquired for and its usefulness is limited to one or more Government contracts in force or being negotiated at the time of acquisition, is allocable to the specific Government contract(s). The cost of any special tooling which is useful under both Government contracts and commercial work will be subject to allocation between them. No part of the cost of tooling which is special to commercial work only will be allocated to Government work. The cost of non-special tooling is not subject to direct allocation, but is subject to depreciation, which is treated elsewhere in this Part, except that in the production of standard commercial products such tooling costs may be treated as indirect manufacturing expense on an expenditure basis, in lieu of depreciation,

of defense work, including the removal of Government property. In many cases, reconversion costs, except for the removal of Government property are incurred for the benefit of future production, in which cases such costs should be assessed against such production. However, in a specific case and where all of the circumstances outlined below exist, reconversion costs may be recognized through specific contractual provision.

(a) There must have been a major alteration or rearrangement of facilities at the inception of defense work for the sole purpose of performance of defense contracts, or facilities were newly acquired buildings in which Government machinery and equipment has been installed. In the latter case, only the cost of removing Government property is to be considered.

(b) The necessity of reconversion of facilities to approximately the same physical arrangement and condition they were in immediately prior to the beginning of defense work and the costs thereof must be reasonably certain and determinable.

(c) There is little or no post defense work commercial benefit to the contractor as the result of such alteration or rearrangement.

(d) Neither the particular contract nor any other contract contains an allowance for the use of facilities which would compensate the contractor for reconversion expenses.

Reconversion costs shall be allowed only in pricing those fixed price contracts in existence or actually being negotiated at the time the costs of conversion were incurred. In the event of subsequent conversions or modifications for additional fixed price contracts, care must be exercised to avoid duplication of allowances for reconversion costs. Specific contractual provisions may be included in cost-reimbursement type contracts to compensate the contractor for actual reconversion costs incurred in circum-

may be divided into two major categories -- (1) product research and development, and (2) general research.

(a) Product research or development is that which is directed toward the design, improvement or utilization of a particular product or product line. In costing production contracts, current costs (or estimates thereof where forward pricing is involved) of product research or development will be allowable. However the principle of direct costing by product or product line, as appropriate, should be applied, and provided further that such costs are not reimbursed to the contractor under separate research and/or development contracts. No costs of product research or development may be allocated to Department of Defense research and/or development contracts other than the direct costs of performing the contract and the proper share of the indirect costs of administering the research or development program. In some instances it may be appropriate to establish by contract provision a ceiling on the amount of product research or development to be allowed.

(b) General research is all research other than that which is directed toward the design, improvement or utilization of a particular product or product line. The cost of general research, when reasonable in amount and incurred in accordance with the contractor's established practice, is allocable to all classes of work, including defense work, provided such costs are not reimbursed to the contractor under separate defense research contracts, gifts, grants, trust funds or other similar sources. No general research costs which were incurred in accounting periods prior to the award of the particular defense contract(s) (including amounts capitalized in the cost of patents obtained) shall be allocated thereto, nor will the contractor be required to defer research costs incurred during the period of performance of defense contracts to subsequent accounting periods. In some instances

when the resultant charges are reasonably equitable between fiscal years. When the entire cost or a substantial portion of the cost of such special tooling has been allocated to fixed-price Government contracts, the asset concerned shall be subject to the provisions of Part 3 of Section XIII and of the Special Tooling contract clause for fixed-price contracts set forth in paragraph 13-504. When such special tooling is acquired under cost-reimbursement type contracts it shall be subject to the provisions of the contract clause set forth in paragraph 13-503 entitled "Government Property" and to the provisions of Appendix B, ASPR, applicable to Government-owned special tooling.

15-313.11 Manufacturing and Production Engineering. Manufacturing and production engineering includes the cost of engineering activities in connection with (1) current manufacturing processes such as motion and time study, methods analysis, job analysis, tool design and fabrication for improved tooling, and (2) production problems such as component design for purposes of simplifying production. Such activities are usually for the purposes closer control and reduction of manufacturing costs and the costs thereof are allowable. A characteristic of this type of expense is that it can be related to a specific contract, product or product line and is therefor chargeable thereto either directly or by allocation. (See ASPR 15-313.2). This is in contrast to general research and development which, by its general nature, cannot be directly associated with a specific contract, product, or product line.

15-313.12. Research and Development. Research and development expenses

(iv) Royalties are paid under an agreement entered into after the award of the contract without the approval of the contracting officer.

In any case involving a patent formerly owned by the contractor, the allowance will be limited to that which would have been made had the contractor retained title thereto. In all other cases, the allowance shall be reduced by the amount considered to be unreasonable.

(c) Care should be exercised to prevent charges for the use of patents when the Government already has, in fact, rights to such patents. The Government may have obtained a royalty free license or title to patents as a result of contract clauses such as contained in paragraph 9-107 and 9-112, as a result of settlement of claims, as a result of the employer's right in employees' inventions provided under Executive Order 10096, as a result of a royalty adjustment settlement, or as a result of separate purchase or gift.

15-313.14 Plant Protection Expenses.

(a) These expenses represent costs incurred in protecting the contractor's personnel and plant against fire, theft, sabotage, espionage, civil disorder, enemy attack, or other violent destructive forces. Plant protection expenses are allowable costs of defense contracts. Normally they will consist of guards' wages and labor costs related thereto, costs of individual equipment, cost of plant protection equipment if of minor amount, and depreciation of plant protection equipment. To the extent these costs are attributable solely to defense special security requirements, they are allocable entirely to defense contracts. Costs of normal plant protection not resulting from such special requirements, generally, should be indirectly allocated to all classes of work.

it may be appropriate to establish by contract provision a ceiling on the amount of general research to be allowed.

(Note -- See paragraph 9-107 for information as to patent rights to be obtained when research or development work is called for or required in the performance of a contract or when allowances are made for costs for product research or development.)

15-313.13 Patents and Royalties.

(a) Amortization of the cost of purchased patents owned by a contractor applicable to products or processes covered by a contract is an allowable element of cost to the extent reasonably allocable to the contract. Research and development costs leading to patents are treated in paragraph 15-313.12.

(b) Royalty costs are allowable if bona fide and reasonable. Special care should be exercised in determining reasonableness of royalties in cases in which amounts may have been arrived at as a result of less than arm's length bargaining. Examples of such cases are those where:

(i) Royalties are paid to persons, including corporations, affiliated with the contractor.

(ii) Royalties are paid to unaffiliated persons, including corporations, upon patents formerly owned by the contractor when the costs of such patents or the research and development work thereon were substantially recovered through charges against the costs of defense business.

(iii) Royalties are paid to unaffiliated persons, including corporations, under an agreement entered into in contemplation that a Government contract would be awarded.

(i) Recommendations and requirements of the duly constituted Governmental authority having jurisdiction over civil defense in the local area.

(ii) The extent of like measures being taken by other businesses within the local area, particularly those not producing under Government contracts.

(iii) The portion of total cost likely to be allocated to Government contracts as furnishing an inducement to the contractor to incur the cost.

15-313.15 Insurance and Bonds.

(a) To the extent that a contractor's insurance program has been reviewed and approved by the insurance authorities of the military departments, procurement and audit personnel of the military departments will be governed thereby.

(b) The net cost of insurance and bonds, after deduction of dividends or other allowances which may be expected, if reasonably necessary to the operation of a business, is an allowable cost on Government contracts to the extent allocable. Some, but not all, of the types of coverage which may be reasonably necessary are property, aircraft, automobile, general liability, product liability, workmen's compensation, employees' group, accident and disability, use and occupancy, (but excluding that portion of the policy premium applicable to anticipated loss of profit and costs which are unallowable under this Section) and fidelity and surety bonds (including performance bonds).

(c) Insurance on the lives of officers is not an allowable cost, except when premiums are paid in behalf of executives or employees pursuant

(b) A special problem may arise in the case of fixed price contracts, the security classification of which is altered after the contract has been entered into. When such a contract price is negotiated, the contractor is presumed to know the plant protection requirements under the contract and is expected therefore to meet such requirements within the contract price. However, if the security classification of the contract were changed by the Government after entering into the contract, additional costs of plant protection may be allowed the contractor by contract amendment. The additional costs may include not only current costs of an operating nature but also costs of a capital nature if the parties agree that the capital costs are incurred solely because of the changed security classification of the contract and would not have been necessary from the contractor's point of view. Also, if a classified contract is reclassified downward during its performance thereby permitting a savings in plant protection costs, such savings should, if material, be the subject of a contract amendment passing the savings on to the Government. (See 7-104.12)

(c) Civil defense costs must be allocated to all work of the contractor performed at the particular location where the costs are incurred. When the Government's portion of the output of the particular plant is not material, the reasonableness of the incurred costs need not be questioned. However, since usually past experience will not provide a guide as to reasonableness, civil defense costs should be the subject of specific agreement when the amount of such costs to be allocated to Government contracts is substantial. When this is the case, reasonableness may be judged in light of:

to take all necessary action in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer, shall be allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs.

(c) Any refund of taxes, penalties or interest thereon shall be credited to contract costs in the proportion in which contract costs absorb the costs of taxes, interest or penalties. If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

(d) Where it becomes evident in negotiating a contract price that a contractor may be required to pay a tax, the legality of which is questionable or in dispute, such tax may be used in negotiating the contract price, provided that the contract contains provisions substantially similar to those set out in subparagraph (b) (1) (2) and (3) above.

15-313.17 Strikes and Lockouts. The situations and conditions surrounding strikes and lockouts are so varied that it is impossible to establish a general principle providing for allowance or disallowance of costs incurred during such occurrences. Each case must be considered on its own

to specific agreement or established policy whereby such payment may be properly considered as additional compensation (Paragraph 15-330.2).

(d) When a contractor self insures against insurable risks of any type (But see paragraph 7-203.22 for limitation on self-insurance in cost-reimbursement type contracts), a reasonable provision for losses estimated by the contractor is an allowable cost if such provision is based upon actual loss experience to the extent feasible; or, in the absence of adequate loss experience data, it is not in excess of net costs which would be paid for such insurance if carried by private insurance companies, less agents' commissions and other acquisition and servicing costs.

(e) Losses resulting from failure to insure (through self-insurance or otherwise) against a contingent loss or damage, where a reasonably prudent businessman would have insured himself against such loss or damage, are not allowable.

15.313.16 Taxes.

(a) In general, taxes which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for Federal income and excess profits taxes; taxes in connection with financing, refinancing or refunding operations (see paragraph 15-330.5); and special assessments on land which represent capital improvements.

(b) Taxes which are believed to be illegally or erroneously assessed against the contractor, may be allowed as a cost of work performed, provided that the contractor; (1) promptly requests instructions from the contracting officer concerning such taxes; (2) agrees to comply with such instructions; and (3) if so directed by the contracting officer also agrees

abnormal in relation to sales effort that the use of historical costs would result in the inclusion of an unreasonable amount of estimated selling expenses. In the latter case, the fixed selling expenses should be charged to normal non-defense sales, leaving the defense sales chargeable only with a proper share of the variable costs. For an illustration of this principle see paragraph 15-320.5 entitled Advertising.

15-320.2 Salesmen's or Agents' Compensation.

(a) Salesmen's or agents' compensation allocable to defense contracts should be reasonable in the light of the services rendered. If inequitable or exorbitant compensation is paid, it shall be subject to disallowance, to the degree deemed excessive, for the purpose of allocation of costs to defense contracts. For example, when defense business consists of standard commercial products which are sold normally on a commission basis, sudden expansion of defense business may necessitate the adjustment in the amount of compensation allocable to defense contracts.

(b) No fee, commission, percentage, or brokerage fee shall be allowed as a contract cost when contingent upon or resulting from an award of a contract, except amounts paid to bona fide employees or established commercial or selling agencies maintained by the contractor for the purpose of securing business. This provision shall be applied in a manner consistent with representations or agreements of contractors or prospective contractors in the light of ASPR, Section I, Part 5.

15-320.3 General Sales Expenses. These expenses, consisting of salaries and expenses in connection with direction and supervision of all sales efforts, clerical expenses in maintaining sales records and statistics in some cases, and similar over-all sales expenses, may be considered to be allocable indirectly to defense products or contracts in some cases based upon

merits in the light of the philosophy expressed or implied in the principles and standards expressed in Part 2 of this Section.

15-320 Selling and Distribution Expenses:

15-320.1 Allocation of Selling and Distribution Expenses. Selling and distribution expenses identifiable in whole or in part with defense work are subject to allocation to the cost of defense work to the extent appropriate, considering the methods of selling and distribution to the Government or to prime contractors or subcontractors. Generally, selling and distribution expenses should be allocated between product lines, or to products sold to the respective customer types (where sales methods are different), based on analysis of the cost elements in relation to the sales efforts. In some cases, it may be appropriate to first allocate these expenses in whole or in part as between defense and non-defense business, and then to allocate the expenses applicable to defense business against the individual defense contracts or products. The principle of direct costing is very important in this area. For example, when special defense products are sold to the Government or to defense contractors by separately identifiable employees of the manufacturer, the compensation and expenses of such employees may be appropriately charge to costs of such products. When, in such cases, there is a separate sales organization or identifiable group of representatives engaged in selling to non-defense customers, no portion of compensation and expenses thereof should be charged to defense products. On the other extreme, when standard commercial products are sold at fixed prices direct to the Government or to defense contractors, as well as to numerous customers not engaged either directly or indirectly in defense production, by means of one established sales organization, the same selling expense per unit of product may be used in cost estimating, except when the quantities expected to be sold are so

technical pamphlets any of which aid users of the contractor's products, including the Government or defense contractors, excluding, of course, the cost of such publications prepared for the Government under separate contract consideration.

(d) Advertising for commercial products, other than as in (a) through (c) above, not in excess of the contractor's average annual costs incurred prior to the award of defense contracts, may be allocated to defense prime contracts and subcontracts for such commercial products on the basis that the costs will first be assigned to the contractor's nondefense business in the same amount per unit sold (or per dollars of sales) as was assignable to such units prior to obtaining defense business; the amount remaining after such assignment may be allocated to defense prime and subcontracts but not in excess of the amount per unit on nondefense business; provided, however, that when defense sales are merely incidental, such cost allocations may be made on an overall prorata basis.

(e) Advertising costs, other than as in (a) through (c) above, may not be allocated to defense prime contracts and subcontracts for non-commercial products.

15-320.6 Product Transportation and Delivery Expenses. These expenses, when required by the terms of a contract, are properly allowable. Whenever significant in amount and provided it is feasible, they should be determined and allocated as a direct cost of the product or contract.

15-320.7 Warehousing Expenses. Whenever a manufacturer maintains and ships products from warehouses strategically located in order to provide better service or reduce transportation costs to customers (as is frequently found

the specific facts in each case, provided the basis of allocation is equitable as between defense and nondefense business as a whole in the light of the relative services rendered.

15-320.4 Bidding Expenses. Current bidding expenses of both successful and unsuccessful bids normally will be treated as indirect expenses and apportioned currently to all business of the contractor in which event no bidding expenses of past accounting periods will be chargeable to defense contracts. However, where it is the contractor's established practice to treat bidding expenses by some other method, such method may be acceptable if the results are considered to be equitable.

15-320.5 Advertising. Advertising expenses include the costs of materials, space, time, layout, and expenses of the department which supervises such activities. Advertising expenses are generally incurred to promote the sale of the contractor's regular commercial products and should be assigned thereto. Advertising may be appropriately considered for allocation to the cost of defense contracts in the following cases:

(a) Advertising directed solely towards the recruitment of new employees.

(b) Advertising in trade and technical journals, provided such advertising does not offer specific products for sale but is placed for the purpose of offering financial support to journals which are valuable for the dissemination of technical information within the contractor's industry. In addition in the case of subcontractors, reasonable expenditures for advertising in such journals for the purpose of establishing necessary business contacts in connection with the sale of defense products to Government contractors.

(c) Publication of maintenance catalogs, parts price lists, and

time considerably beyond delivery. In such cases, it is necessary to estimate the cost of services and warranties, usually as a percentage of product cost, for purposes of price negotiation. Estimating warranty costs must usually be based upon past experience in similar circumstances with due regard to reasonable standards of quality performance. When allowances are made for costs of performance under warranties as product costs, there should be no duplication of the allowance for the risks in figuring allowable profits.

15-320.9 Entertainment Expenses. Entertainment expenses, as such, shall not be considered either directly or indirectly as a cost of performing Government contracts. However, when expenses classified as entertainment represent the purchase of meals, local transportation, rental of facilities for meetings, and other incidental costs, and the primary purpose of incurring such costs is the dissemination of technical information or the stimulation of production, such costs are allowable in determining the cost of Government contracts.

15-330 General and Administrative Expenses.

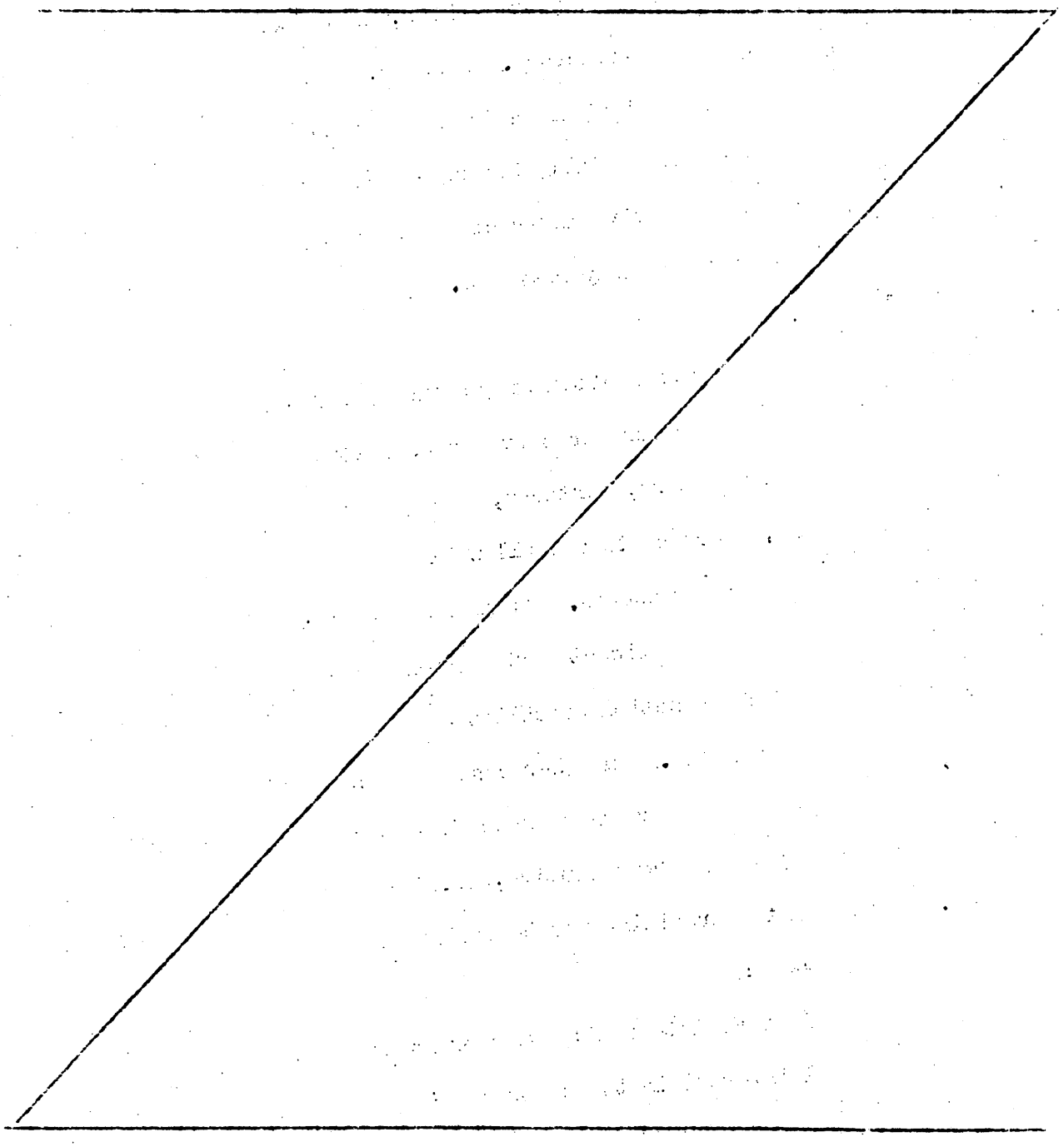
15-330.1 Allocation of General and Administrative Expenses. Among the acceptable bases, depending upon the circumstances, of allocating general and administrative expenses are processing costs (direct labor, factory overhead, and other factory production costs exclusive of direct material), factory input costs (processing costs plus direct material), cost of goods completed, cost of sales, and sales (where no more satisfactory basis is available), provided that equitable results are thereby obtained. In the selection of the particular method or methods of apportionment, special consideration should be given to any such unusual factors as major fixed asset improvement programs and significant changes in proportions of subcontracting.

with standard commercial products or spare parts), the expenses of warehousing such stocks, including transportation from factory to warehouse, are allowable when fairly allocated to defense sales in relation to total sales of products delivered from such warehouses. On the other hand, where products sold under a defen c contract are not delivered or serviced from such warehouses none of the cost of operation thereof is allocable to the contract.

15-320.8 Service and Warranty Expenses. In cases where the contract terms include an obligation on the part of the contractors, without additional separate compensation, to provide service in installation, training operators, correcting defects in the product, replacing defective parts, making refunds in case of inadequate performance, etc., the price or cost of the product may include an allowance for the cost of such undertakings. Generally, any warranty of the product as to performance, materials, and workmanship will be for a definite period of time. In the case of cost-reimbursement-type contracts, actual costs of performance to be reimbursed to the contractor will include such of the foregoing costs as must be borne by the Government under the clause of the contract entitled "Inspection of Supplies and Correction of Defects". (See paragraph 7-203.5). However, in some fixed-price contracts, a warranty may extend for a period of

(2) Ownership of the contractor is limited to a small cohesive group; or

(3) The volume of Government contracts when related to the contractor's total business is such as to influence the contractor in his determination of executive compensation; or



All pertinent factors should be reviewed from time to time, especially if and when there is a change in the nature or volume of production, to determine whether the indirect expenses continue to be apportioned equitably. Where the nature of a contractor's business has not changed basically by a shift to defense production, the presumption is that his former methods, if tested by operation over a considerable period, are satisfactory. However, this is only a presumption and should be reexamined in light of probable increased production. When the business has changed substantially because of such a shift, the contractor's former methods of allocating indirect expenses may be entirely inappropriate and so should be thoroughly reviewed.

15-330.2 Executive Compensation.

(a) Executive compensation consists of all emoluments (including salaries, bonuses, stock options, etc.) paid or accrued for services actually rendered to the contractor by executives, officers, partners, sole proprietors, and others of similar rank and abilities. Such costs are allowable when reasonable in amount in the light of the services rendered. Where the contractor's organization was a going concern for a significant period prior to the award of defense contracts, the amount of compensation established by the contractor will normally be considered reasonable. In other cases and in any case where the amount thereof appears not to have been determined through arm's length bargaining between the employer and the executive, special consideration may be required. Arm's length bargaining may be lacking in any one of the following situations among others:

(1) The executive or a member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization; or

The mode of travel, accommodation or subsistence shall be in keeping with the contractor's established practice. Should there be no established practice, the cost shall not exceed an amount commensurate with the duties and responsibilities of the traveler. Costs of entertainment shall not be included.

Special circumstances create situations for which there may be no precedent. For example, costs of transporting employees and their dependents from one geographic location to another, and reasonable allowance to establish them in the new location, may have to be incurred if a competent skilled labor force is to be recruited and maintained. Generally such costs are allowable, but there may be specific instances in which a part or all will be excluded if considered excessive or unnecessary. Where such circumstances are anticipated, advance understandings should be reached limiting the types and amounts of such costs.

15-330.4 Legal, Accounting, Engineering and Other Professional Expenses. Costs of professional services rendered, whether performed by the contractor's employees or by other members of the particular profession or craft retained by the contractor, are generally allowable. Such costs must be reasonable in light of services rendered, and payment must not be contingent upon recovery of the cost from the Government.

Such services must have been reasonably required by the business, although not necessarily required solely for the performance of Government contracts. Factors to be considered (among others) when determining the reasonableness or necessity of incurring the cost in a particular case are: (i) past pattern of such costs, particularly in the years prior to the award of Government contracts; (ii) the impact of Government contracts on the size of the contractor's business (i.e., what new problems arise); (iii) the nature

(4) The services rendered by any individual are clearly disproportionate in a major degree to the compensation paid.

Allowances for compensation of partners or sole proprietors may properly be included in executive compensation even though not actually paid or accrued in the accounts. In the case of cost-reimbursement type contract, any allowances for compensation for partners or sole proprietors should be incorporated in the contract.

Where executive compensation is considered to be unreasonable in amount, the excess over the amount considered reasonable will not be included in determining the amount allocable to Government contracts.

(b) The cost of options to purchase stock of the contractor corporation granted to executives thereof is a part of executive compensation and, as such, may be allocated to Government contracts, as follows:

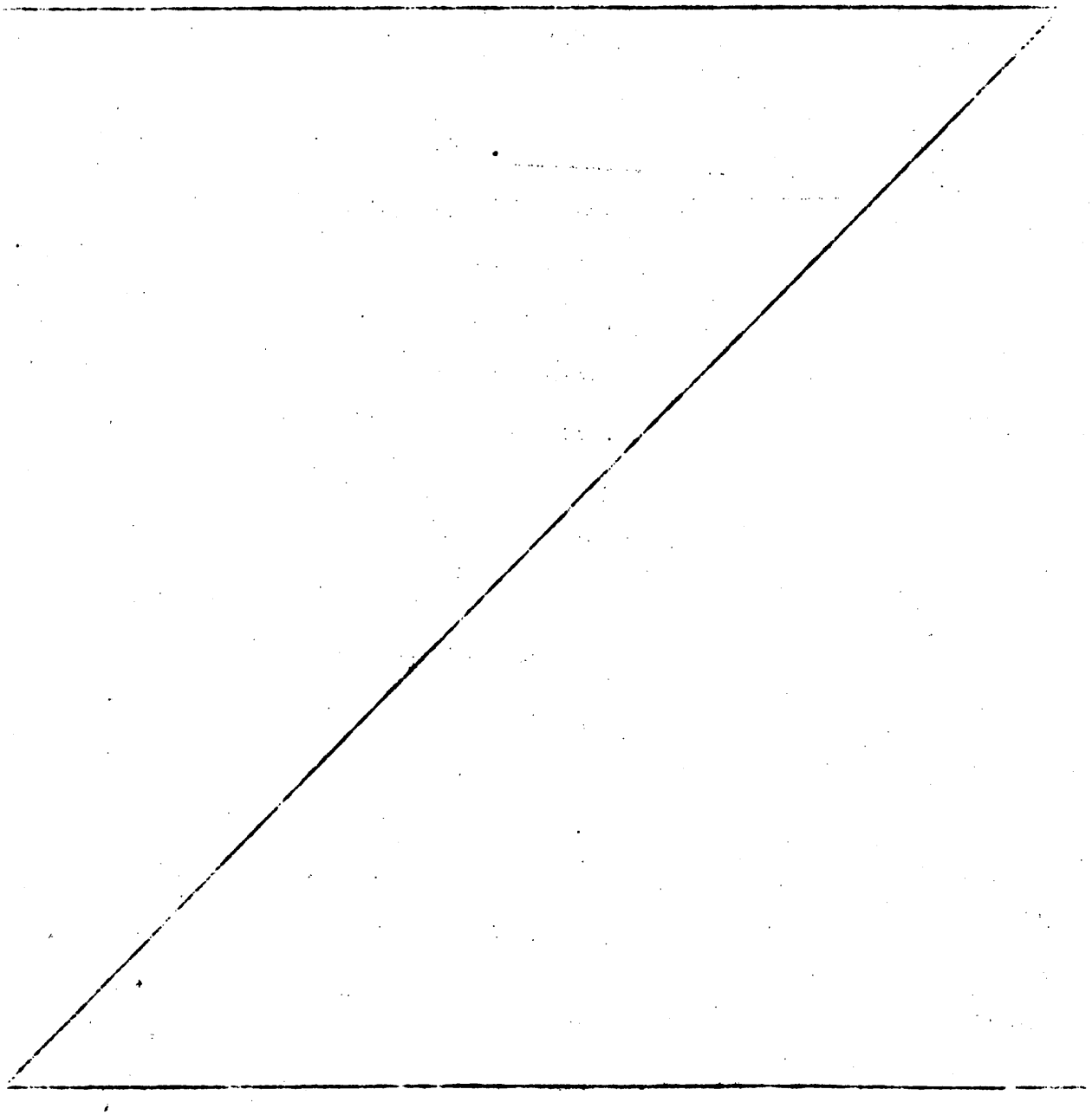
(1) The cost of stock options to the grantor corporation is the excess, if any, of the fair market value of the stock over the option price on the date the option is granted to a specific individual.

(2) Since benefits to the corporation are intended to extent over a period of years and are not limited to the year in which the option was granted or exercised, the cost to the grantor corporation must be amortized at an annual rate not be exceed three percent of the fair market value of the stock on the date the option is granted. The period of amortization is to begin with the date that the option is granted.

15-330.3 Travel Expense. Travel expense, when incurred for business purposes, is an allowable cost. The cost may represent payment for actual costs incurred, or payment may be on a per diem or mileage basis in lieu of actual cost, or a combination of the two methods may be used, provided the method used does not result in an unreasonable charge.

15-330.6 Bad Debts. Bad debt losses, whether actual or estimated, arise from the contractor's non-Government business. No allowance for such losses shall be made in costs or prices under Government [prime] contracts. [However, in the case of subcontracts, particularly lower-tier subcontracts several contracts removed from the prime contractor, consideration may be given to a reasonable allowance for bad debt losses not to exceed the rate experienced by the subcontractor in doing business with the same class of customer.]

15-330.7 Contributions and Donations. Contributions and donations to



and scope of managerial services expected of the contractor's own organization; (iv) the nature of conflict of interests which may exist between the contractor and the U. S. Government; and (v) whether or not the proportion of Government production of the contractor's total production 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 production under Government contracts.

If, in light of the foregoing, it appears that any otherwise allowable costs are not reasonably required by the business or are excessive, the allowable portion will be reduced to an appropriate amount, if any, for purposes of allocation.

15-330.5 Business Organization Expenses. Business organization expenses consist of those ordinary and reasonably necessary expenses which are incurred becuase of the use of the corporate, partnership, or other form of organization. Recurring business organization expenses are allowable. Examples of such recurring expenses, with respect to a corporate form of organization, are fees paid to members of the board of directors, cost of shareholders meetings, proxy solicitations, preparation and publication of annual reports to shareholders and preparation and submission of required reports to regulatory bodies having jurisdiction. Such costs shall normally be considered to be reasonable in amount when incurred in accordance with the contractor's established practices, particularly those in effect prior to the award of Government contracts. Nonrecurring expenses, particularly those directly related to the acquisition of additional capital, are not allowable. Other examples of unallowable costs would include legal and professional fees paid in connection with the preparation of a prospectus, costs of preparation and issuance of stock rights, and amortization of costs of organizing or reorganizing the business.

production has been altered significantly by Government contracts, departure from the prior program may be justified.

(ii) When the organization is a local one and membership would be expected of all similar business firms in the business community. Local organizations must be primarily for trade, business, or professional purposes. Social, cultural, or recreational activities, if any, of such organizations must be incidental.

(iii) If the organization is regional, national, or international in scope, membership therein should be held by a majority of like firms in the same industry.

In determining reasonableness of particular membership costs which appear to be excessive, a review of the nature of the activities of the organization might be necessary in order to reduce the allowable portion of the contractor's membership costs to an amount which would, in effect, exclude a contribution to lobbying or public relations activities.

(b) Subscriptions. The cost of subscriptions to trade, business, professional, or technical periodicals or services is allowable when incurred in accordance with the contractor's established practice and the costs are reasonable in amount.

15-330.9 Employee Morale, Health, and Welfare. Expenses for employee morale, health, and welfare activities, such as employee publications, illness or first aid clinics, improvement of working conditions, and others aimed to improve employer-employee relations or employee performance, are allowable if incurred in accordance with the contractor's established practice or custom in the industry or area.

15-330.10 Cafeterias, Commissaries, Dormitories, and Canteens. This class of expense consists of the cost, less revenue, of food, beverages, or living accommodations provided for members of the contractor's organization

established nonprofit charitable, scientific, and educational organizations are properly allocable to Government contracts; provided that such costs (i) may reasonably be expected to result in future benefits to the contractor through advancing, directly or indirectly, the technology of his industry or increasing the supply of trained manpower available to it; (ii) are in lieu of the cost of similar facilities, which facilities the contractor would otherwise have to provide, as for example, employee medical or recreational facilities; or (iii) are expected of the contractor by the community and it can reasonably be expected that the prestige of the contractor in the community would suffer through the lack of such contributions. In general, contributions and donations under item (iii) will not be allowable unless it is the practice of most business firms in the same community to make contributions to such organizations.

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.

15-330.8 Trade, Business, and Professional Activities.

(a) Memberships. Costs of membership in trade, business, and professional organizations are allowable when incurred in accordance with the following standards:

(i) Memberships are consistent with the established practice of the contractor, particularly his practice prior to the award of Government contracts. However, if the nature or volume of the contractor's

the period of contract performance, but the amount of which is currently indeterminable, may be recognized as follows:

1. A mutually agreed upon settlement may be negotiated in lieu of waiting for the exact future determination.
2. The contract may be held open (by an exception in the final release or by a provision in the pricing amendment) as to the particular item pending the exact determination of the amount of the cost on an actual basis.

Individual paragraphs of this Part contain more specific treatment of contingencies related to the subject matter of such paragraphs, and shall be controlling with respect thereto.

(b) Allowances for specific contingencies which are reasonable certain and determinable may be made in cost estimates for use in negotiating forward prices of fixed price contracts. Other contingencies are not allowable as costs in forward pricing actions, but their possible impact may be considered in establishing contract prices and ceilings in accordance with Part 4, Section III, ASPR.

15-340.3 Losses on Other Contracts. A loss sustained by a contractor on any contract is not allowable as a cost of performance of any other contract. Such losses shall include any excess of cost over income under any and all other contracts whether such other contracts are of a supply, research and development, or other nature.

15-350 Termination Costs.. In the event of termination of the contract for the convenience of the Government, the allowability of particular items of cost will be determined in accordance with the cost principles and standards contained in this Section and will, in addition, be subject to the

at their regular duty stations. When reasonably required by the nature of the contractor's operations, plant location, established policies, or employer-employee agreement, such costs shall be allowable. On the other hand, any profit on such activities shall be considered as a credit to the contractor's overall expenses before allocation to defense contracts, unless such expenses are reduced for all the costs of such activities, including use of facilities, space, and utilities with elimination of such credits from the contractor's general expenses subject to cost allocations to defense business.

15-340 Financial and Other Expenses:

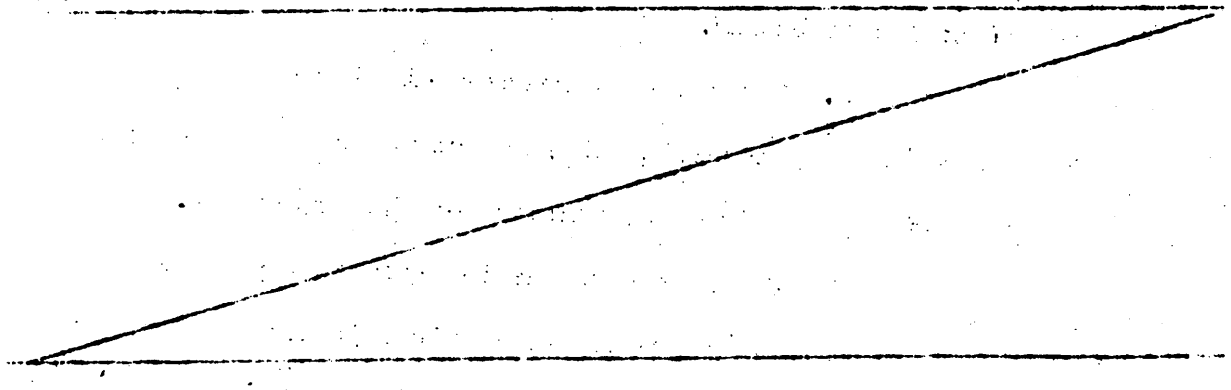
15-340.1 Interest on Borrowed Capital. Profit margins allowable in contract pricing are based, among various factors, upon consideration of normal interest return on total capital employed (including borrowed capital) and compensation for risks (including loss of any capital) except to the extent that risks are the subject of compensation through cost allowances or are assumed by the Government under special forms of contract pricing, when no pricing allowance for such risks should be made. In this way, every contractor should receive nondiscriminatory treatment, whether he furnished his entire capital or borrows a large portion thereof, or whether he is organized in the form of a corporation, a partnership, or a sole proprietorship. Accordingly, interest paid or accrued, regardless of the nature of the obligation which gives rise to the interest cost, is not an allowable item of cost to be charged directly or indirectly to Government contracts.

15-340.2 Contingencies.

(a) No allowance for future contingencies shall be included in making determinations of historical costs. Costs of events which occurred during

4. The cost of items of material reasonably usable on other work of the Contractor, without loss to it, should not be considered. In deciding whether such items are reasonably usable on other work of the Contractor, the Contracting Officer should consider the Contractor's plans and orders for current and scheduled production. Contemporaneous purchases of similar items by the Contractor from other sources will be regarded as evidence that such items are reasonably usable on the Contractor's other work, but in any such case the Contracting Officer will consider any evidence submitted by the Contractor showing that it could not retain such items at cost without sustaining a loss. Any allocation of such costs to the terminated portion of the contract should be made only to the extent that the quantities of the common items on hand, in transit and on order, are in excess of the reasonable quantitative requirements of other work.

15-350.3 Limitations of Certain Costs. In no event shall the aggregate of the amounts allowed in respect of initial costs and preparatory expenses; loss of useful value on special machinery and equipment; experimental, research and development expense; special leases; engineering and development and special tooling, exceed the amount which would have been available from the contract price to cover these items if the contract had been completed, after considering all other costs which would have been required to complete it.



provisions of this paragraph.

15-350.1 Settlement Expenses. The additional costs that arise as the result of termination or cancellation of Government contracts (or subcontracts, including purchase orders), for the convenience of the Government, are allowable. These costs include reasonable costs of settlement, including accounting, legal, clerical, and other expenses reasonably necessary for the preparation of settlement claims and supporting data with respect to the terminated portion of the contract and for the termination and settlement of subcontracts thereunder, including expenses incurred for the purpose of obtaining payment from the Government but only to the extent reasonably necessary for the preparation and presentation of settlement proposals and cost evidence in connection therewith. Settlement expenses include reasonable storage, transportation, and other costs incurred for the protection of property acquired or produced for the contract or in connection with the disposition of such property.

15-350.2 Exclusions. To be excluded from allowable costs in the event of termination are the following:

1. Costs not allocable to the terminated portion of the contract (inventory basis) or to the completed and terminated portions (total cost basis).

2. Costs due to unreasonable delay on the part of the contractor in complying with the clause of the contract entitled "Termination for the Convenience of the Government."

3. Costs incurred as the result of purchasing or producing facilities, materials, or services in excess of the reasonable quantitative requirements of the entire contract.

not result in a reasonably accurate assignment of indirect costs to facilities contracts. Since indirect costs are those which are incurred for common objectives, a grouping of objectives and identification of indirect costs therewith will furnish guidance as to the assignment of indirect costs to the various benefited activities. For example factory accounting and administrative costs may properly be allocated to facilities contracts; while, generally, depreciation on factory production equipment should be excluded. Similarly, any indirect cost incurred solely for the benefit or production should be excluded where the facilities are constructed or installed by a separate service or maintenance department. No selling or distribution expenses (other than engineering expenses incurred in the design, construction, or installation of the facility) will be allocated to the cost of facilities involved. General and administrative costs may be allocated only where the facilities program represents a significant porition of the contractor's work during the period.

(c) The required degree of preciseness in allocating indirect costs to facilities contracts should be related to the materiality of amounts involved. Therefore the foregoing is not intended to require a meticulous identification of such costs. However, it is intended to furnish some criteria for the allocation thereof to facilities contracts on the basis that such contracts should bear the allocable portion of indirect costs incurred for the benefit of the contract. Hence, where the contractor constructs facilities which are generally similar to facilities which he also produces for sale, indirect costs may be allocated in accordance with his established practice. In most other cases in which the contractor performs the facilities construction himself, the decision to do so will have been based upon the fact that he has an already established department

PART 4

Application of Cost Principles
In Facilities Contracts

15-400 Scope of Part. This part sets forth applications of cost principles and standards of Part 2 of this Section in connection with the determination of costs under facilities contracts and under the facilities portion of supply/and research contracts. Generally this Part covers only the allocation of costs to such contracts or facilities portions of supply/ contracts or research contracts. Other Parts of this Section provide guidance as to allowability of particular items of cost and determinations made under this Part should be made in light thereof.

15-410 Direct Cost. The cost of purchased facilities, including costs of acquisition, delivery and placing into condition for use, is allowable at the net purchase or subcontract price. If architectural, engineering, installation, or other collateral services are performed by the contractor's own employees, the direct costs of supplies consumed and labor utilized are allowable. Similarly, if buildings or equipment are constructed, manufactured or rehabilitated by the contractor, the direct costs thereof are allowable.

15-420 Indirect Costs.

(a) No indirect costs will be allocated to the cost of facilities purchased by the contractor on an installed (ready to use) basis.

(b) Where the contractor constructs the facilities or incurs additional costs other than the purchase price of purchased facilities, every reasonable effort should be made to direct-cost the items of cost directly assignable to the facilities. Special problems of allocation arise because such work done by the contractor is usually different from that done in connection with its regular production of goods for sale. Hence the contractor's usual method of overhead distribution to products for sale may

consistent pattern of costing if the results are to be equitable. In some instances, this principle may be applied by direct costing only the major items of a given cost element to all products, leaving minor items, if appropriate, subject to indirect cost allocations.

15-206 Indirect Costs. Indirect costs, which have the character of common or joint costs, usually consist of indirect materials, indirect labor, and other items. These costs generally are grouped in classes, as follows:

(a) Manufacturing (shop, laboratory) expenses (often termed "manufacturing overhead" or "burden"), which are incurred in fabricating the article or performing the service;

(b) Engineering expenses to extent not included in (a) or (c);

(c) Selling and distribution expenses incurred in marketing the products manufactured;

(d) General and administrative expenses incurred in the over-all management, supervision, and conduct of the business;

(e) Financial and other expenses.

15-207 Methods of Allocation of Indirect Costs. No general rules regarding allocation of indirect costs to products, job orders, or contracts can be stated for all individual cases, because the nature of the particular operations and the actual conditions in each instance determine the most suitable method or methods to be employed. The method of allocation of indirect costs will be acceptable if it is in accord with generally accepted accounting principles and practices and if it produces equitable results under the particular circumstances. (See also paragraphs 15-313.1, 15-313.2, 15-320.1 and 15-330.1.)

(a) Cash discounts taken. However, if the contractor does not exercise reasonable precautions in taking advantage of cash discounts available, all cash discounts lost may be deducted in determining allowable costs;

(b) Trade discounts, rebates, refunds, and allowances on material purchased;

(c) Credits for scrap and salvage and materials returned to vendors;

(d) Credits arising from differences between book and physical inventories.

15-311.2 Pricing:

(a) In determining historical costs, any generally recognized method of pricing materials issued from stock may be employed for determining actual cost, provided it has been consistently used by the contractor, is acceptable for internal revenue purposes, and does not discriminate against the Government. When materials in inventory at the commencement date of a Government contract have a provable replacement cost significantly different from book cost, either the contractor or the Government may elect to use such replacement cost in lieu of book cost in pricing materials issued from such inventory. However, such election including identification of the types or kinds of materials involved should be made at the time the contract is entered into and provided for in the contract. When materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be changed to the contract. Costs of subcontracts for components should be determined similarly; proyided that, when subcontracts are performed under contract pricing arrangements other than firm fixed prices, the negotiation of prices or determination of costs shall conform to this section so far as considerations of costs are concerned.

(b) For purposes of estimating material cost, either current market

PART 3 - APPLICATIONS OF COST PRINCIPLES TO SUPPLY CONTRACTS AND RESEARCH AND DEVELOPMENT CONTRACTS WITH COMMERCIAL ORGANIZATIONS

15-300 Scope of Part. This part states, in some detail, applications of the general cost principles and standards set forth in Part 2 of this Section to supply contracts and research and development contracts with commercial organizations. It is impracticable and unnecessary to cover every element of cost or possible situation that might arise in a particular case. However, when this part does not furnish specific guidance, the philosophy expressed or implied in the principles and standards comprising Part 2 of this Section and the more detailed discussions of similar or related items in this Part 3 should be followed.

15-310 Manufacturing Costs:

15-311 Materials. The net costs of materials (including components), both direct and indirect, used or consumed in performance of Government contracts are allowable on the basis hereinafter outlined. Cost may include such collateral items as transportation, insurance, purchasing, receiving, storage, warehousing and adjustments of inventory accounts reasonably related to the period of contract performance resulting from variations at cost between book and physical inventories. (See paragraph 15-311.2 for basis of materials pricing.) If the cost of collateral items is included in material costs, no additional allowance therefor may be made in the determination of manufacturing burden. If such items are not included in material costs, they are properly included in overhead.

15-311.1 Material Credits. In establishing material cost, effect shall be given, as appropriate, directly, or indirectly as a reduction of total manufacturing costs, to such items as:

[(iii) The prices of other suppliers for the same or substantially similar items can be established through quotations, correspondence, or by other means.

[(2) In case the transferor is a separate corporation or partnership in which nonaffiliated parties hold a minority interest of 10 percent or more, a reasonable margin of profit on such sales in recognition of the minority interest may be permitted by agreement notwithstanding inability to determine market prices in accordance with paragraph (1) above.

[(3) Under special circumstances, inter-company or interdivisional sales or transfers may be priced to include a profit to the transferor when no evidence exists as to market prices, provided, in the opinion of the contracting officer, the total price paid by the Government for work performed under the contract of the transferee is not increased by such pricing procedures. This departure from the basis of pricing such sales or transfers at market prices determined in accordance with paragraph (1) above or cost to the transferor should be authorized only where all of the following circumstances exist:

[(i) The management of the transferring unit is significantly independent (though not necessarily autonomous) of the acquiring unit;

[(ii) It is the contractor's long established practice to price inter-company transfers at other than cost and to apply such practice to transfers of commercial work as well;

[(iii) Routing of work through the integrated unit is not affected by departure from the cost basis with consequent increase in total actual production costs of the work.

prices or anticipated acquisition cost may be used, but the basis of pricing must be disclosed. In order to avoid the allowance of contingencies in firm forward pricing actions in which the anticipated replacement cost may be expected to be substantially greater than current market, materials escalation provisions may be made a part of the contract. However, situations involving changes in material costs which are reasonably certain and determinable, or relatively minor in amount, may warrant recognition being given thereto in making estimates.

[(c) In cases in which a contractor has integrated operations involving inter-company or inter-divisional sales or transfers of materials, such materials may be priced to include a profit to the transferor company or division under appropriate circumstances outlined below. In such event, such sales or transfers shall be treated as subcontracts in determining the profit or fee for work performed under the contract of the transferee. In other cases, where the conditions outlined below do not exist, inter-company or inter-divisional sales or transfers of materials shall be stated at cost to the transferor for purposes of contract pricing of the transferee.

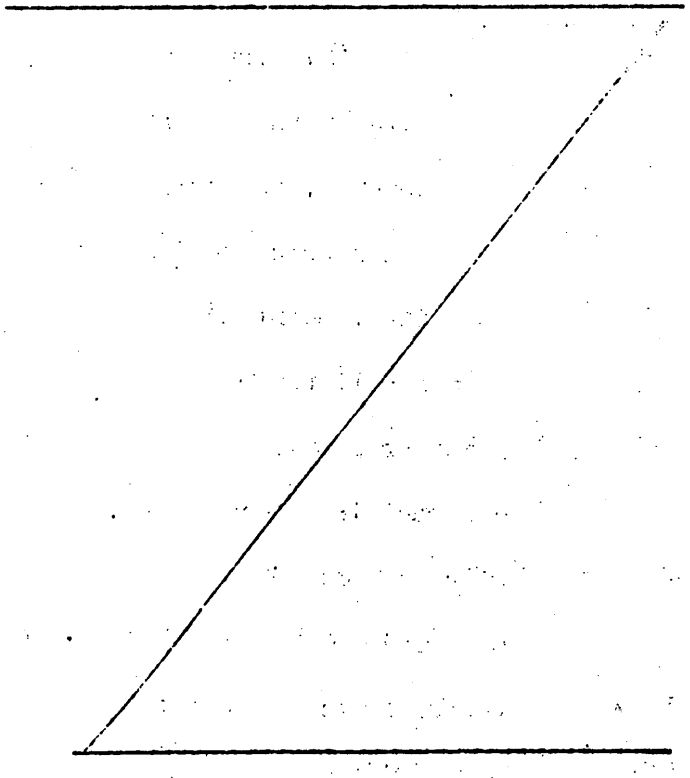
[(1) When inter-company or inter-divisional sales or transfers of materials are priced in excess of cost, they shall be priced, insofar as possible, upon the basis of the lowest market price determined in consideration of the following:

[(i) The price is the transferor's lowest sales price to nonaffiliated customers for the same or a similar item, quantity and quality considered;

[(ii) The price for the same or substantially similar items is quoted at reasonable intervals in financial or trade publications;

the basic salary or wage and all fringe benefits will be considered in determining the reasonableness of the earnings of an individual in relation to services rendered. Direct labor cost consists of salaries and wages identified specifically with the performance of a contract, job, or product. Labor services utilized for joint objectives may be treated as indirect costs if specific identification is impractical or uneconomical and the results of allocation are equitable.

(b) In determining historical costs, labor will generally be charged at actual rates paid by the contractor. However, if it is the contractor's consistent practice to charge for performance of groups of



Determination of the foregoing facts in any case may require submission of cost data of the transferor.7

(c) Inter-company or inter-divisional sales or transfers of materials shall ordinarily be stated on the basis of cost to the transferor. However, under some circumstances, departure from the cost basis may be appropriate but such departure is permissible only if specifically authorized by the contracting officer. Examples of circumstances which may justify departure from the cost basis are as follows:

(1) Cases where the transferor is an affiliated or subsidiary corporation in which non-affiliated parties hold a minority interest of 10 percent or more.

(2) Transactions involving items regularly manufactured and sold by the contractor through commercial channels. In these cases, however, the price must not exceed the lower of (i) the transferor's sales price to its most favored customer for the same or a similar item, quantity and quality considered, or (ii) the prices of other suppliers for the same or substantially similar items.

Departures pursuant to the foregoing, should be authorized at the time contract is entered into, should include identification of the types or kinds of materials involved and the names of the suppliers, and should be provided for in the contract. Also in such event where such sales or transfers are authorized they shall be treated as subcontracts in negotiating the profit or fee for work performed under the contract of the transferee.

15-312 Labor:

(a) The cost of obtaining the services of any individual includes the base salary or wage, plus the cost of all fringe benefits. Therefore, both

(a) Each class of compensation is preferably to be accrued as a cost over the period in which it is earned.

(b) Where it is the contractor's established practice to record the costs at the time of payment, such practice may be acceptable. This is the most commonly used method of accounting for "fringe benefits," but its use might result in inequities in some cases. For example, if a Government contract was performed over the summer months during which most of the contractor's employees took vacations or military leaves, recognition of the cost at time of payment would be inequitable to the Government. On the other hand, if the contract or contracts extended over approximately one year and the proportion of Government work to the contractor's commercial work remained stable, this method might be equitable.

(c) When the costs of any of the elements of fringe benefits are greater or lesser with respect to defense business as compared with non-defense business, such costs should be allocated, so far as feasible and appropriate, between the two classes of business before further allocation of such costs to individual contracts or products. If this method of cost allocation is used, it should be used consistently for all elements of fringe benefits having a different cost relationship of defense business as compared with nondefense business.

(d) It may be practicable to negotiate an equitable rate for fringe benefits based upon experience for a representative period in lieu of individual consideration for each item. Changed conditions and circumstances would have to be considered in making such a determination. The experience rate would then be applied to the more direct labor costs to determine the allowable costs. The use of such rate should be subject

labor at an average rate, or to use standard labor rates, with consequent savings in clerical expense or improvement in labor control, such methods may be used, provided labor groupings and the adjustment for cost variances result in a reasonably accurate assessment of total charges.

(c) When labor costs are required for making cost estimates, the use of standard labor rates and standard time allowances (appropriately adjusted for experience variances) or reliable engineering estimates is acceptable. Ordinarily the use of wage rates higher than current going-rates will not be permitted for estimating purposes. In order to avoid substantial allowances for labor rate contingencies, labor escalation clauses may be utilized in fixed-price type contracts. However, situations involving increases in wage rates which are reasonably certain and determinable or relatively minor in amount may warrant recognition being given thereto in making estimates.

15-312.1 Fringe Benefits—Vacations, Holidays, Sick Leave, Military Leave, and Employee Insurance. Compensation of these types is allowable to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment.

The cost of "fringe benefits" is part of the cost of the work performed by the employee while on the job, and must be considered as having a direct relationship to such work. However, in recognition of the different accounting treatments accorded fringe benefits by different contractors, the cost thereof may be allocated to Government contracts on any of the following bases, provided equitable results are achieved:

unreasonable or otherwise unallowable under this paragraph, and are allocable to all classes of work. Costs of such plans established by nonprofit or other organizations not subject to payment of Federal income taxes are also allowable except to the extent determined to be unreasonable or otherwise unallowable under this paragraph, and are allocable to all classes of work.

(b) Pension or retirement plans of a contractor which are subject to approval of the Bureau of Internal Revenue must have been so approved before costs under the plans may be allowed as charges under defense contracts. Many plans of nonprofit or other tax exempt organizations are also reviewed and approved by the Bureau of Internal Revenue - when not so reviewed and approved, each such plan will be reviewed, and approved or disapproved, by the Department to which audit cognizance is assigned, using, insofar as applicable, the criteria and standards of the Internal Revenue Code and the regulations of the Bureau of Internal Revenue. In any case where the Bureau of Internal Revenue withdraws approval of a plan, approval of amounts allocated to contract costs or estimates will be withdrawn accordingly.

(c) The approval of a pension or retirement plan by the Bureau of Internal Revenue will generally be the only approval required by the Departments; however, the right is reserved to require submission of any such plan for consideration by a Department and to disapprove such plan in its entirety or any feature thereof whenever the circumstances in a particular case are deemed to warrant such action. Such consideration will be the responsibility of the Department to which audit cognizance

to revision in light of changed conditions.

15-312.2 Fringe Benefits - Bonuses. Bonuses to employees, such as production incentives and suggestion or safety awards, represent a part of their total compensation and are an allowable cost under Government contracts when appropriately allocated to all classes of work, if they are: (1) reasonable in amount, (2) paid in connection with an established plan which was in effect before the award of the Government contract under consideration, and the plan is consistently followed by the contractor, (3) paid for current services rendered by the employee, (4) available to all employees of the contractor, or to all employees within a group or salary classification, provided such group or salary classification is not unreasonably restricted, and (5) represented by current expenditures of funds rather than by accrual of expenses or issuance of stock.

Bonuses will not be allowed as a cost on Government contracts when they are contingent upon profits and constitute a distribution of profit rather than reasonable compensation for services. Bonuses will not be allowed when they are restricted to officer or other employee stockholders or are distributed in relation to stockholdings.

15-312.3 Fringe Benefits - Pension and Retirement Plans.

(a) The costs of pension and retirement plans, including reasonable incidental benefits, such as disability, withdrawal, insurance or survivorship allowances which are deductible from taxable income in accordance with the Internal Revenue Code and the regulations of the Bureau of Internal Revenue, are allowable except to the extent determined to be

(h) Credits which arise from various sources, such as dividends and cancellation of employee benefits, which have not vested at the time of termination of their employment, must be taken into account in an equitable manner in arriving at pension and retirement costs. Special provision for these credits is usually necessary when the contractor's organization has substantially expanded for the performance of defense contracts and there is reasonable expectation that the employment of a large number of the additional employees will be terminated upon curtailment of defense work. Under these circumstances, 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. There are two general methods which may be used, individually or in combination, in making such arrangements:

(i) A lump sum or percentage discount (of current pension cost) allowance negotiated and agreed upon in advance. Determination of such allowance is not often an actuarial problem involving a calculation based upon known factors, but rather is an attempt to reach a negotiated agreement as to various uncertain or variable factors in a complex situation. Mass lay-off of employees which may result in the incurrence of severance payments costs should generally lead to a reduction in pension costs through an increase in pension credits.

(ii) A retrospective determination at some time in the future when a more accurate estimate can be made by virtue of experience which may have developed. Until such determination, current costs may be

is assigned, and the subsequent action taken by that Department will generally be accepted by the other Departments.

(d) Approval of a pension or retirement plan by the Bureau of Internal Revenue or by the Departments does not imply that the cost thereof for any particular year will be allowable for apportionment to contract costs or estimates, except to the extent costs for that year meet all other requirements of the Bureau of Internal Revenue as a deduction for income tax purposes, and are allowable under the provisions of this paragraph and the other provisions of this section.

(e) Pension and retirement costs constitute a part of the total compensation by a contractor to any individual covered by the plan, and accordingly are subject to the provisions of this section with respect to reasonableness of the total compensation paid to the individual for the services rendered (see ASPR 15-312 and ASPR 15-330.2).

(f) Where contributions to pension or retirement plans are based on profits, providing that provisions of the Internal Revenue Code and regulations of the Bureau of Internal Revenue have been met, the amount allowable for apportionment to contracts in any one year shall be the amount contributed to the pension trust(s) for that year, but not to exceed 15 percent of the total compensation otherwise paid or accrued in that year to the individuals covered under the plan(s).

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

sentative past period. In determining historical costs, such recurring nominal severance payments actually made are allowable. Where the Contractor provides for accruals of severance payments in lieu of recording the cost thereof at the time of payment, such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made over a representative past period. Generally, the cost of severance payments made during the performance of defense contracts should be allocated to all classes of work being performed at the time of payment since it is a reduction of total work which causes the severance. The following paragraphs are devoted to the treatment of severance payments anticipated to be necessary upon the completion or termination of defense production.

(b) Mass severances.

(1) Fixed-price type contracts. The considerable uncertainty as to whether mass severance payments will ever have to be made is such that no consideration will be given thereto in making cost estimates or in determining historical costs. This risk is one which the contractor must assume and for which he is compensated in the profit. However, where, because of termination of the contract for convenience of the Government, the Contractor does not have the opportunity to earn the profit contemplated by the contracting parties at the inception of the contract, costs of severance payments actually made and which are allocable to the terminated contract are allowable. In allocating costs to the terminated contract(s) the costs shall be assigned to the period in which the severance pay was actually earned and apportioned to all business of the Contractor performed during that period. The cost apportioned to the period of of production of the terminated contract(s) should then be allocated

allowed provided an appropriate contractual arrangement can be agreed upon which reserves the Government's right to these credits. Such recapture provisions will vary in the extent and duration of application and time of determination. For example, such provisions may be contract-wide or contractor-wide and the determination may be made at termination of a defense contract or defense contracts, at mass lay-off of contractor's employees or at the time of substantial decline in proportion of contractor's total sales under defense contracts.

15-312.4 Fringe Benefits - Severance Pay. The cost of severance pay will be considered only to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment. Theoretically, the right to severance pay is earned during the entire period of employment of the indivual or, when based upon specified years of service, is earned during those years. In theory, the cost of severance payments should be recorded in the contractor's accounts during the periods in which the employee earned the right to such payments. However, few contractors accrue severance payments because (1) the clerical expense involved in identifying and recording the cost for each employee is not justified; and (2) there is considerable doubt that any substantial payments will have to be made since payment is solely contingent upon future events.

(a) Recurring, nominal severance payments. The cost of severance payments arising from regular employee severances as distinct from mass layoffs may be included in cost estimates only to the extent that such estimates are based upon severance payments actually made over a repre-

15-312.5 Fringe Benefits -- Premium Payments for Overtime and Extra-Shift Work. Costs of this nature consist of only the premium portion of overtime and extra-shift payments or accruals to employees, not the straight-time portion. Thus, if the rate for overtime work is time-and-one-half of the regular rate, the premium portion is the additional one-half. Similarly, if the wage rate for a second shift is twenty cents an hour above the regular rate, this additional amount is the premium.

Overtime and shift premiums are allowable if authorized or approved pursuant to the requirements of paragraph 12-102.

Such premiums may be classified as either direct or indirect labor cost, but overtime premiums should be separately stated in either event. When treated as direct labor cost, overtime premiums should not be included in the base for distribution of overhead. The amount of overtime and shift premium cost charged on Government contracts shall not be disproportionate to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant.

15-312.6 Fringe Benefits -- Unclaimed Wages. Costs under cost-reimbursement type contracts should reflect a credit for unclaimed wages based upon agreement as to the amount thereof reasonably expected not to be paid subsequent to the date of completion or settlement. In this event, all unclaimed wage liability rests with the contractor. When such an agreement cannot be reached, the Government will assume liability for payment of unclaimed wages and eliminate all allowances therefor from reimbursement to the contractor.

between the terminated contract(s) and all other business of the Contractor. If the termination claim is prepared on the total cost basis, the amount so allocated is properly allowable. If the claim is prepared on the inventory basis, the amount allocated to the terminated contract must be further subdivided between that portion of production billed as completed units and the portion to be inventoried. Only the severance pay costs applicable to the latter portion is includible in the termination claim.

(2) Cost-reimbursement type contracts. Mass severance pay costs will not be considered in the evaluation of cost estimates; nor will any allowance be made on an estimated basis in determining historical costs. Likewise, the contingency of severance payments will not be considered to be a risk assumed by the contractor in determining the fee since the Government assumes the risk. The cost of severance payments actually made upon cessation of Government work where there is no reasonable prospect of continuing employment on other work of the Contractor are allowable. The allowable cost shall be determined by assigning the total cost to the period in which the severance pay was actually earned and apportioning such cost to cost-reimbursement type contracts and all other business of the contractor performed during that period.

A reservation in the final release of claims (see ASPR 7-203.4) may be made in the case of completed cost-reimbursement type contracts where it is reasonable to assume that severance payments allocable to the contract will have to be made at some future date.

15-313 Other Manufacturing Expenses:

15-313.1 Allocation of Indirect Manufacturing Expenses. Among the acceptable bases, depending upon circumstances, for allocating indirect manufacturing expenses are direct-labor-cost, direct-labor-hours, machine-hours, and units processed. In more complex manufacturing plants, it is appropriate to departmentalize the plant for purposes of accounting for manufacturing expenses when any given type of defense production is concentrated in departments having a much higher or lower expense rate than the average. Expense departmentalization is also desirable in larger and more complex plants for purposes of expense budgeting and control by the responsible foreman, regardless of the need for a more refined method of expense allocation. When manufacturing expenses are departmentalized, it is necessary to charge service-department expenses (such as the power plant) and factory general expenses (such as taxes, insurance, 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 should be selected for service-department and other expense distributions to productive departments - e.g., kilowatts of connected power load or metered power consumption, in the case of electric power.

Direct-labor-hours may be preferable for use as a basis for distribution of indirect manufacturing expenses when, for example, wage rates vary widely within a given cost center or department. When direct-labor dollars expended fairly reflect machine effort, as well as labor effort, in any productive department, it is most simple, as well as appropriate, to use that basis of expense allocation in preference to a direct-labor-hour or machine-hour basis. When there is much automatic or semiautomatic machinery in a

productive department, the use of a machine-hour-rate is generally more appropriate for expense allocation. The units-processed-basis of allocation is generally appropriate when a given productive department processes only one item, or the several items are so similar as to be susceptible to measurement of units processed in terms of a common denominator -- e.g., steel sheets of various gauges processed through a rolling mill.

15-313.2 Allocation of Engineering Expenses. Engineering expenses are included in such items as the cost of product design, tool design, experimental development, manufacturing and production development, lay-out of production lines, determination of machine methods and related blueprinting and drafting. The principle of direct costing (see paragraph 15-211) would indicate the desirability of charging directly to the benefited activities (such as production, facilities, and research and development) all engineering costs which can be directly identified with such activities. Only a relatively minor amount of engineering costs (consisting chiefly of engineering administrative expenses) should remain to be allocated to the activities on an indirect basis. All engineering costs charged directly or allocated should in turn be assigned to products, product lines, job orders, contracts, etc. For further treatment of the costing of research and development, special tooling, manufacturing and production engineering and preproduction expenses, see paragraphs 15-313.7, 15-313.10, 15-313.11 and 15-313.12; facilities contracts are included in Part 4 of this Section.

15-313.3 Depreciation.

(a) Depreciation accounting is a system of accounting which aims to distribute the cost of tangible capital assets, less estimated salvage value (if any), over their estimated useful life in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the

generally be determined by groups of facilities for which the factors bearing on estimated useful life are similar. The amount of depreciation written off in any fiscal period may vary with volume of production or be increased for multishift operation, provided the method followed is consistent with basic objective set forth in subparagraph (b) above. Special methods have been established for determining depreciation on emergency facilities covered by Certificates of Necessity by a special directive set forth in an appendix of this Section.

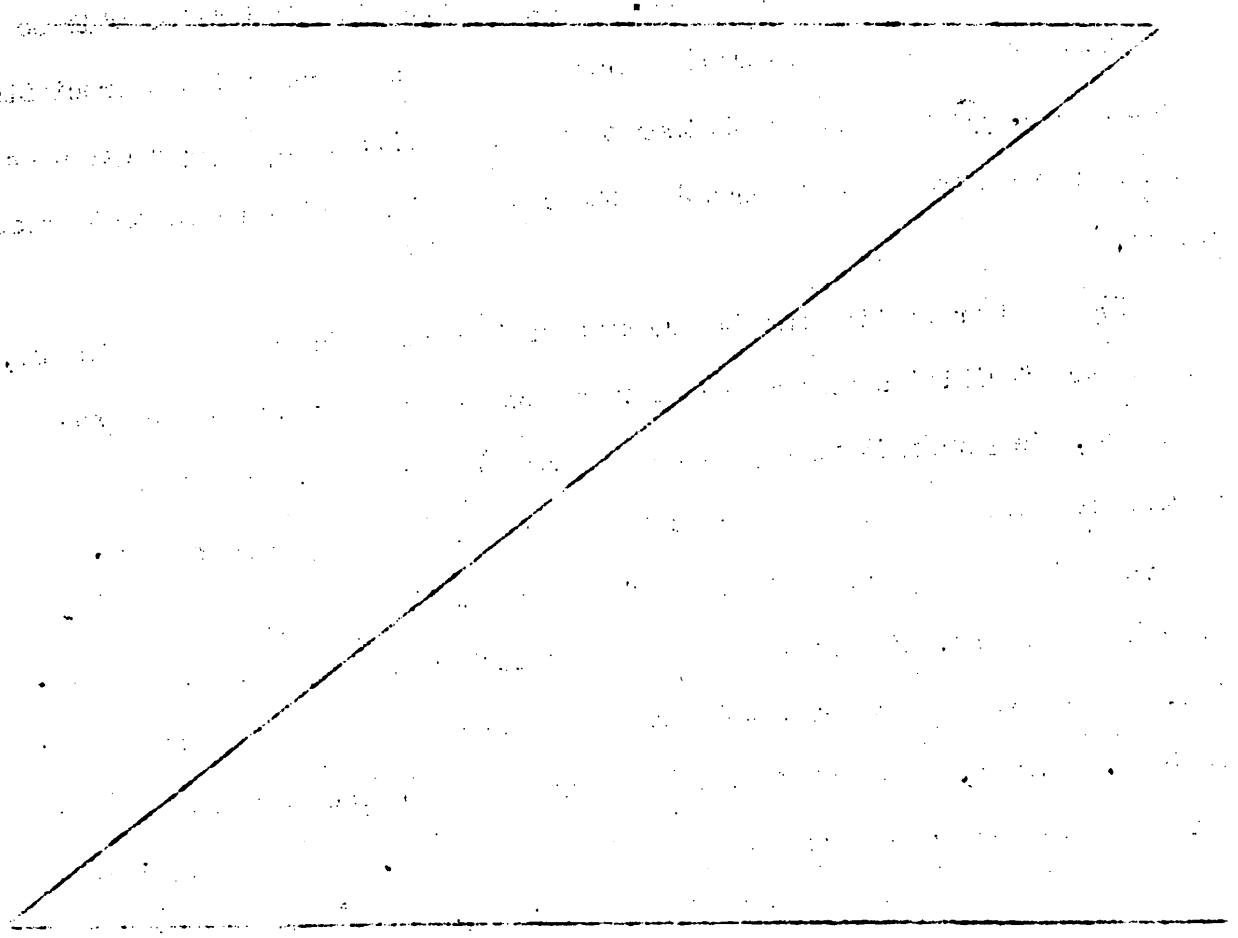
(d) Depreciation should be based upon original cost of the facilities, whether measured by purchase agreement for a cash consideration, the fair value of securities issued in exchange, or similar appropriate measures, [although it is permissible that such cost of facilities be adjusted, where desired by the contractor for purposes of depreciation computations for contract pricing, to current price levels by the use of a general price index, provided in such event that the practice will be followed consistently in the future and also provided that otherwise the charge is made at the same annual rates applied to such adjusted costs as would have been appropriately applied on original costs in view of the estimated useful life of the facilities. In other words, no deficiency in actual depreciation provisions in any prior year, based upon current price levels, should be included in the depreciation charge for the current year. No other basis of determining appreciation in value of facilities may be utilized in determining depreciation for purposes of contract costs; for this purpose the tax basis of facilities values acceptable for internal revenue purposes is applicable.]

year is the portion of the total charge under such a system that is allocated to the year. Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, usually of an indirect nature.

(b) Useful life, as above referred to, has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life. In establishing estimated useful life, consideration should be given to all of the factors of wear and tear, obsolescence (both economic and technological), and inadequacy, which are common to the depreciation problem. Of these factors, obsolescence is most often the limiting or controlling one. Obsolescence of facilities, from the standpoint of economic utility, is always a prospect or contingency to be anticipated (differing only in degree, in each instance) with respect to an entire enterprise or an individual plant, as well as groups or individual items of plant and equipment. Costs of depreciation and maintenance are mutually related. Wear and tear may be increased by lack of maintenance or may be made good by maintenance (often indefinitely, so long as it is economical to do so and provided obsolescence or inadequacy has not become preeminent). Hence, estimates of useful life of facilities in each case should take into consideration the actual maintenance policy in effect.

(c) Depreciation may be determined by application of any one of the generally accepted methods; however, the selected method and rate of depreciation used should, in the absence of compelling reasons to the contrary, consistently be applied from year to year. Generally, however, depreciation is too intangible to warrant meticulous computations by application of rates by individual items of plant and equipment, although such computations are frequent and will be recognized. Hence, depreciation will

15-313.4 Repairs and Maintenance. Repairs and maintenance of facilities (including Government-owned facilities) are allowable elements of contract costs. It is necessary that such expenses exclude expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and made the subject of depreciation. There is, of course, a twilight zone between repairs or maintenance and capital expenditures within which a contractor should be permitted to operate upon the basis of his established accounting practice, if the results are equitable. For example, certain major costs of building alterations and rebuilding or



(e) No depreciation will be allowable as such, or as a rental or use charge, on the cost of facilities which are fully depreciated but still in use when a substantial portion of such depreciation was on a basis that represented, in effect, a recovery thereof as a charge against defense contracts or subcontracts in negotiated pricing or statutory renegotiation of contracts. Otherwise, the contractor may compute normal depreciation on the cost of facilities in use without reference to previous depreciation provisions. However, if the amount of depreciation allowed on fully depreciated assets is material, this might be evidence of the application of excessive depreciation rates to assets not fully depreciated. If excessive rates are used, total depreciation claimed should be reduced so as to reflect the application of more equitable rates. Fully depreciated facilities will be determined on the basis of relating original cost to accumulated depreciation on such cost. [regardless of whether there is an adjustment of current depreciation charges based upon adjusting the cost of facilities to current price levels.]

(f) No depreciation may be allowed on facilities which are not in use, except such facilities as are held for reasonable production standby purposes and, when specifically provided by mutual agreement, on facilities representing additional plant capacity reserved for defense production.

(g) There are several methods of accounting for small tools and expendable equipment, if in accord with generally accepted accounting principles, any method consistently applied by the contractor will be acceptable; provided, however, that allowances for such items are recognized to represent depreciation allowances for the use of the items. Where acquisition costs are not capitalized, particular attention should be given to the residual value of such items upon completion or termination of the contract.

tractor, an additional cost allowance may be made in determining costs of the terminated contracts for the purpose of contract settlement, provided such facilities are transferred to the Government, if so desired, or an equitable adjustment is made in favor of the Government in recognition of any resale or salvage value estimated for such facilities.

15-313.6 Rentals of Plant and Equipment. Rentals of plant or equipment are allowable if reasonably required for the performance of the contract and if bona fide and reasonable as to rate and duration. Special care should be exercised in determining reasonableness of rentals in cases in which rates were arrived at as a result of less than arm's length bargaining. Rental costs may not be bona fide under the following circumstances:

(a) Rentals paid to persons, including corporations, affiliated with the contractor.

(b) Rentals paid to unaffiliated persons, including corporations, upon property formerly owned by the contractor when such property was fully depreciated or substantially fully depreciated before sale or transfer and Government contracts absorbed a significant portion of such depreciation. In either case (a) or (b), rentals will be limited to a reasonable amount of depreciation, as might be determined if the property were owned by the contractor, plus carrying costs which are not paid by the contractor under the terms of the lease, including maintenance, taxes, and insurance (but not interest on the investment).

15-313.7 Preparatory Costs. Preparatory costs or expenses, also known as "make-ready costs", are costs specially incurred in preparing to operate under a specific contract or contracts. They include costs of organization and planning, employee recruitment and training, engineering and development (including product design, product specifications, and

rehabilitating machinery and equipment may reasonably be treated in some instances as either repairs and maintenance expenses or capital expenditures, depending in part upon the contractor's established policy. In making decisions with respect to the alternative accounting treatment of these items, consideration should be given to the materiality of the amounts involved, and the question of the substantial enhancement in value of a contractor's facilities at the expense of the Government. In the latter case, for contract pricing purposes, the cost generally should be considered to be of a capital nature and the subject of depreciation. In those instances where it may be appropriate to charge the cost of extraordinary rehabilitation to expense, special care should be taken in equitably allocating the costs to all the benefited classes of work (see 15-313.7 "Preparatory Costs"). Repairs and maintenance costs on facilities which are not in use will not be allowed, except on individual items of machinery and equipment (as distinct from entire plants or significant portions thereof) held for reasonable standby purposes. Repairs and maintenance on additional plant capacity reserved for defense production will be allowed only if specifically provided by contractual agreement.

15-313.5 Profits or Losses on Disposition of Plant and Equipment. In determining contract costs, no recognition will be given to profits or losses on disposition of plant and equipment for reason that depreciation reasonably determined, provides the exclusive charge for the cost of using a contractor's facilities. However, when a contractor has capitalized special purpose facilities acquired solely for performance under defense contracts (rather than charge the costs thereof to specific contracts) and engineering changes or complete or partial termination of contracts finds such facilities not fully depreciated and not reasonably useful for other business of the con-

Initial production costs may consist of the excessive portion of material costs incurred in the early stages of production, on contracts requiring new products or greatly increased production, as the result of abnormal quantities of materials used or abnormal scrap losses. Initial costs may also consist of the excessive portion of direct-labor costs, plus a proper portion of the related overhead, incurred in the early stages of production due to such causes as excessive defective work resulting from inexperienced labor, idle time and subnormal production occasioned by testing and changing methods of processing, and cost of training employees. The justification for such special costs depends upon their nature and causes, and not merely upon the fact that total production costs are high.

After a reasonable volume of production has been attained and initial manufacturing difficulties have been overcome, unit cost will usually tend to level off, thereby evidencing the end of the initial period of production but not necessarily representing the lowest unit cost eventaully attainable during the operation of the entire contract. If, however, these costs continue abnormally high after a contractor has been allowed a reasonable length of time in which to learn how to make a product efficiently, the excessive costs may not properly be allowable for purposes of estimating under cost reimbursement type contracts or estimating for formal pricing purposes in fixed price type contracts, and should receive special consideration in determining historical costs under existing contracts, or in establishing costs under terminated contract settlements.

/15-313.9 Reconversion Expenses. Reconversion expenses are those connected with restoration of facilities to approximately the same physical arrangement and condition they were in immediately prior to the beginning

planning of production processes and layout) and plant alternation and rearrangement. Preparatory costs do not include initial production (starting load) costs which are treated in paragraph 15-313.8, or manufacturing and production engineering which is treated in paragraph 15-313.11 or special tooling which is treated in paragraph 15-313.10.

Preparatory costs, when incurred for the exclusive benefit of Government production, are allocable directly or indirectly to the contracts benefiting from such costs. When preparatory costs benefit other classes of work as well as Government work, an equitable allocation to all benefited classes of work is proper.

Preparatory costs (sometimes called "Anticipatory Costs") may have been incurred prior to the award of a definitive contract. The amounts of such costs, for purposes of contract cost allowances, are subject to approval of contracting officers based upon advance understandings or upon subsequent negotiation. In such case a specific provision limiting the amount, types and period of pre-award preparatory costs should be incorporated in any definitive contract. Similarly, it is desirable that prior approval of the contracting officer be obtained in the event that unusual charges of this type are to be incurred during the life of the contract. However, the absence of such provision or approval will not preclude consideration of the costs in subsequent price negotiations or determinations under such contracts.

15-313.8 Initial Production Costs. Initial Production Costs, also known as "starting-load costs", are non-recurring costs that arise in the early stages of production because of the contractor's unfamiliarity or lack of experience with the particular materials, manufacturing processes, or techniques involved. They are to be distinguished from preparatory costs or expenses (also known as "make-ready costs").

stances meeting the above conditions.7

15-313.9 Reconversion Costs. Reconversion costs are those incurred in the restoration of facilities to approximately the same physical arrangement and condition they were in immediately prior to the beginning of defense work, and includes the cost of removal of Government property. Reconversion costs, except for the removal of Government property, are incurred for the benefit of future production, and as such are properly chargeable against such production. Except for the costs of removing Government property, and the restoration and rehabilitation costs caused by such removal and specifically provided for in the contract, reconversion costs are not allowable.

15-313.10 Special Tooling. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment.

The cost of special tooling, when acquired for and its usefulness is limited to one or more Government contracts in force or being negotiated at the time of acquisition, is allocable to the specific Government contract(s). The cost of any special tooling which is useful under both Government contracts and commercial work will be subject to allocation between them. No part of the cost of tooling which is special to commercial work only will be allocated to Government work. The cost of non-special tooling is not subject to direct allocation, but is subject to depreciation, which is treated elsewhere in this Part, except that in the production of standard commercial products such tooling costs may be treated as indirect manufacturing expense on an expenditure basis, in lieu of depreciation,

of defense work, including the removal of Government property. In many cases, reconversion costs, except for the removal of Government property are incurred for the benefit of future production, in which cases such costs should be assessed against such production. However, in a specific case and where all of the circumstances outlined below exist, reconversion costs may be recognized through specific contractual provision.

(a) There must have been a major alteration or rearrangement of facilities at the inception of defense work for the sole purpose of performance of defense contracts, or facilities were newly acquired buildings in which Government machinery and equipment has been installed. In the latter case, only the cost of removing Government property is to be considered.

(b) The necessity of reconversion of facilities to approximately the same physical arrangement and condition they were in immediately prior to the beginning of defense work and the costs thereof must be reasonably certain and determinable.

(c) There is little or no post defense work commercial benefit to the contractor as the result of such alteration or rearrangement.

(d) Neither the particular contract nor any other contract contains an allowance for the use of facilities which would compensate the contractor for reconversion expenses.

Reconversion costs shall be allowed only in pricing those fixed price contracts in existence or actually being negotiated at the time the costs of conversion were incurred. In the event of subsequent conversions or modifications for additional fixed price contracts, care must be exercised to avoid duplication of allowances for reconversion costs. Specific contractual provisions may be included in cost-reimbursement type contracts to compensate the contractor for actual reconversion costs incurred in circum-

may be divided into two major categories -- (1) product research and development, and (2) general research.

(a) Product research or development is that which is directed toward the design, improvement or utilization of a particular product or product line. In costing production contracts, current costs (or estimates thereof where forward pricing is involved) of product research or development will be allowable. However the principle of direct costing by product or product line, as appropriate, should be applied, and provided further that such costs are not reimbursed to the contractor under separate research and/or development contracts. No costs of product research or development may be allocated to Department of Defense research and/or development contracts other than the direct costs of performing the contract and the proper share of the indirect costs of administering the research or development program. In some instances it may be appropriate to establish by contract provision a ceiling on the amount of product research or development to be allowed.

(b) General research is all research other than that which is directed toward the design, improvement or utilization of a particular product or product line. The cost of general research, when reasonable in amount and incurred in accordance with the contractor's established practice, is allocable to all classes of work, including defense work, provided such costs are not reimbursed to the contractor under separate defense research contracts, gifts, grants, trust funds or other similar sources. No general research costs which were incurred in accounting periods prior to the award of the particular defense contract(s) (including amounts capitalized in the cost of patents obtained) shall be allocated thereto, nor will the contractor be required to defer research costs incurred during the period of performance of defense contracts to subsequent accounting periods. In some instances

when the resultant charges are reasonably equitable between fiscal years. When the entire cost or a substantial portion of the cost of such special tooling has been allocated to fixed-price Government contracts, the asset concerned shall be subject to the provisions of Part 3 of Section XIII and of the Special Tooling contract clause for fixed-price contracts set forth in paragraph 13-504. When such special tooling is acquired under cost-reimbursement type contracts it shall be subject to the provisions of the contract clause set forth in paragraph 13-503 entitled "Government Property" and to the provisions of Appendix B, ASPR, applicable to Government-owned special tooling.

15-313.11 Manufacturing and Production Engineering. Manufacturing and production engineering includes the cost of engineering activities in connection with (1) current manufacturing processes such as motion and time study, methods analysis, job analysis, tool design and fabrication for improved tooling, and (2) production problems such as component design for purposes of simplifying production. Such activities are usually for the purposes closer control and reduction of manufacturing costs and the costs thereof are allowable. A characteristic of this type of expense is that it can be related to a specific contract, product or product line and is therefor chargeable thereto either directly or by allocation. (See ASPR 15-313.2). This is in contrast to general research and development which, by its general nature, cannot be directly associated with a specific contract, product, or product line.

15-313.12. Research and Development. Research and development expenses

(iv) Royalties are paid under an agreement entered into after the award of the contract without the approval of the contracting officer.

In any case involving a patent formerly owned by the contractor, the allowance will be limited to that which would have been made had the contractor retained title thereto. In all other cases, the allowance shall be reduced by the amount considered to be unreasonable.

(c) Care should be exercised to prevent charges for the use of patents when the Government already has, in fact, rights to such patents. The Government may have obtained a royalty free license or title to patents as a result of contract clauses such as contained in paragraph 9-107 and 9-112, as a result of settlement of claims, as a result of the employer's right in employees' inventions provided under Executive Order 10096, as a result of a royalty adjustment settlement, or as a result of separate purchase or gift.

15-313.14 Plant Protection Expenses.

(a) These expenses represent costs incurred in protecting the contractor's personnel and plant against fire, theft, sabotage, espionage, civil disorder, enemy attack, or other violent destructive forces. Plant protection expenses are allowable costs of defense contracts. Normally they will consist of guards' wages and labor costs related thereto, costs of individual equipment, cost of plant protection equipment if of minor amount, and depreciation of plant protection equipment. To the extent these costs are attributable solely to defense special security requirements, they are allocable entirely to defense contracts. Costs of normal plant protection not resulting from such special requirements, generally, should be indirectly allocated to all classes of work.

it may be appropriate to establish by contract provision a ceiling on the amount of general research to be allowed.

(Note -- See paragraph 9-107 for information as to patent rights to be obtained when research or development work is called for or required in the performance of a contract or when allowances are made for costs for product research or development.)

15-313.13 Patents and Royalties.

(a) Amortization of the cost of purchased patents owned by a contractor applicable to products or processes covered by a contract is an allowable element of cost to the extent reasonably allocable to the contract. Research and development costs leading to patents are treated in paragraph 15-313.12.

(b) Royalty costs are allowable if bona fide and reasonable. Special care should be exercised in determining reasonableness of royalties in cases in which amounts may have been arrived at as a result of less than arm's length bargaining. Examples of such cases are those where:

(i) Royalties are paid to persons, including corporations, affiliated with the contractor.

(ii) Royalties are paid to unaffiliated persons, including corporations, upon patents formerly owned by the contractor when the costs of such patents or the research and development work thereon were substantially recovered through charges against the costs of defense business.

(iii) Royalties are paid to unaffiliated persons, including corporations, under an agreement entered into in contemplation that a Government contract would be awarded.

(i) Recommendations and requirements of the duly constituted Governmental authority having jurisdiction over civil defense in the local area.

(ii) The extent of like measures being taken by other businesses within the local area, particularly those not producing under Government contracts.

(iii) The portion of total cost likely to be allocated to Government contracts as furnishing an inducement to the contractor to incur the cost.

15-313.15 Insurance and Bonds.

(a) To the extent that a contractor's insurance program has been reviewed and approved by the insurance authorities of the military departments, procurement and audit personnel of the military departments will be governed thereby.

(b) The net cost of insurance and bonds, after deduction of dividends or other allowances which may be expected, if reasonably necessary to the operation of a business, is an allowable cost on Government contracts to the extent allocable. Some, but not all, of the types of coverage which may be reasonably necessary are property, aircraft, automobile, general liability, product liability, workmen's compensation, employees' group, accident and disability, use and occupancy, (but excluding that portion of the policy premium applicable to anticipated loss of profit and costs which are unallowable under this Section) and fidelity and surety bonds (including performance bonds).

(c) Insurance on the lives of officers is not an allowable cost, except when premiums are paid in behalf of executives or employees pursuant

(b) A special problem may arise in the case of fixed price contracts, the security classification of which is altered after the contract has been entered into. When such a contract price is negotiated, the contractor is presumed to know the plant protection requirements under the contract and is expected therefore to meet such requirements within the contract price. However, if the security classification of the contract were changed by the Government after entering into the contract, additional costs of plant protection may be allowed the contractor by contract amendment. The additional costs may include not only current costs of an operating nature but also costs of a capital nature if the parties agree that the capital costs are incurred solely because of the changed security classification of the contract and would not have been necessary from the contractor's point of view. Also, if a classified contract is reclassified downward during its performance thereby permitting a savings in plant protection costs, such savings should, if material, be the subject of a contract amendment passing the savings on to the Government. (See 7-104.12)

(c) Civil defense costs must be allocated to all work of the contractor performed at the particular location where the costs are incurred. When the Government's portion of the output of the particular plant is not material, the reasonableness of the incurred costs need not be questioned. However, since usually past experience will not provide a guide as to reasonableness, civil defense costs should be the subject of specific agreement when the amount of such costs to be allocated to Government contracts is substantial. When this is the case, reasonableness may be judged in light of:

to take all necessary action in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer, shall be allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs.

(c) Any refund of taxes, penalties or interest thereon shall be credited to contract costs in the proportion in which contract costs absorb the costs of taxes, interest or penalties. If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

(d) Where it becomes evident in negotiating a contract price that a contractor may be required to pay a tax, the legality of which is questionable or in dispute, such tax may be used in negotiating the contract price, provided that the contract contains provisions substantially similar to those set out in subparagraph (b) (1) (2) and (3) above.

15-313.17 Strikes and Lockouts. The situations and conditions surrounding strikes and lockouts are so varied that it is impossible to establish a general principle providing for allowance or disallowance of costs incurred during such occurrences. Each case must be considered on its own

to specific agreement or established policy whereby such payment may be properly considered as additional compensation (Paragraph 15-330.2).

(d) When a contractor self insures against insurable risks of any type (But see paragraph 7-203.22 for limitation on self-insurance in cost-reimbursement type contracts), a reasonable provision for losses estimated by the contractor is an allowable cost if such provision is based upon actual loss experience to the extent feasible; or, in the absence of adequate loss experience data, it is not in excess of net costs which would be paid for such insurance if carried by private insurance companies, less agents' commissions and other acquisition and servicing costs.

(e) Losses resulting from failure to insure (through self-insurance or otherwise) against a contingent loss or damage, where a reasonably prudent businessman would have insured himself against such loss or damage, are not allowable.

15.313.16 Taxes.

(a) In general, taxes which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for Federal income and excess profits taxes; taxes in connection with financing, refinancing or refunding operations (see paragraph 15-330.5); and special assessments on land which represent capital improvements.

(b) Taxes which are believed to be illegally or erroneously assessed against the contractor, may be allowed as a cost of work performed, provided that the contractor; (1) promptly requests instructions from the contracting officer concerning such taxes; (2) agrees to comply with such instructions; and (3) if so directed by the contracting officer also agrees

abnormal in relation to sales effort that the use of historical costs would result in the inclusion of an unreasonable amount of estimated selling expenses. In the latter case, the fixed selling expenses should be charged to normal non-defense sales, leaving the defense sales chargeable only with a proper share of the variable costs. For an illustration of this principle see paragraph 15-320.5 entitled Advertising.

15-320.2 Salesmen's or Agents' Compensation.

(a) Salesmen's or agents' compensation allocable to defense contracts should be reasonable in the light of the services rendered. If inequitable or exorbitant compensation is paid, it shall be subject to disallowance, to the degree deemed excessive, for the purpose of allocation of costs to defense contracts. For example, when defense business consists of standard commercial products which are sold normally on a commission basis, sudden expansion of defense business may necessitate the adjustment in the amount of compensation allocable to defense contracts.

(b) No fee, commission, percentage, or brokerage fee shall be allowed as a contract cost when contingent upon or resulting from an award of a contract, except amounts paid to bona fide employees or established commercial or selling agencies maintained by the contractor for the purpose of securing business. This provision shall be applied in a manner consistent with representations or agreements of contractors or prospective contractors in the light of ASPR, Section I, Part 5.

15-320.3 General Sales Expenses. These expenses, consisting of salaries and expenses in connection with direction and supervision of all sales efforts, clerical expenses in maintaining sales records and statistics in some cases, and similar over-all sales expenses, may be considered to be allocable indirectly to defense products or contracts in some cases based upon

merits in the light of the philosophy expressed or implied in the principles and standards expressed in Part 2 of this Section.

15-320 Selling and Distribution Expenses:

15-320.1 Allocation of Selling and Distribution Expenses. Selling and distribution expenses identifiable in whole or in part with defense work are subject to allocation to the cost of defense work to the extent appropriate, considering the methods of selling and distribution to the Government or to prime contractors or subcontractors. Generally, selling and distribution expenses should be allocated between product lines, or to products sold to the respective customer types (where sales methods are different), based on analysis of the cost elements in relation to the sales efforts. In some cases, it may be appropriate to first allocate these expenses in whole or in part as between defense and non-defense business, and then to allocate the expenses applicable to defense business against the individual defense contracts or products. The principle of direct costing is very important in this area. For example, when special defense products are sold to the Government or to defense contractors by separately identifiable employees of the manufacturer, the compensation and expenses of such employees may be appropriately charge to costs of such products. When, in such cases, there is a separate sales organization or identifiable group of representatives engaged in selling to non-defense customers, no portion of compensation and expenses thereof should be charged to defense products. On the other extreme, when standard commercial products are sold at fixed prices direct to the Government or to defense contractors, as well as to numerous customers not engaged either directly or indirectly in defense production, by means of one established sales organization, the same selling expense per unit of product may be used in cost estimating, except when the quantities expected to be sold are so

technical pamphlets any of which aid users of the contractor's products, including the Government or defense contractors, excluding, of course, the cost of such publications prepared for the Government under separate contract consideration.

(d) Advertising for commercial products, other than as in (a) through (c) above, not in excess of the contractor's average annual costs incurred prior to the award of defense contracts, may be allocated to defense prime contracts and subcontracts for such commercial products on the basis that the costs will first be assigned to the contractor's nondefense business in the same amount per unit sold (or per dollars of sales) as was assignable to such units prior to obtaining defense business; the amount remaining after such assignment may be allocated to defense prime and subcontracts but not in excess of the amount per unit on nondefense business; provided, however, that when defense sales are merely incidental, such cost allocations may be made on an overall prorata basis.

(e) Advertising costs, other than as in (a) through (c) above, may not be allocated to defense prime contracts and subcontracts for non-commercial products.

15-320.6 Product Transportation and Delivery Expenses. These expenses, when required by the terms of a contract, are properly allowable. Whenever significant in amount and provided it is feasible, they should be determined and allocated as a direct cost of the product or contract.

15-320.7 Warehousing Expenses. Whenever a manufacturer maintains and ships products from warehouses strategically located in order to provide better service or reduce transportation costs to customers (as is frequently found

the specific facts in each case, provided the basis of allocation is equitable as between defense and nondefense business as a whole in the light of the relative services rendered.

15-320.4 Bidding Expenses. Current bidding expenses of both successful and unsuccessful bids normally will be treated as indirect expenses and apportioned currently to all business of the contractor in which event no bidding expenses of past accounting periods will be chargeable to defense contracts. However, where it is the contractor's established practice to treat bidding expenses by some other method, such method may be acceptable if the results are considered to be equitable.

15-320.5 Advertising. Advertising expenses include the costs of materials, space, time, layout, and expenses of the department which supervises such activities. Advertising expenses are generally incurred to promote the sale of the contractor's regular commercial products and should be assigned thereto. Advertising may be appropriately considered for allocation to the cost of defense contracts in the following cases:

(a) Advertising directed solely towards the recruitment of new employees.

(b) Advertising in trade and technical journals, provided such advertising does not offer specific products for sale but is placed for the purpose of offering financial support to journals which are valuable for the dissemination of technical information within the contractor's industry. In addition in the case of subcontractors, reasonable expenditures for advertising in such journals for the purpose of establishing necessary business contacts in connection with the sale of defense products to Government contractors.

(c) Publication of maintenance catalogs, parts price lists, and

time considerably beyond delivery. In such cases, it is necessary to estimate the cost of services and warranties, usually as a percentage of product cost, for purposes of price negotiation. Estimating warranty costs must usually be based upon past experience in similar circumstances with due regard to reasonable standards of quality performance. When allowances are made for costs of performance under warranties as product costs, there should be no duplication of the allowance for the risks in figuring allowable profits.

15-320.9 Entertainment Expenses. Entertainment expenses, as such, shall not be considered either directly or indirectly as a cost of performing Government contracts. However, when expenses classified as entertainment represent the purchase of meals, local transportation, rental of facilities for meetings, and other incidental costs, and the primary purpose of incurring such costs is the dissemination of technical information or the stimulation of production, such costs are allowable in determining the cost of Government contracts.

15-330 General and Administrative Expenses.

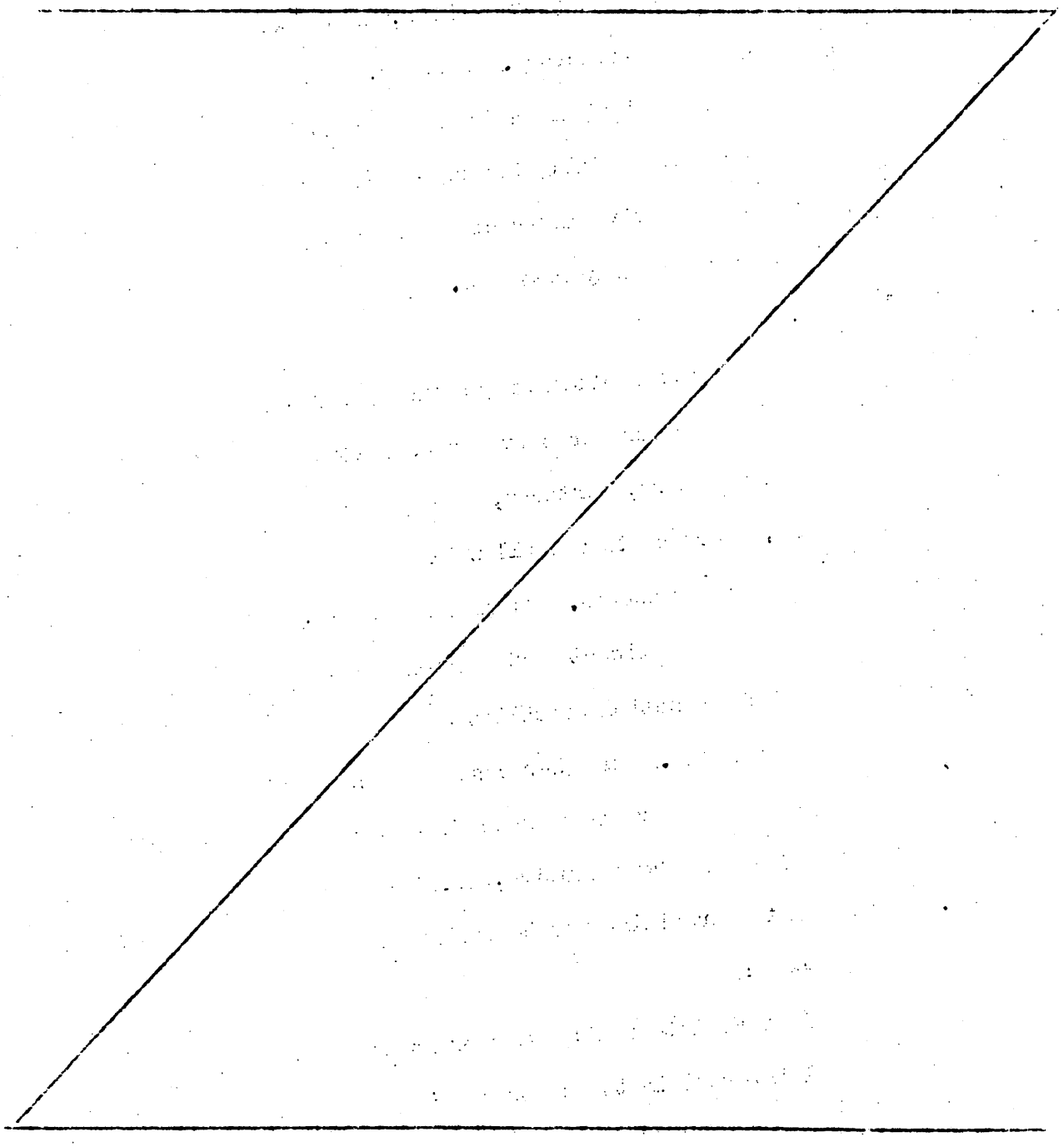
15-330.1 Allocation of General and Administrative Expenses. Among the acceptable bases, depending upon the circumstances, of allocating general and administrative expenses are processing costs (direct labor, factory overhead, and other factory production costs exclusive of direct material), factory input costs (processing costs plus direct material), cost of goods completed, cost of sales, and sales (where no more satisfactory basis is available), provided that equitable results are thereby obtained. In the selection of the particular method or methods of apportionment, special consideration should be given to any such unusual factors as major fixed asset improvement programs and significant changes in proportions of subcontracting.

with standard commercial products or spare parts), the expenses of warehousing such stocks, including transportation from factory to warehouse, are allowable when fairly allocated to defense sales in relation to total sales of products delivered from such warehouses. On the other hand, where products sold under a defen c contract are not delivered or serviced from such warehouses none of the cost of operation thereof is allocable to the contract.

15-320.8 Service and Warranty Expenses. In cases where the contract terms include an obligation on the part of the contractors, without additional separate compensation, to provide service in installation, training operators, correcting defects in the product, replacing defective parts, making refunds in case of inadequate performance, etc., the price or cost of the product may include an allowance for the cost of such undertakings. Generally, any warranty of the product as to performance, materials, and workmanship will be for a definite period of time. In the case of cost-reimbursement-type contracts, actual costs of performance to be reimbursed to the contractor will include such of the foregoing costs as must be borne by the Government under the clause of the contract entitled "Inspection of Supplies and Correction of Defects". (See paragraph 7-203.5). However, in some fixed-price contracts, a warranty may extend for a period of

(2) Ownership of the contractor is limited to a small cohesive group; or

(3) The volume of Government contracts when related to the contractor's total business is such as to influence the contractor in his determination of executive compensation; or



All pertinent factors should be reviewed from time to time, especially if and when there is a change in the nature or volume of production, to determine whether the indirect expenses continue to be apportioned equitably. Where the nature of a contractor's business has not changed basically by a shift to defense production, the presumption is that his former methods, if tested by operation over a considerable period, are satisfactory. However, this is only a presumption and should be reexamined in light of probable increased production. When the business has changed substantially because of such a shift, the contractor's former methods of allocating indirect expenses may be entirely inappropriate and so should be thoroughly reviewed.

15-330.2 Executive Compensation.

(a) Executive compensation consists of all emoluments (including salaries, bonuses, stock options, etc.) paid or accrued for services actually rendered to the contractor by executives, officers, partners, sole proprietors, and others of similar rank and abilities. Such costs are allowable when reasonable in amount in the light of the services rendered. Where the contractor's organization was a going concern for a significant period prior to the award of defense contracts, the amount of compensation established by the contractor will normally be considered reasonable. In other cases and in any case where the amount thereof appears not to have been determined through arm's length bargaining between the employer and the executive, special consideration may be required. Arm's length bargaining may be lacking in any one of the following situations among others:

(1) The executive or a member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization; or

The mode of travel, accommodation or subsistence shall be in keeping with the contractor's established practice. Should there be no established practice, the cost shall not exceed an amount commensurate with the duties and responsibilities of the traveler. Costs of entertainment shall not be included.

Special circumstances create situations for which there may be no precedent. For example, costs of transporting employees and their dependents from one geographic location to another, and reasonable allowance to establish them in the new location, may have to be incurred if a competent skilled labor force is to be recruited and maintained. Generally such costs are allowable, but there may be specific instances in which a part or all will be excluded if considered excessive or unnecessary. Where such circumstances are anticipated, advance understandings should be reached limiting the types and amounts of such costs.

15-330.4 Legal, Accounting, Engineering and Other Professional Expenses. Costs of professional services rendered, whether performed by the contractor's employees or by other members of the particular profession or craft retained by the contractor, are generally allowable. Such costs must be reasonable in light of services rendered, and payment must not be contingent upon recovery of the cost from the Government.

Such services must have been reasonably required by the business, although not necessarily required solely for the performance of Government contracts. Factors to be considered (among others) when determining the reasonableness or necessity of incurring the cost in a particular case are: (i) past pattern of such costs, particularly in the years prior to the award of Government contracts; (ii) the impact of Government contracts on the size of the contractor's business (i.e., what new problems arise); (iii) the nature

(4) The services rendered by any individual are clearly disproportionate in a major degree to the compensation paid.

Allowances for compensation of partners or sole proprietors may properly be included in executive compensation even though not actually paid or accrued in the accounts. In the case of cost-reimbursement type contract, any allowances for compensation for partners or sole proprietors should be incorporated in the contract.

Where executive compensation is considered to be unreasonable in amount, the excess over the amount considered reasonable will not be included in determining the amount allocable to Government contracts.

(b) The cost of options to purchase stock of the contractor corporation granted to executives thereof is a part of executive compensation and, as such, may be allocated to Government contracts, as follows:

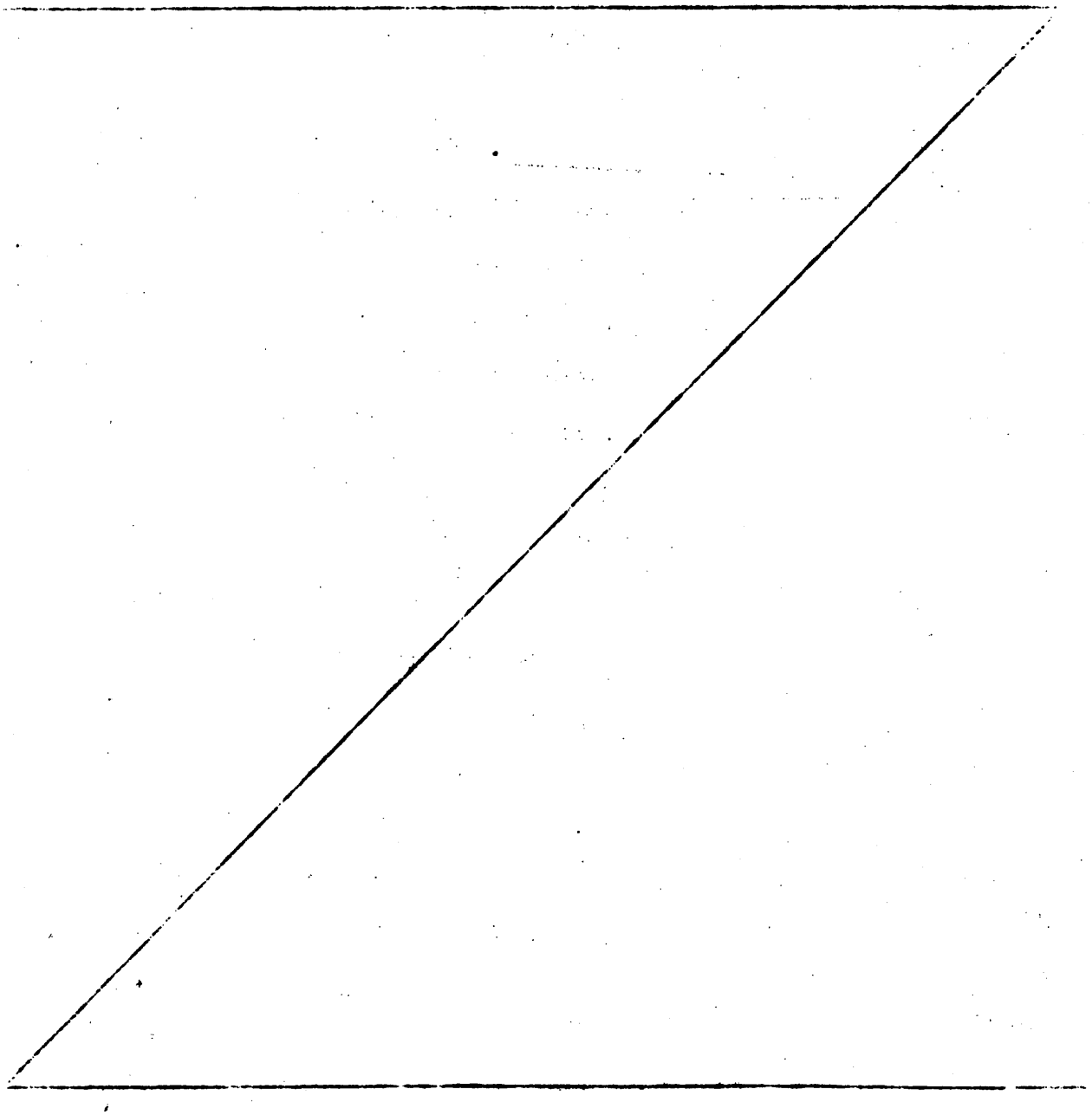
(1) The cost of stock options to the grantor corporation is the excess, if any, of the fair market value of the stock over the option price on the date the option is granted to a specific individual.

(2) Since benefits to the corporation are intended to extent over a period of years and are not limited to the year in which the option was granted or exercised, the cost to the grantor corporation must be amortized at an annual rate not be exceed three percent of the fair market value of the stock on the date the option is granted. The period of amortization is to begin with the date that the option is granted.

15-330.3 Travel Expense. Travel expense, when incurred for business purposes, is an allowable cost. The cost may represent payment for actual costs incurred, or payment may be on a per diem or mileage basis in lieu of actual cost, or a combination of the two methods may be used, provided the method used does not result in an unreasonable charge.

15-330.6 Bad Debts. Bad debt losses, whether actual or estimated, arise from the contractor's non-Government business. No allowance for such losses shall be made in costs or prices under Government [prime] contracts. [However, in the case of subcontracts, particularly lower-tier subcontracts several contracts removed from the prime contractor, consideration may be given to a reasonable allowance for bad debt losses not to exceed the rate experienced by the subcontractor in doing business with the same class of customer.]

15-330.7 Contributions and Donations. Contributions and donations to



and scope of managerial services expected of the contractor's own organization; (iv) the nature of conflict of interests which may exist between the contractor and the U. S. Government; and (v) whether or not the proportion of Government production of the contractor's total production 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 production under Government contracts.

If, in light of the foregoing, it appears that any otherwise allowable costs are not reasonably required by the business or are excessive, the allowable portion will be reduced to an appropriate amount, if any, for purposes of allocation.

15-330.5 Business Organization Expenses. Business organization expenses consist of those ordinary and reasonably necessary expenses which are incurred becuase of the use of the corporate, partnership, or other form of organization. Recurring business organization expenses are allowable. Examples of such recurring expenses, with respect to a corporate form of organization, are fees paid to members of the board of directors, cost of shareholders meetings, proxy solicitations, preparation and publication of annual reports to shareholders and preparation and submission of required reports to regulatory bodies having jurisdiction. Such costs shall normally be considered to be reasonable in amount when incurred in accordance with the contractor's established practices, particularly those in effect prior to the award of Government contracts. Nonrecurring expenses, particularly those directly related to the acquisition of additional capital, are not allowable. Other examples of unallowable costs would include legal and professional fees paid in connection with the preparation of a prospectus, costs of preparation and issuance of stock rights, and amortization of costs of organizing or reorganizing the business.

production has been altered significantly by Government contracts, departure from the prior program may be justified.

(ii) When the organization is a local one and membership would be expected of all similar business firms in the business community. Local organizations must be primarily for trade, business, or professional purposes. Social, cultural, or recreational activities, if any, of such organizations must be incidental.

(iii) If the organization is regional, national, or international in scope, membership therein should be held by a majority of like firms in the same industry.

In determining reasonableness of particular membership costs which appear to be excessive, a review of the nature of the activities of the organization might be necessary in order to reduce the allowable portion of the contractor's membership costs to an amount which would, in effect, exclude a contribution to lobbying or public relations activities.

(b) Subscriptions. The cost of subscriptions to trade, business, professional, or technical periodicals or services is allowable when incurred in accordance with the contractor's established practice and the costs are reasonable in amount.

15-330.9 Employee Morale, Health, and Welfare. Expenses for employee morale, health, and welfare activities, such as employee publications, illness or first aid clinics, improvement of working conditions, and others aimed to improve employer-employee relations or employee performance, are allowable if incurred in accordance with the contractor's established practice or custom in the industry or area.

15-330.10 Cafeterias, Commissaries, Dormitories, and Canteens. This class of expense consists of the cost, less revenue, of food, beverages, or living accommodations provided for members of the contractor's organization

established nonprofit charitable, scientific, and educational organizations are properly allocable to Government contracts; provided that such costs (i) may reasonably be expected to result in future benefits to the contractor through advancing, directly or indirectly, the technology of his industry or increasing the supply of trained manpower available to it; (ii) are in lieu of the cost of similar facilities, which facilities the contractor would otherwise have to provide, as for example, employee medical or recreational facilities; or (iii) are expected of the contractor by the community and it can reasonably be expected that the prestige of the contractor in the community would suffer through the lack of such contributions. In general, contributions and donations under item (iii) will not be allowable unless it is the practice of most business firms in the same community to make contributions to such organizations.

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.

15-330.8 Trade, Business, and Professional Activities.

(a) Memberships. Costs of membership in trade, business, and professional organizations are allowable when incurred in accordance with the following standards:

(i) Memberships are consistent with the established practice of the contractor, particularly his practice prior to the award of Government contracts. However, if the nature or volume of the contractor's

the period of contract performance, but the amount of which is currently indeterminable, may be recognized as follows:

1. A mutually agreed upon settlement may be negotiated in lieu of waiting for the exact future determination.
2. The contract may be held open (by an exception in the final release or by a provision in the pricing amendment) as to the particular item pending the exact determination of the amount of the cost on an actual basis.

Individual paragraphs of this Part contain more specific treatment of contingencies related to the subject matter of such paragraphs, and shall be controlling with respect thereto.

(b) Allowances for specific contingencies which are reasonable certain and determinable may be made in cost estimates for use in negotiating forward prices of fixed price contracts. Other contingencies are not allowable as costs in forward pricing actions, but their possible impact may be considered in establishing contract prices and ceilings in accordance with Part 4, Section III, ASPR.

15-340.3 Losses on Other Contracts. A loss sustained by a contractor on any contract is not allowable as a cost of performance of any other contract. Such losses shall include any excess of cost over income under any and all other contracts whether such other contracts are of a supply, research and development, or other nature.

15-350 Termination Costs.. In the event of termination of the contract for the convenience of the Government, the allowability of particular items of cost will be determined in accordance with the cost principles and standards contained in this Section and will, in addition, be subject to the

at their regular duty stations. When reasonably required by the nature of the contractor's operations, plant location, established policies, or employer-employee agreement, such costs shall be allowable. On the other hand, any profit on such activities shall be considered as a credit to the contractor's overall expenses before allocation to defense contracts, unless such expenses are reduced for all the costs of such activities, including use of facilities, space, and utilities with elimination of such credits from the contractor's general expenses subject to cost allocations to defense business.

15-340 Financial and Other Expenses:

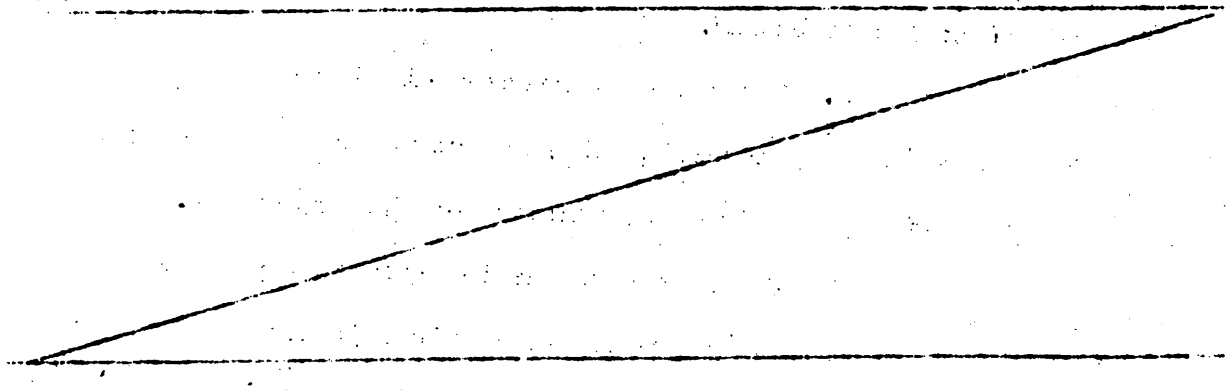
15-340.1 Interest on Borrowed Capital. Profit margins allowable in contract pricing are based, among various factors, upon consideration of normal interest return on total capital employed (including borrowed capital) and compensation for risks (including loss of any capital) except to the extent that risks are the subject of compensation through cost allowances or are assumed by the Government under special forms of contract pricing, when no pricing allowance for such risks should be made. In this way, every contractor should receive nondiscriminatory treatment, whether he furnished his entire capital or borrows a large portion thereof, or whether he is organized in the form of a corporation, a partnership, or a sole proprietorship. Accordingly, interest paid or accrued, regardless of the nature of the obligation which gives rise to the interest cost, is not an allowable item of cost to be charged directly or indirectly to Government contracts.

15-340.2 Contingencies.

(a) No allowance for future contingencies shall be included in making determinations of historical costs. Costs of events which occurred during

4. The cost of items of material reasonably usable on other work of the Contractor, without loss to it, should not be considered. In deciding whether such items are reasonably usable on other work of the Contractor, the Contracting Officer should consider the Contractor's plans and orders for current and scheduled production. Contemporaneous purchases of similar items by the Contractor from other sources will be regarded as evidence that such items are reasonably usable on the Contractor's other work, but in any such case the Contracting Officer will consider any evidence submitted by the Contractor showing that it could not retain such items at cost without sustaining a loss. Any allocation of such costs to the terminated portion of the contract should be made only to the extent that the quantities of the common items on hand, in transit and on order, are in excess of the reasonable quantitative requirements of other work.

15-350.3 Limitations of Certain Costs. In no event shall the aggregate of the amounts allowed in respect of initial costs and preparatory expenses; loss of useful value on special machinery and equipment; experimental, research and development expense; special leases; engineering and development and special tooling, exceed the amount which would have been available from the contract price to cover these items if the contract had been completed, after considering all other costs which would have been required to complete it.



provisions of this paragraph.

15-350.1 Settlement Expenses. The additional costs that arise as the result of termination or cancellation of Government contracts (or subcontracts, including purchase orders), for the convenience of the Government, are allowable. These costs include reasonable costs of settlement, including accounting, legal, clerical, and other expenses reasonably necessary for the preparation of settlement claims and supporting data with respect to the terminated portion of the contract and for the termination and settlement of subcontracts thereunder, including expenses incurred for the purpose of obtaining payment from the Government but only to the extent reasonably necessary for the preparation and presentation of settlement proposals and cost evidence in connection therewith. Settlement expenses include reasonable storage, transportation, and other costs incurred for the protection of property acquired or produced for the contract or in connection with the disposition of such property.

15-350.2 Exclusions. To be excluded from allowable costs in the event of termination are the following:

1. Costs not allocable to the terminated portion of the contract (inventory basis) or to the completed and terminated portions (total cost basis).

2. Costs due to unreasonable delay on the part of the contractor in complying with the clause of the contract entitled "Termination for the Convenience of the Government."

3. Costs incurred as the result of purchasing or producing facilities, materials, or services in excess of the reasonable quantitative requirements of the entire contract.

not result in a reasonably accurate assignment of indirect costs to facilities contracts. Since indirect costs are those which are incurred for common objectives, a grouping of objectives and identification of indirect costs therewith will furnish guidance as to the assignment of indirect costs to the various benefited activities. For example factory accounting and administrative costs may properly be allocated to facilities contracts; while, generally, depreciation on factory production equipment should be excluded. Similarly, any indirect cost incurred solely for the benefit or production should be excluded where the facilities are constructed or installed by a separate service or maintenance department. No selling or distribution expenses (other than engineering expenses incurred in the design, construction, or installation of the facility) will be allocated to the cost of facilities involved. General and administrative costs may be allocated only where the facilities program represents a significant porition of the contractor's work during the period.

(c) The required degree of preciseness in allocating indirect costs to facilities contracts should be related to the materiality of amounts involved. Therefore the foregoing is not intended to require a meticulous identification of such costs. However, it is intended to furnish some criteria for the allocation thereof to facilities contracts on the basis that such contracts should bear the allocable portion of indirect costs incurred for the benefit of the contract. Hence, where the contractor constructs facilities which are generally similar to facilities which he also produces for sale, indirect costs may be allocated in accordance with his established practice. In most other cases in which the contractor performs the facilities construction himself, the decision to do so will have been based upon the fact that he has an already established department

PART 4

Application of Cost Principles
In Facilities Contracts

15-400 Scope of Part. This part sets forth applications of cost principles and standards of Part 2 of this Section in connection with the determination of costs under facilities contracts and under the facilities portion of supply/and research contracts. Generally this Part covers only the allocation of costs to such contracts or facilities portions of supply/ contracts or research contracts. Other Parts of this Section provide guidance as to allowability of particular items of cost and determinations made under this Part should be made in light thereof.

15-410 Direct Cost. The cost of purchased facilities, including costs of acquisition, delivery and placing into condition for use, is allowable at the net purchase or subcontract price. If architectural, engineering, installation, or other collateral services are performed by the contractor's own employees, the direct costs of supplies consumed and labor utilized are allowable. Similarly, if buildings or equipment are constructed, manufactured or rehabilitated by the contractor, the direct costs thereof are allowable.

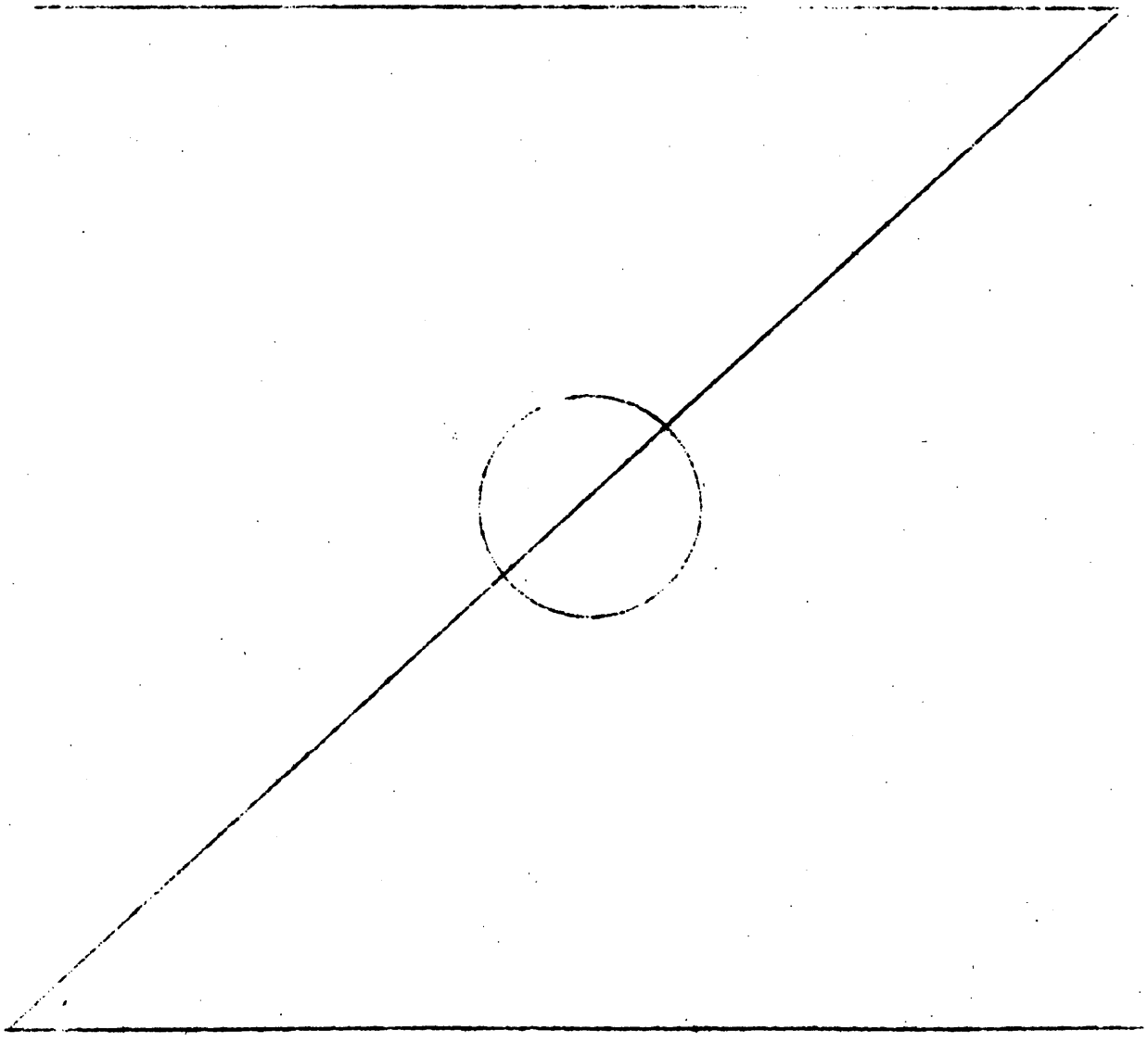
15-420 Indirect Costs.

(a) No indirect costs will be allocated to the cost of facilities purchased by the contractor on an installed (ready to use) basis.

(b) Where the contractor constructs the facilities or incurs additional costs other than the purchase price of purchased facilities, every reasonable effort should be made to direct-cost the items of cost directly assignable to the facilities. Special problems of allocation arise because such work done by the contractor is usually different from that done in connection with its regular production of goods for sale. Hence the contractor's usual method of overhead distribution to products for sale may

or shop for fulfilling similar requirements of his normal operations. For example, a facilities contract involving sheet metal work might be performed by the contractor, if he already has a shop for providing sheet metal items required in his regular production processes and if his normal accounting system in connection therewith provides cost data which are reasonably equitable in light of the foregoing criteria, such costs will be acceptable.

(d) The negotiation of predetermined overhead rates is permissible (see paragraph 2-). Where such predetermined overhead rates are used, they should be developed in consideration of the principles set forth in this part.



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Draft 29 Sep 1953

PART 4

Application of Cost Principles
In Facilities Contracts

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15-400 Scope of Part. This part sets forth applications of cost principles and standards of Part 2 of this Section in connection with the determination of costs under facilities contracts and under the facilities portion of supply and research contracts with commercial organizations. Except as modified by coverage in this Part 4, the cost principles set forth in Part 3 of this Section will be applicable.

15-410 Direct Costs. The cost of structures and equipment obtained by purchase or subcontract is allowable at the purchase or subcontract price, including delivery and installation in accordance with the application of principles as set forth in Parts 3 or 6 of this Section as appropriate. However, if architectural, engineering, installation, or like services are performed by the contractor's own employees, the direct costs of supplies consumed and labor utilized are allowable. Similarly, if buildings or equipment are constructed or manufactured by the contractor, the direct costs thereof are allowable.

15-420 Indirect Costs.

(a) No indirect costs will be allocated to the cost of facilities purchased by the contractor on an installed (ready to use) basis.

(b) Where the contractor constructs the facilities or incurs additional costs other than the purchase price of purchased facilities, indirect costs will be allocable to the facilities contract but only

upon the basis of work actually performed by the contractor. In this event, special problems of allocation arise because such work done by the contractor is usually different from that done in connection with its regular production of goods for sale. Hence the contractor's usual method of overhead distribution to products for sale may not result in a reasonably accurate assignment of indirect costs to facilities contracts.

(c) After all reasonable efforts have been made to direct-cost the items of cost directly assignable to the facilities, there is left the problem of allocating the remaining indirect costs which have been incurred for joint objectives. Hence, a grouping of objectives and identification of indirect costs therewith will furnish guidance as to the assignment of indirect costs to the various benefited activities. For example factory accounting and administrative costs may properly be allocated to facilities contracts; while, generally, depreciation on factory production equipment should be excluded. Similarly, any indirect cost incurred solely for the benefit of production should be excluded where the facilities are constructed or installed by a separate service or maintenance department. No selling or distribution expenses (other than engineering expenses incurred in the design, construction, or installation of the facility) will be allocated to the cost of facilities involved. General and administrative costs may be allocated only where the facilities program represents a significant portion of the contractor's work during the period.

(d) The required degree of preciseness of allocation of indirect costs to facilities contracts should be related to the materiality of amounts involved. Therefore the foregoing is not intended to require

a meticulous identification of such costs. However, it is intended to furnish some criteria for the allocation thereof to facilities contracts on the basis that such contracts should bear the allocable portion of indirect costs incurred for the benefit of the contract. Hence, where the contractor constructs facilities which are generally similar to his usual production for sale, indirect costs may be allocated in accordance with his established practice. In most other cases in which the contractor performs the facilities construction himself, the decision to do so will have been based upon the fact that he has an already established department or shop for fulfilling similar requirements of his normal operations. For example, a facilities contract involving sheet metal work might be performed by the contractor, if he already has a shop for providing sheet metal items required in his regular production processes and his normal accounting system in connection therewith provides cost data which are reasonably equitable in light of the foregoing criteria, such costs will be acceptable.

(e) The negotiation of predetermined overhead rates is permissible (see paragraph 2-). Where such predetermined overhead rates are used, they should be developed in consideration of the principles set forth in this part.

consistent pattern of costing if the results are to be equitable. In some instances, this principle may be applied by direct costing only the major items of a given cost element to all products, leaving minor items, if appropriate, subject to indirect cost allocations.

15-206 Indirect Costs. Indirect costs, which have the character of common or joint costs, usually consist of indirect materials, indirect labor, and other items. These costs generally are grouped in classes, as follows:

(a) Manufacturing (shop, laboratory) expenses (often termed "manufacturing overhead" or "burden"), which are incurred in fabricating the article or performing the service;

(b) Engineering expenses to extent not included in (a) or (c);

(c) Selling and distribution expenses incurred in marketing the products manufactured;

(d) General and administrative expenses incurred in the over-all management, supervision, and conduct of the business;

(e) Financial and other expenses.

15-207 Methods of Allocation of Indirect Costs. No general rules regarding allocation of indirect costs to products, job orders, or contracts can be stated for all individual cases, because the nature of the particular operations and the actual conditions in each instance determine the most suitable method or methods to be employed. The method of allocation of indirect costs will be acceptable if it is in accord with generally accepted accounting principles and practices and if it produces equitable results under the particular circumstances. (See also paragraphs 15-313.1, 15-313.2, 15-320.1 and 15-330.1.)

(a) Cash discounts taken. However, if the contractor does not exercise reasonable precautions in taking advantage of cash discounts available, all cash discounts lost may be deducted in determining allowable costs;

(b) Trade discounts, rebates, refunds, and allowances on material purchased;

(c) Credits for scrap and salvage and materials returned to vendors;

(d) Credits arising from differences between book and physical inventories.

15-311.2 Pricing:

(a) In determining historical costs, any generally recognized method of pricing materials issued from stock may be employed for determining actual cost, provided it has been consistently used by the contractor, is acceptable for internal revenue purposes, and does not discriminate against the Government. When materials in inventory at the commencement date of a Government contract have a provable replacement cost significantly different from book cost, either the contractor or the Government may elect to use such replacement cost in lieu of book cost in pricing materials issued from such inventory. However, such election including identification of the types or kinds of materials involved should be made at the time the contract is entered into and provided for in the contract. When materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be changed to the contract. Costs of subcontracts for components should be determined similarly; proyided that, when subcontracts are performed under contract pricing arrangements other than firm fixed prices, the negotiation of prices or determination of costs shall conform to this section so far as considerations of costs are concerned.

(b) For purposes of estimating material cost, either current market

PART 3 - APPLICATIONS OF COST PRINCIPLES TO SUPPLY CONTRACTS AND RESEARCH AND DEVELOPMENT CONTRACTS WITH COMMERCIAL ORGANIZATIONS

15-300 Scope of Part. This part states, in some detail, applications of the general cost principles and standards set forth in Part 2 of this Section to supply contracts and research and development contracts with commercial organizations. It is impracticable and unnecessary to cover every element of cost or possible situation that might arise in a particular case. However, when this part does not furnish specific guidance, the philosophy expressed or implied in the principles and standards comprising Part 2 of this Section and the more detailed discussions of similar or related items in this Part 3 should be followed.

15-310 Manufacturing Costs:

15-311 Materials. The net costs of materials (including components), both direct and indirect, used or consumed in performance of Government contracts are allowable on the basis hereinafter outlined. Cost may include such collateral items as transportation, insurance, purchasing, receiving, storage, warehousing and adjustments of inventory accounts reasonably related to the period of contract performance resulting from variations at cost between book and physical inventories. (See paragraph 15-311.2 for basis of materials pricing.) If the cost of collateral items is included in material costs, no additional allowance therefor may be made in the determination of manufacturing burden. If such items are not included in material costs, they are properly included in overhead.

15-311.1 Material Credits. In establishing material cost, effect shall be given, as appropriate, directly, or indirectly as a reduction of total manufacturing costs, to such items as:

[(iii) The prices of other suppliers for the same or substantially similar items can be established through quotations, correspondence, or by other means.

[(2) In case the transferor is a separate corporation or partnership in which nonaffiliated parties hold a minority interest of 10 percent or more, a reasonable margin of profit on such sales in recognition of the minority interest may be permitted by agreement notwithstanding inability to determine market prices in accordance with paragraph (1) above.

[(3) Under special circumstances, inter-company or interdivisional sales or transfers may be priced to include a profit to the transferor when no evidence exists as to market prices, provided, in the opinion of the contracting officer, the total price paid by the Government for work performed under the contract of the transferee is not increased by such pricing procedures. This departure from the basis of pricing such sales or transfers at market prices determined in accordance with paragraph (1) above or cost to the transferor should be authorized only where all of the following circumstances exist:

[(i) The management of the transferring unit is significantly independent (though not necessarily autonomous) of the acquiring unit;

[(ii) It is the contractor's long established practice to price inter-company transfers at other than cost and to apply such practice to transfers of commercial work as well;

[(iii) Routing of work through the integrated unit is not affected by departure from the cost basis with consequent increase in total actual production costs of the work.

prices or anticipated acquisition cost may be used, but the basis of pricing must be disclosed. In order to avoid the allowance of contingencies in firm forward pricing actions in which the anticipated replacement cost may be expected to be substantially greater than current market, materials escalation provisions may be made a part of the contract. However, situations involving changes in material costs which are reasonably certain and determinable, or relatively minor in amount, may warrant recognition being given thereto in making estimates.

[(c) In cases in which a contractor has integrated operations involving inter-company or inter-divisional sales or transfers of materials, such materials may be priced to include a profit to the transferor company or division under appropriate circumstances outlined below. In such event, such sales or transfers shall be treated as subcontracts in determining the profit or fee for work performed under the contract of the transferee. In other cases, where the conditions outlined below do not exist, inter-company or inter-divisional sales or transfers of materials shall be stated at cost to the transferor for purposes of contract pricing of the transferee.

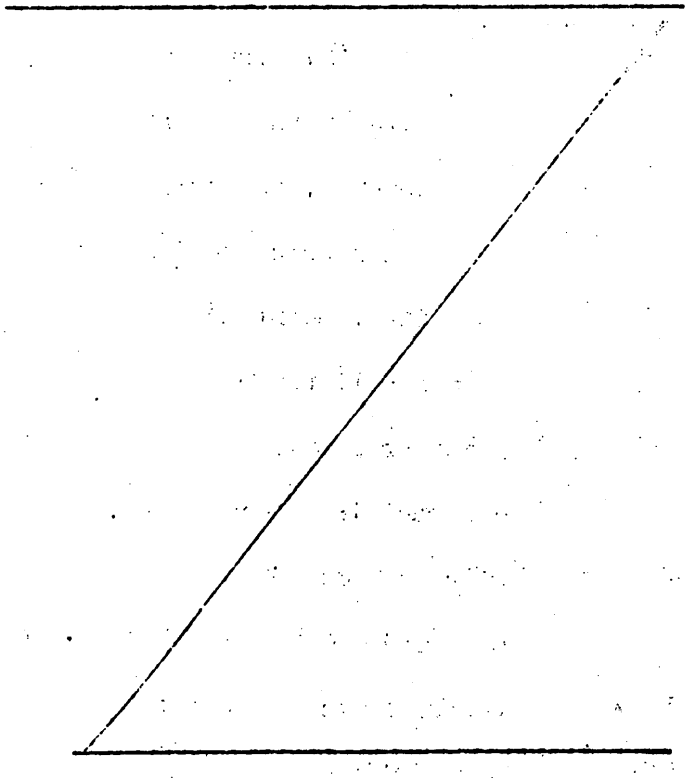
[(1) When inter-company or inter-divisional sales or transfers of materials are priced in excess of cost, they shall be priced, insofar as possible, upon the basis of the lowest market price determined in consideration of the following:

[(i) The price is the transferor's lowest sales price to nonaffiliated customers for the same or a similar item, quantity and quality considered;

[(ii) The price for the same or substantially similar items is quoted at reasonable intervals in financial or trade publications;

the basic salary or wage and all fringe benefits will be considered in determining the reasonableness of the earnings of an individual in relation to services rendered. Direct labor cost consists of salaries and wages identified specifically with the performance of a contract, job, or product. Labor services utilized for joint objectives may be treated as indirect costs if specific identification is impractical or uneconomical and the results of allocation are equitable.

(b) In determining historical costs, labor will generally be charged at actual rates paid by the contractor. However, if it is the contractor's consistent practice to charge for performance of groups of



Determination of the foregoing facts in any case may require submission of cost data of the transferor.7

(c) Inter-company or inter-divisional sales or transfers of materials shall ordinarily be stated on the basis of cost to the transferor. However, under some circumstances, departure from the cost basis may be appropriate but such departure is permissible only if specifically authorized by the contracting officer. Examples of circumstances which may justify departure from the cost basis are as follows:

(1) Cases where the transferor is an affiliated or subsidiary corporation in which non-affiliated parties hold a minority interest of 10 percent or more.

(2) Transactions involving items regularly manufactured and sold by the contractor through commercial channels. In these cases, however, the price must not exceed the lower of (i) the transferor's sales price to its most favored customer for the same or a similar item, quantity and quality considered, or (ii) the prices of other suppliers for the same or substantially similar items.

Departures pursuant to the foregoing, should be authorized at the time contract is entered into, should include identification of the types or kinds of materials involved and the names of the suppliers, and should be provided for in the contract. Also in such event where such sales or transfers are authorized they shall be treated as subcontracts in negotiating the profit or fee for work performed under the contract of the transferee.

15-312 Labor:

(a) The cost of obtaining the services of any individual includes the base salary or wage, plus the cost of all fringe benefits. Therefore, both

(a) Each class of compensation is preferably to be accrued as a cost over the period in which it is earned.

(b) Where it is the contractor's established practice to record the costs at the time of payment, such practice may be acceptable. This is the most commonly used method of accounting for "fringe benefits," but its use might result in inequities in some cases. For example, if a Government contract was performed over the summer months during which most of the contractor's employees took vacations or military leaves, recognition of the cost at time of payment would be inequitable to the Government. On the other hand, if the contract or contracts extended over approximately one year and the proportion of Government work to the contractor's commercial work remained stable, this method might be equitable.

(c) When the costs of any of the elements of fringe benefits are greater or lesser with respect to defense business as compared with non-defense business, such costs should be allocated, so far as feasible and appropriate, between the two classes of business before further allocation of such costs to individual contracts or products. If this method of cost allocation is used, it should be used consistently for all elements of fringe benefits having a different cost relationship of defense business as compared with nondefense business.

(d) It may be practicable to negotiate an equitable rate for fringe benefits based upon experience for a representative period in lieu of individual consideration for each item. Changed conditions and circumstances would have to be considered in making such a determination. The experience rate would then be applied to the more direct labor costs to determine the allowable costs. The use of such rate should be subject

labor at an average rate, or to use standard labor rates, with consequent savings in clerical expense or improvement in labor control, such methods may be used, provided labor groupings and the adjustment for cost variances result in a reasonably accurate assessment of total charges.

(c) When labor costs are required for making cost estimates, the use of standard labor rates and standard time allowances (appropriately adjusted for experience variances) or reliable engineering estimates is acceptable. Ordinarily the use of wage rates higher than current going-rates will not be permitted for estimating purposes. In order to avoid substantial allowances for labor rate contingencies, labor escalation clauses may be utilized in fixed-price type contracts. However, situations involving increases in wage rates which are reasonably certain and determinable or relatively minor in amount may warrant recognition being given thereto in making estimates.

15-312.1 Fringe Benefits—Vacations, Holidays, Sick Leave, Military Leave, and Employee Insurance. Compensation of these types is allowable to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment.

The cost of "fringe benefits" is part of the cost of the work performed by the employee while on the job, and must be considered as having a direct relationship to such work. However, in recognition of the different accounting treatments accorded fringe benefits by different contractors, the cost thereof may be allocated to Government contracts on any of the following bases, provided equitable results are achieved:

unreasonable or otherwise unallowable under this paragraph, and are allocable to all classes of work. Costs of such plans established by nonprofit or other organizations not subject to payment of Federal income taxes are also allowable except to the extent determined to be unreasonable or otherwise unallowable under this paragraph, and are allocable to all classes of work.

(b) Pension or retirement plans of a contractor which are subject to approval of the Bureau of Internal Revenue must have been so approved before costs under the plans may be allowed as charges under defense contracts. Many plans of nonprofit or other tax exempt organizations are also reviewed and approved by the Bureau of Internal Revenue - when not so reviewed and approved, each such plan will be reviewed, and approved or disapproved, by the Department to which audit cognizance is assigned, using, insofar as applicable, the criteria and standards of the Internal Revenue Code and the regulations of the Bureau of Internal Revenue. In any case where the Bureau of Internal Revenue withdraws approval of a plan, approval of amounts allocated to contract costs or estimates will be withdrawn accordingly.

(c) The approval of a pension or retirement plan by the Bureau of Internal Revenue will generally be the only approval required by the Departments; however, the right is reserved to require submission of any such plan for consideration by a Department and to disapprove such plan in its entirety or any feature thereof whenever the circumstances in a particular case are deemed to warrant such action. Such consideration will be the responsibility of the Department to which audit cognizance

to revision in light of changed conditions.

15-312.2 Fringe Benefits - Bonuses. Bonuses to employees, such as production incentives and suggestion or safety awards, represent a part of their total compensation and are an allowable cost under Government contracts when appropriately allocated to all classes of work, if they are: (1) reasonable in amount, (2) paid in connection with an established plan which was in effect before the award of the Government contract under consideration, and the plan is consistently followed by the contractor, (3) paid for current services rendered by the employee, (4) available to all employees of the contractor, or to all employees within a group or salary classification, provided such group or salary classification is not unreasonably restricted, and (5) represented by current expenditures of funds rather than by accrual of expenses or issuance of stock.

Bonuses will not be allowed as a cost on Government contracts when they are contingent upon profits and constitute a distribution of profit rather than reasonable compensation for services. Bonuses will not be allowed when they are restricted to officer or other employee stockholders or are distributed in relation to stockholdings.

15-312.3 Fringe Benefits - Pension and Retirement Plans.

(a) The costs of pension and retirement plans, including reasonable incidental benefits, such as disability, withdrawal, insurance or survivorship allowances which are deductible from taxable income in accordance with the Internal Revenue Code and the regulations of the Bureau of Internal Revenue, are allowable except to the extent determined to be

(h) Credits which arise from various sources, such as dividends and cancellation of employee benefits, which have not vested at the time of termination of their employment, must be taken into account in an equitable manner in arriving at pension and retirement costs. Special provision for these credits is usually necessary when the contractor's organization has substantially expanded for the performance of defense contracts and there is reasonable expectation that the employment of a large number of the additional employees will be terminated upon curtailment of defense work. Under these circumstances, 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. There are two general methods which may be used, individually or in combination, in making such arrangements:

(i) A lump sum or percentage discount (of current pension cost) allowance negotiated and agreed upon in advance. Determination of such allowance is not often an actuarial problem involving a calculation based upon known factors, but rather is an attempt to reach a negotiated agreement as to various uncertain or variable factors in a complex situation. Mass lay-off of employees which may result in the incurrence of severance payments costs should generally lead to a reduction in pension costs through an increase in pension credits.

(ii) A retrospective determination at some time in the future when a more accurate estimate can be made by virtue of experience which may have developed. Until such determination, current costs may be

is assigned, and the subsequent action taken by that Department will generally be accepted by the other Departments.

(d) Approval of a pension or retirement plan by the Bureau of Internal Revenue or by the Departments does not imply that the cost thereof for any particular year will be allowable for apportionment to contract costs or estimates, except to the extent costs for that year meet all other requirements of the Bureau of Internal Revenue as a deduction for income tax purposes, and are allowable under the provisions of this paragraph and the other provisions of this section.

(e) Pension and retirement costs constitute a part of the total compensation by a contractor to any individual covered by the plan, and accordingly are subject to the provisions of this section with respect to reasonableness of the total compensation paid to the individual for the services rendered (see ASPR 15-312 and ASPR 15-330.2).

(f) Where contributions to pension or retirement plans are based on profits, providing that provisions of the Internal Revenue Code and regulations of the Bureau of Internal Revenue have been met, the amount allowable for apportionment to contracts in any one year shall be the amount contributed to the pension trust(s) for that year, but not to exceed 15 percent of the total compensation otherwise paid or accrued in that year to the individuals covered under the plan(s).

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

sentative past period. In determining historical costs, such recurring nominal severance payments actually made are allowable. Where the Contractor provides for accruals of severance payments in lieu of recording the cost thereof at the time of payment, such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made over a representative past period. Generally, the cost of severance payments made during the performance of defense contracts should be allocated to all classes of work being performed at the time of payment since it is a reduction of total work which causes the severance. The following paragraphs are devoted to the treatment of severance payments anticipated to be necessary upon the completion or termination of defense production.

(b) Mass severances.

(1) Fixed-price type contracts. The considerable uncertainty as to whether mass severance payments will ever have to be made is such that no consideration will be given thereto in making cost estimates or in determining historical costs. This risk is one which the contractor must assume and for which he is compensated in the profit. However, where, because of termination of the contract for convenience of the Government, the Contractor does not have the opportunity to earn the profit contemplated by the contracting parties at the inception of the contract, costs of severance payments actually made and which are allocable to the terminated contract are allowable. In allocating costs to the terminated contract(s) the costs shall be assigned to the period in which the severance pay was actually earned and apportioned to all business of the Contractor performed during that period. The cost apportioned to the period of of production of the terminated contract(s) should then be allocated

allowed provided an appropriate contractual arrangement can be agreed upon which reserves the Government's right to these credits. Such recapture provisions will vary in the extent and duration of application and time of determination. For example, such provisions may be contract-wide or contractor-wide and the determination may be made at termination of a defense contract or defense contracts, at mass lay-off of contractor's employees or at the time of substantial decline in proportion of contractor's total sales under defense contracts.

15-312.4 Fringe Benefits - Severance Pay. The cost of severance pay will be considered only to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment. Theoretically, the right to severance pay is earned during the entire period of employment of the indivual or, when based upon specified years of service, is earned during those years. In theory, the cost of severance payments should be recorded in the contractor's accounts during the periods in which the employee earned the right to such payments. However, few contractors accrue severance payments because (1) the clerical expense involved in identifying and recording the cost for each employee is not justified; and (2) there is considerable doubt that any substantial payments will have to be made since payment is solely contingent upon future events.

(a) Recurring, nominal severance payments. The cost of severance payments arising from regular employee severances as distinct from mass layoffs may be included in cost estimates only to the extent that such estimates are based upon severance payments actually made over a repre-

15-312.5 Fringe Benefits -- Premium Payments for Overtime and Extra-Shift Work. Costs of this nature consist of only the premium portion of overtime and extra-shift payments or accruals to employees, not the straight-time portion. Thus, if the rate for overtime work is time-and-one-half of the regular rate, the premium portion is the additional one-half. Similarly, if the wage rate for a second shift is twenty cents an hour above the regular rate, this additional amount is the premium.

Overtime and shift premiums are allowable if authorized or approved pursuant to the requirements of paragraph 12-102.

Such premiums may be classified as either direct or indirect labor cost, but overtime premiums should be separately stated in either event. When treated as direct labor cost, overtime premiums should not be included in the base for distribution of overhead. The amount of overtime and shift premium cost charged on Government contracts shall not be disproportionate to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant.

15-312.6 Fringe Benefits -- Unclaimed Wages. Costs under cost-reimbursement type contracts should reflect a credit for unclaimed wages based upon agreement as to the amount thereof reasonably expected not to be paid subsequent to the date of completion or settlement. In this event, all unclaimed wage liability rests with the contractor. When such an agreement cannot be reached, the Government will assume liability for payment of unclaimed wages and eliminate all allowances therefor from reimbursement to the contractor.

between the terminated contract(s) and all other business of the Contractor. If the termination claim is prepared on the total cost basis, the amount so allocated is properly allowable. If the claim is prepared on the inventory basis, the amount allocated to the terminated contract must be further subdivided between that portion of production billed as completed units and the portion to be inventoried. Only the severance pay costs applicable to the latter portion is includible in the termination claim.

(2) Cost-reimbursement type contracts. Mass severance pay costs will not be considered in the evaluation of cost estimates; nor will any allowance be made on an estimated basis in determining historical costs. Likewise, the contingency of severance payments will not be considered to be a risk assumed by the contractor in determining the fee since the Government assumes the risk. The cost of severance payments actually made upon cessation of Government work where there is no reasonable prospect of continuing employment on other work of the Contractor are allowable. The allowable cost shall be determined by assigning the total cost to the period in which the severance pay was actually earned and apportioning such cost to cost-reimbursement type contracts and all other business of the contractor performed during that period.

A reservation in the final release of claims (see ASPR 7-203.4) may be made in the case of completed cost-reimbursement type contracts where it is reasonable to assume that severance payments allocable to the contract will have to be made at some future date.

15-313 Other Manufacturing Expenses:

15-313.1 Allocation of Indirect Manufacturing Expenses. Among the acceptable bases, depending upon circumstances, for allocating indirect manufacturing expenses are direct-labor-cost, direct-labor-hours, machine-hours, and units processed. In more complex manufacturing plants, it is appropriate to departmentalize the plant for purposes of accounting for manufacturing expenses when any given type of defense production is concentrated in departments having a much higher or lower expense rate than the average. Expense departmentalization is also desirable in larger and more complex plants for purposes of expense budgeting and control by the responsible foreman, regardless of the need for a more refined method of expense allocation. When manufacturing expenses are departmentalized, it is necessary to charge service-department expenses (such as the power plant) and factory general expenses (such as taxes, insurance, 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 should be selected for service-department and other expense distributions to productive departments - e.g., kilowatts of connected power load or metered power consumption, in the case of electric power.

Direct-labor-hours may be preferable for use as a basis for distribution of indirect manufacturing expenses when, for example, wage rates vary widely within a given cost center or department. When direct-labor dollars expended fairly reflect machine effort, as well as labor effort, in any productive department, it is most simple, as well as appropriate, to use that basis of expense allocation in preference to a direct-labor-hour or machine-hour basis. When there is much automatic or semiautomatic machinery in a

productive department, the use of a machine-hour-rate is generally more appropriate for expense allocation. The units-processed-basis of allocation is generally appropriate when a given productive department processes only one item, or the several items are so similar as to be susceptible to measurement of units processed in terms of a common denominator -- e.g., steel sheets of various gauges processed through a rolling mill.

15-313.2 Allocation of Engineering Expenses. Engineering expenses are included in such items as the cost of product design, tool design, experimental development, manufacturing and production development, lay-out of production lines, determination of machine methods and related blueprinting and drafting. The principle of direct costing (see paragraph 15-211) would indicate the desirability of charging directly to the benefited activities (such as production, facilities, and research and development) all engineering costs which can be directly identified with such activities. Only a relatively minor amount of engineering costs (consisting chiefly of engineering administrative expenses) should remain to be allocated to the activities on an indirect basis. All engineering costs charged directly or allocated should in turn be assigned to products, product lines, job orders, contracts, etc. For further treatment of the costing of research and development, special tooling, manufacturing and production engineering and preproduction expenses, see paragraphs 15-313.7, 15-313.10, 15-313.11 and 15-313.12; facilities contracts are included in Part 4 of this Section.

15-313.3 Depreciation.

(a) Depreciation accounting is a system of accounting which aims to distribute the cost of tangible capital assets, less estimated salvage value (if any), over their estimated useful life in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the

generally be determined by groups of facilities for which the factors bearing on estimated useful life are similar. The amount of depreciation written off in any fiscal period may vary with volume of production or be increased for multishift operation, provided the method followed is consistent with basic objective set forth in subparagraph (b) above. Special methods have been established for determining depreciation on emergency facilities covered by Certificates of Necessity by a special directive set forth in an appendix of this Section.

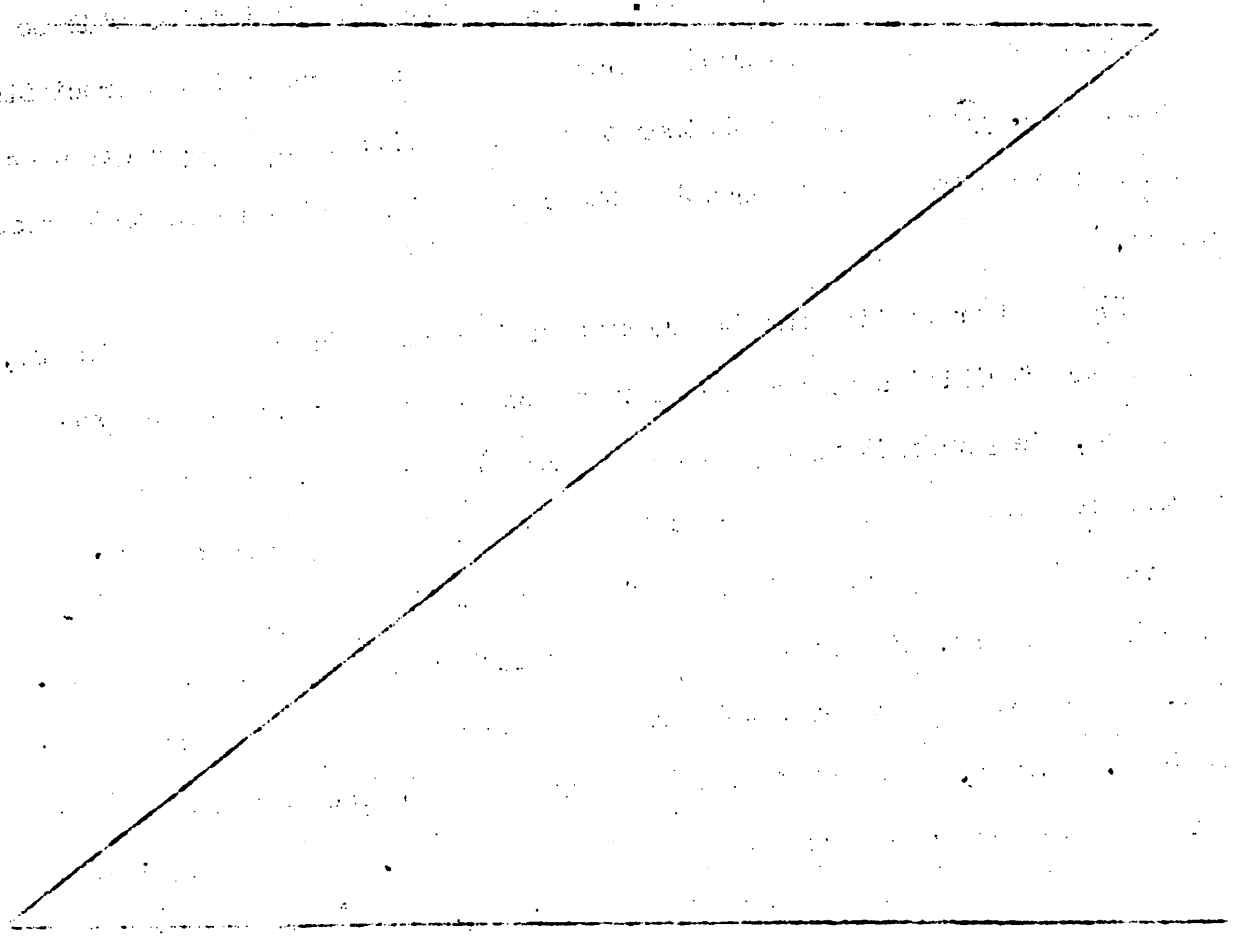
(d) Depreciation should be based upon original cost of the facilities, whether measured by purchase agreement for a cash consideration, the fair value of securities issued in exchange, or similar appropriate measures, [although it is permissible that such cost of facilities be adjusted, where desired by the contractor for purposes of depreciation computations for contract pricing, to current price levels by the use of a general price index, provided in such event that the practice will be followed consistently in the future and also provided that otherwise the charge is made at the same annual rates applied to such adjusted costs as would have been appropriately applied on original costs in view of the estimated useful life of the facilities. In other words, no deficiency in actual depreciation provisions in any prior year, based upon current price levels, should be included in the depreciation charge for the current year. No other basis of determining appreciation in value of facilities may be utilized in determining depreciation for purposes of contract costs; for this purpose the tax basis of facilities values acceptable for internal revenue purposes is applicable.]

year is the portion of the total charge under such a system that is allocated to the year. Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, usually of an indirect nature.

(b) Useful life, as above referred to, has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life. In establishing estimated useful life, consideration should be given to all of the factors of wear and tear, obsolescence (both economic and technological), and inadequacy, which are common to the depreciation problem. Of these factors, obsolescence is most often the limiting or controlling one. Obsolescence of facilities, from the standpoint of economic utility, is always a prospect or contingency to be anticipated (differing only in degree, in each instance) with respect to an entire enterprise or an individual plant, as well as groups or individual items of plant and equipment. Costs of depreciation and maintenance are mutually related. Wear and tear may be increased by lack of maintenance or may be made good by maintenance (often indefinitely, so long as it is economical to do so and provided obsolescence or inadequacy has not become preeminent). Hence, estimates of useful life of facilities in each case should take into consideration the actual maintenance policy in effect.

(c) Depreciation may be determined by application of any one of the generally accepted methods; however, the selected method and rate of depreciation used should, in the absence of compelling reasons to the contrary, consistently be applied from year to year. Generally, however, depreciation is too intangible to warrant meticulous computations by application of rates by individual items of plant and equipment, although such computations are frequent and will be recognized. Hence, depreciation will

15-313.4 Repairs and Maintenance. Repairs and maintenance of facilities (including Government-owned facilities) are allowable elements of contract costs. It is necessary that such expenses exclude expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and made the subject of depreciation. There is, of course, a twilight zone between repairs or maintenance and capital expenditures within which a contractor should be permitted to operate upon the basis of his established accounting practice, if the results are equitable. For example, certain major costs of building alterations and rebuilding or



(e) No depreciation will be allowable as such, or as a rental or use charge, on the cost of facilities which are fully depreciated but still in use when a substantial portion of such depreciation was on a basis that represented, in effect, a recovery thereof as a charge against defense contracts or subcontracts in negotiated pricing or statutory renegotiation of contracts. Otherwise, the contractor may compute normal depreciation on the cost of facilities in use without reference to previous depreciation provisions. However, if the amount of depreciation allowed on fully depreciated assets is material, this might be evidence of the application of excessive depreciation rates to assets not fully depreciated. If excessive rates are used, total depreciation claimed should be reduced so as to reflect the application of more equitable rates. Fully depreciated facilities will be determined on the basis of relating original cost to accumulated depreciation on such cost. [regardless of whether there is an adjustment of current depreciation charges based upon adjusting the cost of facilities to current price levels.]

(f) No depreciation may be allowed on facilities which are not in use, except such facilities as are held for reasonable production standby purposes and, when specifically provided by mutual agreement, on facilities representing additional plant capacity reserved for defense production.

(g) There are several methods of accounting for small tools and expendable equipment, if in accord with generally accepted accounting principles, any method consistently applied by the contractor will be acceptable; provided, however, that allowances for such items are recognized to represent depreciation allowances for the use of the items. Where acquisition costs are not capitalized, particular attention should be given to the residual value of such items upon completion or termination of the contract.

tractor, an additional cost allowance may be made in determining costs of the terminated contracts for the purpose of contract settlement, provided such facilities are transferred to the Government, if so desired, or an equitable adjustment is made in favor of the Government in recognition of any resale or salvage value estimated for such facilities.

15-313.6 Rentals of Plant and Equipment. Rentals of plant or equipment are allowable if reasonably required for the performance of the contract and if bona fide and reasonable as to rate and duration. Special care should be exercised in determining reasonableness of rentals in cases in which rates were arrived at as a result of less than arm's length bargaining. Rental costs may not be bona fide under the following circumstances:

(a) Rentals paid to persons, including corporations, affiliated with the contractor.

(b) Rentals paid to unaffiliated persons, including corporations, upon property formerly owned by the contractor when such property was fully depreciated or substantially fully depreciated before sale or transfer and Government contracts absorbed a significant portion of such depreciation. In either case (a) or (b), rentals will be limited to a reasonable amount of depreciation, as might be determined if the property were owned by the contractor, plus carrying costs which are not paid by the contractor under the terms of the lease, including maintenance, taxes, and insurance (but not interest on the investment).

15-313.7 Preparatory Costs. Preparatory costs or expenses, also known as "make-ready costs", are costs specially incurred in preparing to operate under a specific contract or contracts. They include costs of organization and planning, employee recruitment and training, engineering and development (including product design, product specifications, and

rehabilitating machinery and equipment may reasonably be treated in some instances as either repairs and maintenance expenses or capital expenditures, depending in part upon the contractor's established policy. In making decisions with respect to the alternative accounting treatment of these items, consideration should be given to the materiality of the amounts involved, and the question of the substantial enhancement in value of a contractor's facilities at the expense of the Government. In the latter case, for contract pricing purposes, the cost generally should be considered to be of a capital nature and the subject of depreciation. In those instances where it may be appropriate to charge the cost of extraordinary rehabilitation to expense, special care should be taken in equitably allocating the costs to all the benefited classes of work (see 15-313.7 "Preparatory Costs"). Repairs and maintenance costs on facilities which are not in use will not be allowed, except on individual items of machinery and equipment (as distinct from entire plants or significant portions thereof) held for reasonable standby purposes. Repairs and maintenance on additional plant capacity reserved for defense production will be allowed only if specifically provided by contractual agreement.

15-313.5 Profits or Losses on Disposition of Plant and Equipment. In determining contract costs, no recognition will be given to profits or losses on disposition of plant and equipment for reason that depreciation reasonably determined, provides the exclusive charge for the cost of using a contractor's facilities. However, when a contractor has capitalized special purpose facilities acquired solely for performance under defense contracts (rather than charge the costs thereof to specific contracts) and engineering changes or complete or partial termination of contracts finds such facilities not fully depreciated and not reasonably useful for other business of the con-

Initial production costs may consist of the excessive portion of material costs incurred in the early stages of production, on contracts requiring new products or greatly increased production, as the result of abnormal quantities of materials used or abnormal scrap losses. Initial costs may also consist of the excessive portion of direct-labor costs, plus a proper portion of the related overhead, incurred in the early stages of production due to such causes as excessive defective work resulting from inexperienced labor, idle time and subnormal production occasioned by testing and changing methods of processing, and cost of training employees. The justification for such special costs depends upon their nature and causes, and not merely upon the fact that total production costs are high.

After a reasonable volume of production has been attained and initial manufacturing difficulties have been overcome, unit cost will usually tend to level off, thereby evidencing the end of the initial period of production but not necessarily representing the lowest unit cost eventaully attainable during the operation of the entire contract. If, however, these costs continue abnormally high after a contractor has been allowed a reasonable length of time in which to learn how to make a product efficiently, the excessive costs may not properly be allowable for purposes of estimating under cost reimbursement type contracts or estimating for formal pricing purposes in fixed price type contracts, and should receive special consideration in determining historical costs under existing contracts, or in establishing costs under terminated contract settlements.

/15-313.9 Reconversion Expenses. Reconversion expenses are those connected with restoration of facilities to approximately the same physical arrangement and condition they were in immediately prior to the beginning

planning of production processes and layout) and plant alternation and rearrangement. Preparatory costs do not include initial production (starting load) costs which are treated in paragraph 15-313.8, or manufacturing and production engineering which is treated in paragraph 15-313.11 or special tooling which is treated in paragraph 15-313.10.

Preparatory costs, when incurred for the exclusive benefit of Government production, are allocable directly or indirectly to the contracts benefiting from such costs. When preparatory costs benefit other classes of work as well as Government work, an equitable allocation to all benefited classes of work is proper.

Preparatory costs (sometimes called "Anticipatory Costs") may have been incurred prior to the award of a definitive contract. The amounts of such costs, for purposes of contract cost allowances, are subject to approval of contracting officers based upon advance understandings or upon subsequent negotiation. In such case a specific provision limiting the amount, types and period of pre-award preparatory costs should be incorporated in any definitive contract. Similarly, it is desirable that prior approval of the contracting officer be obtained in the event that unusual charges of this type are to be incurred during the life of the contract. However, the absence of such provision or approval will not preclude consideration of the costs in subsequent price negotiations or determinations under such contracts.

15-313.8 Initial Production Costs. Initial Production Costs, also known as "starting-load costs", are non-recurring costs that arise in the early stages of production because of the contractor's unfamiliarity or lack of experience with the particular materials, manufacturing processes, or techniques involved. They are to be distinguished from preparatory costs or expenses (also known as "make-ready costs").

stances meeting the above conditions.7

15-313.9 Reconversion Costs. Reconversion costs are those incurred in the restoration of facilities to approximately the same physical arrangement and condition they were in immediately prior to the beginning of defense work, and includes the cost of removal of Government property. Reconversion costs, except for the removal of Government property, are incurred for the benefit of future production, and as such are properly chargeable against such production. Except for the costs of removing Government property, and the restoration and rehabilitation costs caused by such removal and specifically provided for in the contract, reconversion costs are not allowable.

15-313.10 Special Tooling. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment.

The cost of special tooling, when acquired for and its usefulness is limited to one or more Government contracts in force or being negotiated at the time of acquisition, is allocable to the specific Government contract(s). The cost of any special tooling which is useful under both Government contracts and commercial work will be subject to allocation between them. No part of the cost of tooling which is special to commercial work only will be allocated to Government work. The cost of non-special tooling is not subject to direct allocation, but is subject to depreciation, which is treated elsewhere in this Part, except that in the production of standard commercial products such tooling costs may be treated as indirect manufacturing expense on an expenditure basis, in lieu of depreciation,

of defense work, including the removal of Government property. In many cases, reconversion costs, except for the removal of Government property are incurred for the benefit of future production, in which cases such costs should be assessed against such production. However, in a specific case and where all of the circumstances outlined below exist, reconversion costs may be recognized through specific contractual provision.

(a) There must have been a major alteration or rearrangement of facilities at the inception of defense work for the sole purpose of performance of defense contracts, or facilities were newly acquired buildings in which Government machinery and equipment has been installed. In the latter case, only the cost of removing Government property is to be considered.

(b) The necessity of reconversion of facilities to approximately the same physical arrangement and condition they were in immediately prior to the beginning of defense work and the costs thereof must be reasonably certain and determinable.

(c) There is little or no post defense work commercial benefit to the contractor as the result of such alteration or rearrangement.

(d) Neither the particular contract nor any other contract contains an allowance for the use of facilities which would compensate the contractor for reconversion expenses.

Reconversion costs shall be allowed only in pricing those fixed price contracts in existence or actually being negotiated at the time the costs of conversion were incurred. In the event of subsequent conversions or modifications for additional fixed price contracts, care must be exercised to avoid duplication of allowances for reconversion costs. Specific contractual provisions may be included in cost-reimbursement type contracts to compensate the contractor for actual reconversion costs incurred in circum-

may be divided into two major categories -- (1) product research and development, and (2) general research.

(a) Product research or development is that which is directed toward the design, improvement or utilization of a particular product or product line. In costing production contracts, current costs (or estimates thereof where forward pricing is involved) of product research or development will be allowable. However the principle of direct costing by product or product line, as appropriate, should be applied, and provided further that such costs are not reimbursed to the contractor under separate research and/or development contracts. No costs of product research or development may be allocated to Department of Defense research and/or development contracts other than the direct costs of performing the contract and the proper share of the indirect costs of administering the research or development program. In some instances it may be appropriate to establish by contract provision a ceiling on the amount of product research or development to be allowed.

(b) General research is all research other than that which is directed toward the design, improvement or utilization of a particular product or product line. The cost of general research, when reasonable in amount and incurred in accordance with the contractor's established practice, is allocable to all classes of work, including defense work, provided such costs are not reimbursed to the contractor under separate defense research contracts, gifts, grants, trust funds or other similar sources. No general research costs which were incurred in accounting periods prior to the award of the particular defense contract(s) (including amounts capitalized in the cost of patents obtained) shall be allocated thereto, nor will the contractor be required to defer research costs incurred during the period of performance of defense contracts to subsequent accounting periods. In some instances

when the resultant charges are reasonably equitable between fiscal years. When the entire cost or a substantial portion of the cost of such special tooling has been allocated to fixed-price Government contracts, the asset concerned shall be subject to the provisions of Part 3 of Section XIII and of the Special Tooling contract clause for fixed-price contracts set forth in paragraph 13-504. When such special tooling is acquired under cost-reimbursement type contracts it shall be subject to the provisions of the contract clause set forth in paragraph 13-503 entitled "Government Property" and to the provisions of Appendix B, ASPR, applicable to Government-owned special tooling.

15-313.11 Manufacturing and Production Engineering. Manufacturing and production engineering includes the cost of engineering activities in connection with (1) current manufacturing processes such as motion and time study, methods analysis, job analysis, tool design and fabrication for improved tooling, and (2) production problems such as component design for purposes of simplifying production. Such activities are usually for the purposes closer control and reduction of manufacturing costs and the costs thereof are allowable. A characteristic of this type of expense is that it can be related to a specific contract, product or product line and is therefor chargeable thereto either directly or by allocation. (See ASPR 15-313.2). This is in contrast to general research and development which, by its general nature, cannot be directly associated with a specific contract, product, or product line.

15-313.12. Research and Development. Research and development expenses

(iv) Royalties are paid under an agreement entered into after the award of the contract without the approval of the contracting officer.

In any case involving a patent formerly owned by the contractor, the allowance will be limited to that which would have been made had the contractor retained title thereto. In all other cases, the allowance shall be reduced by the amount considered to be unreasonable.

(c) Care should be exercised to prevent charges for the use of patents when the Government already has, in fact, rights to such patents. The Government may have obtained a royalty free license or title to patents as a result of contract clauses such as contained in paragraph 9-107 and 9-112, as a result of settlement of claims, as a result of the employer's right in employees' inventions provided under Executive Order 10096, as a result of a royalty adjustment settlement, or as a result of separate purchase or gift.

15-313.14 Plant Protection Expenses.

(a) These expenses represent costs incurred in protecting the contractor's personnel and plant against fire, theft, sabotage, espionage, civil disorder, enemy attack, or other violent destructive forces. Plant protection expenses are allowable costs of defense contracts. Normally they will consist of guards' wages and labor costs related thereto, costs of individual equipment, cost of plant protection equipment if of minor amount, and depreciation of plant protection equipment. To the extent these costs are attributable solely to defense special security requirements, they are allocable entirely to defense contracts. Costs of normal plant protection not resulting from such special requirements, generally, should be indirectly allocated to all classes of work.

it may be appropriate to establish by contract provision a ceiling on the amount of general research to be allowed.

(Note -- See paragraph 9-107 for information as to patent rights to be obtained when research or development work is called for or required in the performance of a contract or when allowances are made for costs for product research or development.)

15-313.13 Patents and Royalties.

(a) Amortization of the cost of purchased patents owned by a contractor applicable to products or processes covered by a contract is an allowable element of cost to the extent reasonably allocable to the contract. Research and development costs leading to patents are treated in paragraph 15-313.12.

(b) Royalty costs are allowable if bona fide and reasonable. Special care should be exercised in determining reasonableness of royalties in cases in which amounts may have been arrived at as a result of less than arm's length bargaining. Examples of such cases are those where:

(i) Royalties are paid to persons, including corporations, affiliated with the contractor.

(ii) Royalties are paid to unaffiliated persons, including corporations, upon patents formerly owned by the contractor when the costs of such patents or the research and development work thereon were substantially recovered through charges against the costs of defense business.

(iii) Royalties are paid to unaffiliated persons, including corporations, under an agreement entered into in contemplation that a Government contract would be awarded.

(i) Recommendations and requirements of the duly constituted Governmental authority having jurisdiction over civil defense in the local area.

(ii) The extent of like measures being taken by other businesses within the local area, particularly those not producing under Government contracts.

(iii) The portion of total cost likely to be allocated to Government contracts as furnishing an inducement to the contractor to incur the cost.

15-313.15 Insurance and Bonds.

(a) To the extent that a contractor's insurance program has been reviewed and approved by the insurance authorities of the military departments, procurement and audit personnel of the military departments will be governed thereby.

(b) The net cost of insurance and bonds, after deduction of dividends or other allowances which may be expected, if reasonably necessary to the operation of a business, is an allowable cost on Government contracts to the extent allocable. Some, but not all, of the types of coverage which may be reasonably necessary are property, aircraft, automobile, general liability, product liability, workmen's compensation, employees' group, accident and disability, use and occupancy, (but excluding that portion of the policy premium applicable to anticipated loss of profit and costs which are unallowable under this Section) and fidelity and surety bonds (including performance bonds).

(c) Insurance on the lives of officers is not an allowable cost, except when premiums are paid in behalf of executives or employees pursuant

(b) A special problem may arise in the case of fixed price contracts, the security classification of which is altered after the contract has been entered into. When such a contract price is negotiated, the contractor is presumed to know the plant protection requirements under the contract and is expected therefore to meet such requirements within the contract price. However, if the security classification of the contract were changed by the Government after entering into the contract, additional costs of plant protection may be allowed the contractor by contract amendment. The additional costs may include not only current costs of an operating nature but also costs of a capital nature if the parties agree that the capital costs are incurred solely because of the changed security classification of the contract and would not have been necessary from the contractor's point of view. Also, if a classified contract is reclassified downward during its performance thereby permitting a savings in plant protection costs, such savings should, if material, be the subject of a contract amendment passing the savings on to the Government. (See 7-104.12)

(c) Civil defense costs must be allocated to all work of the contractor performed at the particular location where the costs are incurred. When the Government's portion of the output of the particular plant is not material, the reasonableness of the incurred costs need not be questioned. However, since usually past experience will not provide a guide as to reasonableness, civil defense costs should be the subject of specific agreement when the amount of such costs to be allocated to Government contracts is substantial. When this is the case, reasonableness may be judged in light of:

to take all necessary action in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer, shall be allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs.

(c) Any refund of taxes, penalties or interest thereon shall be credited to contract costs in the proportion in which contract costs absorb the costs of taxes, interest or penalties. If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

(d) Where it becomes evident in negotiating a contract price that a contractor may be required to pay a tax, the legality of which is questionable or in dispute, such tax may be used in negotiating the contract price, provided that the contract contains provisions substantially similar to those set out in subparagraph (b) (1) (2) and (3) above.

15-313.17 Strikes and Lockouts. The situations and conditions surrounding strikes and lockouts are so varied that it is impossible to establish a general principle providing for allowance or disallowance of costs incurred during such occurrences. Each case must be considered on its own

to specific agreement or established policy whereby such payment may be properly considered as additional compensation (Paragraph 15-330.2).

(d) When a contractor self insures against insurable risks of any type (But see paragraph 7-203.22 for limitation on self-insurance in cost-reimbursement type contracts), a reasonable provision for losses estimated by the contractor is an allowable cost if such provision is based upon actual loss experience to the extent feasible; or, in the absence of adequate loss experience data, it is not in excess of net costs which would be paid for such insurance if carried by private insurance companies, less agents' commissions and other acquisition and servicing costs.

(e) Losses resulting from failure to insure (through self-insurance or otherwise) against a contingent loss or damage, where a reasonably prudent businessman would have insured himself against such loss or damage, are not allowable.

15.313.16 Taxes.

(a) In general, taxes which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for Federal income and excess profits taxes; taxes in connection with financing, refinancing or refunding operations (see paragraph 15-330.5); and special assessments on land which represent capital improvements.

(b) Taxes which are believed to be illegally or erroneously assessed against the contractor, may be allowed as a cost of work performed, provided that the contractor; (1) promptly requests instructions from the contracting officer concerning such taxes; (2) agrees to comply with such instructions; and (3) if so directed by the contracting officer also agrees

abnormal in relation to sales effort that the use of historical costs would result in the inclusion of an unreasonable amount of estimated selling expenses. In the latter case, the fixed selling expenses should be charged to normal non-defense sales, leaving the defense sales chargeable only with a proper share of the variable costs. For an illustration of this principle see paragraph 15-320.5 entitled Advertising.

15-320.2 Salesmen's or Agents' Compensation.

(a) Salesmen's or agents' compensation allocable to defense contracts should be reasonable in the light of the services rendered. If inequitable or exorbitant compensation is paid, it shall be subject to disallowance, to the degree deemed excessive, for the purpose of allocation of costs to defense contracts. For example, when defense business consists of standard commercial products which are sold normally on a commission basis, sudden expansion of defense business may necessitate the adjustment in the amount of compensation allocable to defense contracts.

(b) No fee, commission, percentage, or brokerage fee shall be allowed as a contract cost when contingent upon or resulting from an award of a contract, except amounts paid to bona fide employees or established commercial or selling agencies maintained by the contractor for the purpose of securing business. This provision shall be applied in a manner consistent with representations or agreements of contractors or prospective contractors in the light of ASPR, Section I, Part 5.

15-320.3 General Sales Expenses. These expenses, consisting of salaries and expenses in connection with direction and supervision of all sales efforts, clerical expenses in maintaining sales records and statistics in some cases, and similar over-all sales expenses, may be considered to be allocable indirectly to defense products or contracts in some cases based upon

merits in the light of the philosophy expressed or implied in the principles and standards expressed in Part 2 of this Section.

15-320 Selling and Distribution Expenses:

15-320.1 Allocation of Selling and Distribution Expenses. Selling and distribution expenses identifiable in whole or in part with defense work are subject to allocation to the cost of defense work to the extent appropriate, considering the methods of selling and distribution to the Government or to prime contractors or subcontractors. Generally, selling and distribution expenses should be allocated between product lines, or to products sold to the respective customer types (where sales methods are different), based on analysis of the cost elements in relation to the sales efforts. In some cases, it may be appropriate to first allocate these expenses in whole or in part as between defense and non-defense business, and then to allocate the expenses applicable to defense business against the individual defense contracts or products. The principle of direct costing is very important in this area. For example, when special defense products are sold to the Government or to defense contractors by separately identifiable employees of the manufacturer, the compensation and expenses of such employees may be appropriately charge to costs of such products. When, in such cases, there is a separate sales organization or identifiable group of representatives engaged in selling to non-defense customers, no portion of compensation and expenses thereof should be charged to defense products. On the other extreme, when standard commercial products are sold at fixed prices direct to the Government or to defense contractors, as well as to numerous customers not engaged either directly or indirectly in defense production, by means of one established sales organization, the same selling expense per unit of product may be used in cost estimating, except when the quantities expected to be sold are so

technical pamphlets any of which aid users of the contractor's products, including the Government or defense contractors, excluding, of course, the cost of such publications prepared for the Government under separate contract consideration.

(d) Advertising for commercial products, other than as in (a) through (c) above, not in excess of the contractor's average annual costs incurred prior to the award of defense contracts, may be allocated to defense prime contracts and subcontracts for such commercial products on the basis that the costs will first be assigned to the contractor's nondefense business in the same amount per unit sold (or per dollars of sales) as was assignable to such units prior to obtaining defense business; the amount remaining after such assignment may be allocated to defense prime and subcontracts but not in excess of the amount per unit on nondefense business; provided, however, that when defense sales are merely incidental, such cost allocations may be made on an overall prorata basis.

(e) Advertising costs, other than as in (a) through (c) above, may not be allocated to defense prime contracts and subcontracts for non-commercial products.

15-320.6 Product Transportation and Delivery Expenses. These expenses, when required by the terms of a contract, are properly allowable. Whenever significant in amount and provided it is feasible, they should be determined and allocated as a direct cost of the product or contract.

15-320.7 Warehousing Expenses. Whenever a manufacturer maintains and ships products from warehouses strategically located in order to provide better service or reduce transportation costs to customers (as is frequently found

the specific facts in each case, provided the basis of allocation is equitable as between defense and nondefense business as a whole in the light of the relative services rendered.

15-320.4 Bidding Expenses. Current bidding expenses of both successful and unsuccessful bids normally will be treated as indirect expenses and apportioned currently to all business of the contractor in which event no bidding expenses of past accounting periods will be chargeable to defense contracts. However, where it is the contractor's established practice to treat bidding expenses by some other method, such method may be acceptable if the results are considered to be equitable.

15-320.5 Advertising. Advertising expenses include the costs of materials, space, time, layout, and expenses of the department which supervises such activities. Advertising expenses are generally incurred to promote the sale of the contractor's regular commercial products and should be assigned thereto. Advertising may be appropriately considered for allocation to the cost of defense contracts in the following cases:

(a) Advertising directed solely towards the recruitment of new employees.

(b) Advertising in trade and technical journals, provided such advertising does not offer specific products for sale but is placed for the purpose of offering financial support to journals which are valuable for the dissemination of technical information within the contractor's industry. In addition in the case of subcontractors, reasonable expenditures for advertising in such journals for the purpose of establishing necessary business contacts in connection with the sale of defense products to Government contractors.

(c) Publication of maintenance catalogs, parts price lists, and

time considerably beyond delivery. In such cases, it is necessary to estimate the cost of services and warranties, usually as a percentage of product cost, for purposes of price negotiation. Estimating warranty costs must usually be based upon past experience in similar circumstances with due regard to reasonable standards of quality performance. When allowances are made for costs of performance under warranties as product costs, there should be no duplication of the allowance for the risks in figuring allowable profits.

15-320.9 Entertainment Expenses. Entertainment expenses, as such, shall not be considered either directly or indirectly as a cost of performing Government contracts. However, when expenses classified as entertainment represent the purchase of meals, local transportation, rental of facilities for meetings, and other incidental costs, and the primary purpose of incurring such costs is the dissemination of technical information or the stimulation of production, such costs are allowable in determining the cost of Government contracts.

15-330 General and Administrative Expenses.

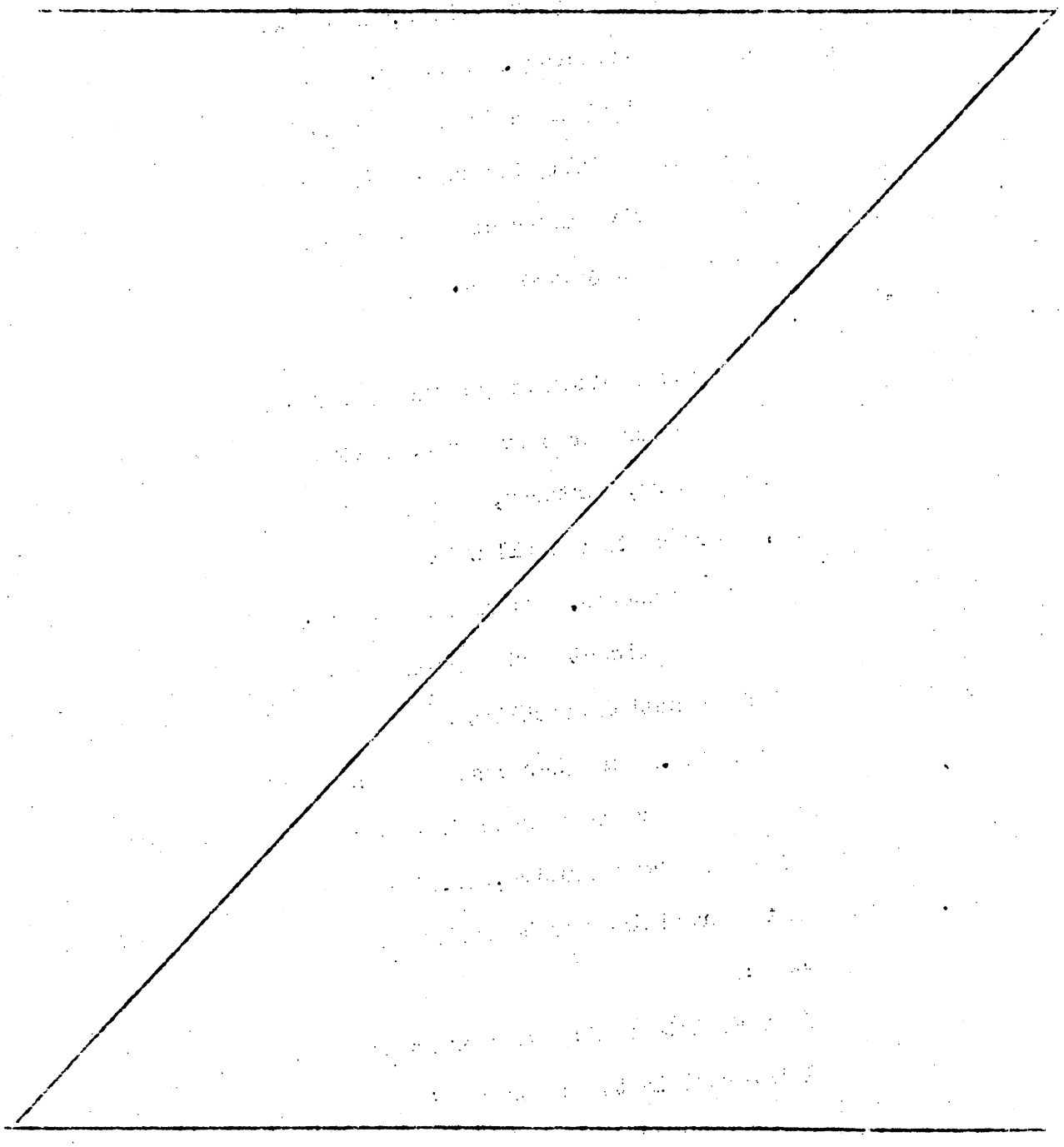
15-330.1 Allocation of General and Administrative Expenses. Among the acceptable bases, depending upon the circumstances, of allocating general and administrative expenses are processing costs (direct labor, factory overhead, and other factory production costs exclusive of direct material), factory input costs (processing costs plus direct material), cost of goods completed, cost of sales, and sales (where no more satisfactory basis is available), provided that equitable results are thereby obtained. In the selection of the particular method or methods of apportionment, special consideration should be given to any such unusual factors as major fixed asset improvement programs and significant changes in proportions of subcontracting.

with standard commercial products or spare parts), the expenses of warehousing such stocks, including transportation from factory to warehouse, are allowable when fairly allocated to defense sales in relation to total sales of products delivered from such warehouses. On the other hand, where products sold under a defen c contract are not delivered or serviced from such warehouses none of the cost of operation thereof is allocable to the contract.

15-320.8 Service and Warranty Expenses. In cases where the contract terms include an obligation on the part of the contractors, without additional separate compensation, to provide service in installation, training operators, correcting defects in the product, replacing defective parts, making refunds in case of inadequate performance, etc., the price or cost of the product may include an allowance for the cost of such undertakings. Generally, any warranty of the product as to performance, materials, and workmanship will be for a definite period of time. In the case of cost-reimbursement-type contracts, actual costs of performance to be reimbursed to the contractor will include such of the foregoing costs as must be borne by the Government under the clause of the contract entitled "Inspection of Supplies and Correction of Defects". (See paragraph 7-203.5). However, in some fixed-price contracts, a warranty may extend for a period of

(2) Ownership of the contractor is limited to a small cohesive group; or

(3) The volume of Government contracts when related to the contractor's total business is such as to influence the contractor in his determination of executive compensation; or



All pertinent factors should be reviewed from time to time, especially if and when there is a change in the nature or volume of production, to determine whether the indirect expenses continue to be apportioned equitably. Where the nature of a contractor's business has not changed basically by a shift to defense production, the presumption is that his former methods, if tested by operation over a considerable period, are satisfactory. However, this is only a presumption and should be reexamined in light of probable increased production. When the business has changed substantially because of such a shift, the contractor's former methods of allocating indirect expenses may be entirely inappropriate and so should be thoroughly reviewed.

15-330.2 Executive Compensation.

(a) Executive compensation consists of all emoluments (including salaries, bonuses, stock options, etc.) paid or accrued for services actually rendered to the contractor by executives, officers, partners, sole proprietors, and others of similar rank and abilities. Such costs are allowable when reasonable in amount in the light of the services rendered. Where the contractor's organization was a going concern for a significant period prior to the award of defense contracts, the amount of compensation established by the contractor will normally be considered reasonable. In other cases and in any case where the amount thereof appears not to have been determined through arm's length bargaining between the employer and the executive, special consideration may be required. Arm's length bargaining may be lacking in any one of the following situations among others:

(1) The executive or a member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization; or

The mode of travel, accommodation or subsistence shall be in keeping with the contractor's established practice. Should there be no established practice, the cost shall not exceed an amount commensurate with the duties and responsibilities of the traveler. Costs of entertainment shall not be included.

Special circumstances create situations for which there may be no precedent. For example, costs of transporting employees and their dependents from one geographic location to another, and reasonable allowance to establish them in the new location, may have to be incurred if a competent skilled labor force is to be recruited and maintained. Generally such costs are allowable, but there may be specific instances in which a part or all will be excluded if considered excessive or unnecessary. Where such circumstances are anticipated, advance understandings should be reached limiting the types and amounts of such costs.

15-330.4 Legal, Accounting, Engineering and Other Professional Expenses. Costs of professional services rendered, whether performed by the contractor's employees or by other members of the particular profession or craft retained by the contractor, are generally allowable. Such costs must be reasonable in light of services rendered, and payment must not be contingent upon recovery of the cost from the Government.

Such services must have been reasonably required by the business, although not necessarily required solely for the performance of Government contracts. Factors to be considered (among others) when determining the reasonableness or necessity of incurring the cost in a particular case are: (i) past pattern of such costs, particularly in the years prior to the award of Government contracts; (ii) the impact of Government contracts on the size of the contractor's business (i.e., what new problems arise); (iii) the nature

(4) The services rendered by any individual are clearly disproportionate in a major degree to the compensation paid.

Allowances for compensation of partners or sole proprietors may properly be included in executive compensation even though not actually paid or accrued in the accounts. In the case of cost-reimbursement type contract, any allowances for compensation for partners or sole proprietors should be incorporated in the contract.

Where executive compensation is considered to be unreasonable in amount, the excess over the amount considered reasonable will not be included in determining the amount allocable to Government contracts.

(b) The cost of options to purchase stock of the contractor corporation granted to executives thereof is a part of executive compensation and, as such, may be allocated to Government contracts, as follows:

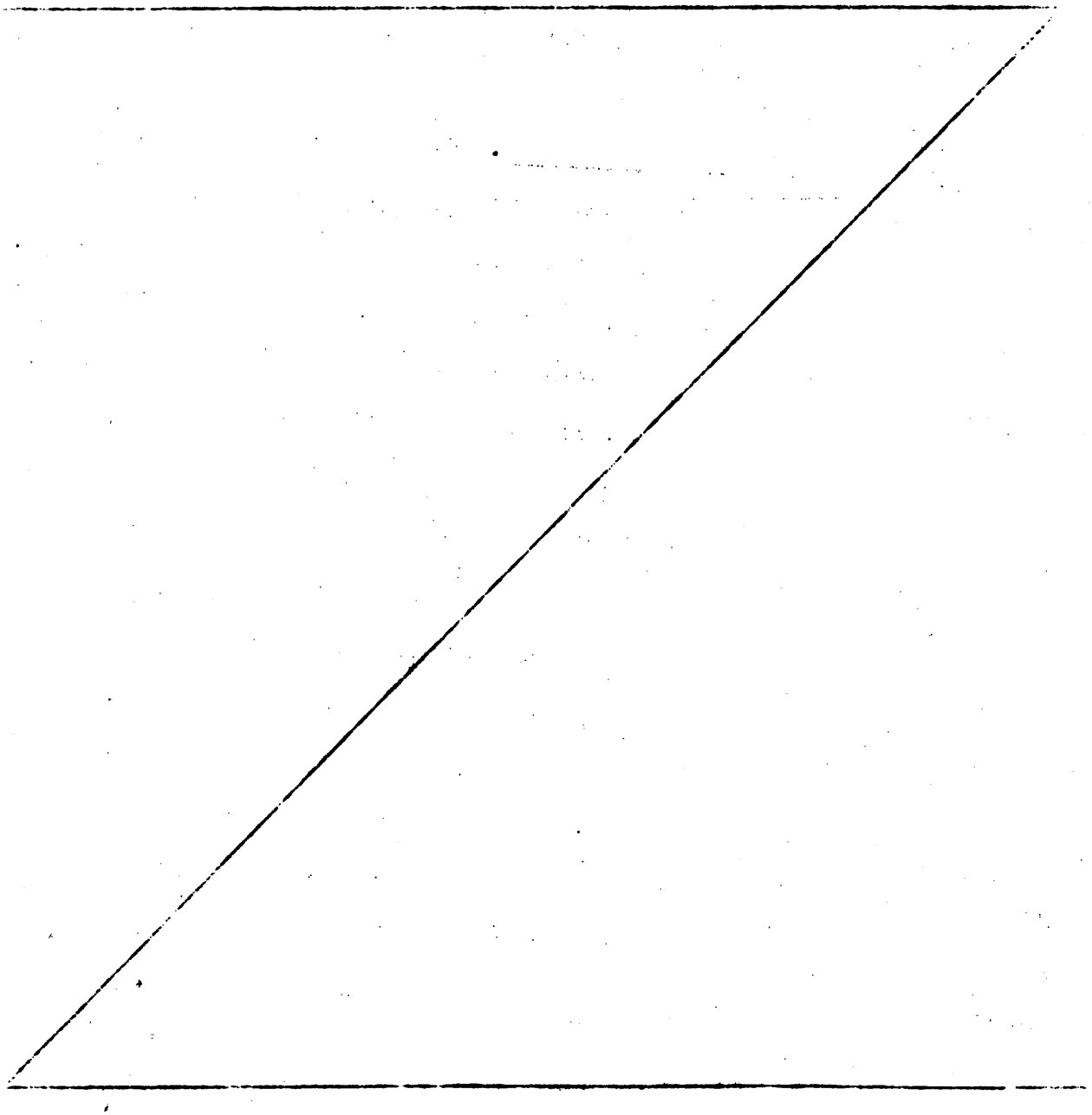
(1) The cost of stock options to the grantor corporation is the excess, if any, of the fair market value of the stock over the option price on the date the option is granted to a specific individual.

(2) Since benefits to the corporation are intended to extent over a period of years and are not limited to the year in which the option was granted or exercised, the cost to the grantor corporation must be amortized at an annual rate not be exceed three percent of the fair market value of the stock on the date the option is granted. The period of amortization is to begin with the date that the option is granted.

15-330.3 Travel Expense. Travel expense, when incurred for business purposes, is an allowable cost. The cost may represent payment for actual costs incurred, or payment may be on a per diem or mileage basis in lieu of actual cost, or a combination of the two methods may be used, provided the method used does not result in an unreasonable charge.

15-330.6 Bad Debts. Bad debt losses, whether actual or estimated, arise from the contractor's non-Government business. No allowance for such losses shall be made in costs or prices under Government [prime] contracts. [However, in the case of subcontracts, particularly lower-tier subcontracts several contracts removed from the prime contractor, consideration may be given to a reasonable allowance for bad debt losses not to exceed the rate experienced by the subcontractor in doing business with the same class of customer.]

15-330.7 Contributions and Donations. Contributions and donations to



and scope of managerial services expected of the contractor's own organization; (iv) the nature of conflict of interests which may exist between the contractor and the U. S. Government; and (v) whether or not the proportion of Government production of the contractor's total production 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 production under Government contracts.

If, in light of the foregoing, it appears that any otherwise allowable costs are not reasonably required by the business or are excessive, the allowable portion will be reduced to an appropriate amount, if any, for purposes of allocation.

15-330.5 Business Organization Expenses. Business organization expenses consist of those ordinary and reasonably necessary expenses which are incurred becuase of the use of the corporate, partnership, or other form of organization. Recurring business organization expenses are allowable. Examples of such recurring expenses, with respect to a corporate form of organization, are fees paid to members of the board of directors, cost of shareholders meetings, proxy solicitations, preparation and publication of annual reports to shareholders and preparation and submission of required reports to regulatory bodies having jurisdiction. Such costs shall normally be considered to be reasonable in amount when incurred in accordance with the contractor's established practices, particularly those in effect prior to the award of Government contracts. Nonrecurring expenses, particularly those directly related to the acquisition of additional capital, are not allowable. Other examples of unallowable costs would include legal and professional fees paid in connection with the preparation of a prospectus, costs of preparation and issuance of stock rights, and amortization of costs of organizing or reorganizing the business.

production has been altered significantly by Government contracts, departure from the prior program may be justified.

(ii) When the organization is a local one and membership would be expected of all similar business firms in the business community. Local organizations must be primarily for trade, business, or professional purposes. Social, cultural, or recreational activities, if any, of such organizations must be incidental.

(iii) If the organization is regional, national, or international in scope, membership therein should be held by a majority of like firms in the same industry.

In determining reasonableness of particular membership costs which appear to be excessive, a review of the nature of the activities of the organization might be necessary in order to reduce the allowable portion of the contractor's membership costs to an amount which would, in effect, exclude a contribution to lobbying or public relations activities.

(b) Subscriptions. The cost of subscriptions to trade, business, professional, or technical periodicals or services is allowable when incurred in accordance with the contractor's established practice and the costs are reasonable in amount.

15-330.9 Employee Morale, Health, and Welfare. Expenses for employee morale, health, and welfare activities, such as employee publications, illness or first aid clinics, improvement of working conditions, and others aimed to improve employer-employee relations or employee performance, are allowable if incurred in accordance with the contractor's established practice or custom in the industry or area.

15-330.10 Cafeterias, Commissaries, Dormitories, and Canteens. This class of expense consists of the cost, less revenue, of food, beverages, or living accommodations provided for members of the contractor's organization

established nonprofit charitable, scientific, and educational organizations are properly allocable to Government contracts; provided that such costs (i) may reasonably be expected to result in future benefits to the contractor through advancing, directly or indirectly, the technology of his industry or increasing the supply of trained manpower available to it; (ii) are in lieu of the cost of similar facilities, which facilities the contractor would otherwise have to provide, as for example, employee medical or recreational facilities; or (iii) are expected of the contractor by the community and it can reasonably be expected that the prestige of the contractor in the community would suffer through the lack of such contributions. In general, contributions and donations under item (iii) will not be allowable unless it is the practice of most business firms in the same community to make contributions to such organizations.

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.

15-330.8 Trade, Business, and Professional Activities.

(a) Memberships. Costs of membership in trade, business, and professional organizations are allowable when incurred in accordance with the following standards:

(i) Memberships are consistent with the established practice of the contractor, particularly his practice prior to the award of Government contracts. However, if the nature or volume of the contractor's

the period of contract performance, but the amount of which is currently indeterminable, may be recognized as follows:

1. A mutually agreed upon settlement may be negotiated in lieu of waiting for the exact future determination.
2. The contract may be held open (by an exception in the final release or by a provision in the pricing amendment) as to the particular item pending the exact determination of the amount of the cost on an actual basis.

Individual paragraphs of this Part contain more specific treatment of contingencies related to the subject matter of such paragraphs, and shall be controlling with respect thereto.

(b) Allowances for specific contingencies which are reasonable certain and determinable may be made in cost estimates for use in negotiating forward prices of fixed price contracts. Other contingencies are not allowable as costs in forward pricing actions, but their possible impact may be considered in establishing contract prices and ceilings in accordance with Part 4, Section III, ASPR.

15-340.3 Losses on Other Contracts. A loss sustained by a contractor on any contract is not allowable as a cost of performance of any other contract. Such losses shall include any excess of cost over income under any and all other contracts whether such other contracts are of a supply, research and development, or other nature.

15-350 Termination Costs.. In the event of termination of the contract for the convenience of the Government, the allowability of particular items of cost will be determined in accordance with the cost principles and standards contained in this Section and will, in addition, be subject to the

at their regular duty stations. When reasonably required by the nature of the contractor's operations, plant location, established policies, or employer-employee agreement, such costs shall be allowable. On the other hand, any profit on such activities shall be considered as a credit to the contractor's overall expenses before allocation to defense contracts, unless such expenses are reduced for all the costs of such activities, including use of facilities, space, and utilities with elimination of such credits from the contractor's general expenses subject to cost allocations to defense business.

15-340 Financial and Other Expenses:

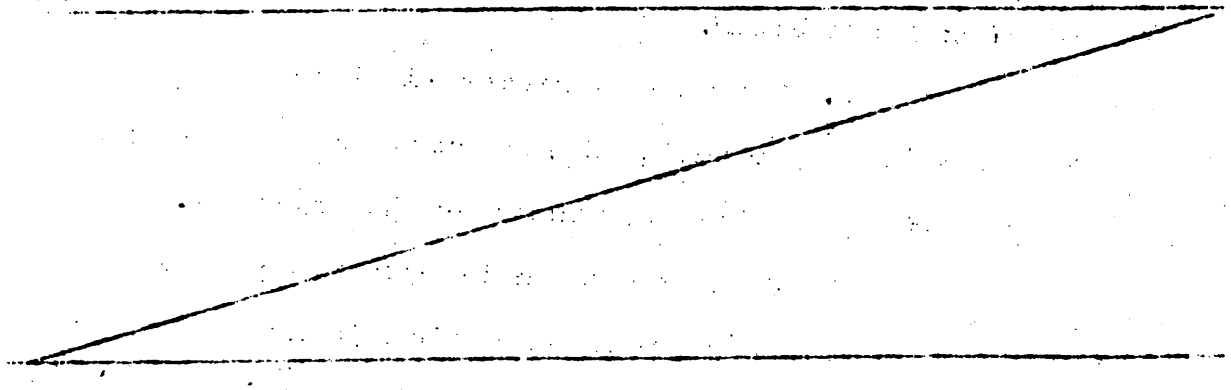
15-340.1 Interest on Borrowed Capital. Profit margins allowable in contract pricing are based, among various factors, upon consideration of normal interest return on total capital employed (including borrowed capital) and compensation for risks (including loss of any capital) except to the extent that risks are the subject of compensation through cost allowances or are assumed by the Government under special forms of contract pricing, when no pricing allowance for such risks should be made. In this way, every contractor should receive nondiscriminatory treatment, whether he furnished his entire capital or borrows a large portion thereof, or whether he is organized in the form of a corporation, a partnership, or a sole proprietorship. Accordingly, interest paid or accrued, regardless of the nature of the obligation which gives rise to the interest cost, is not an allowable item of cost to be charged directly or indirectly to Government contracts.

15-340.2 Contingencies.

(a) No allowance for future contingencies shall be included in making determinations of historical costs. Costs of events which occurred during

4. The cost of items of material reasonably usable on other work of the Contractor, without loss to it, should not be considered. In deciding whether such items are reasonably usable on other work of the Contractor, the Contracting Officer should consider the Contractor's plans and orders for current and scheduled production. Contemporaneous purchases of similar items by the Contractor from other sources will be regarded as evidence that such items are reasonably usable on the Contractor's other work, but in any such case the Contracting Officer will consider any evidence submitted by the Contractor showing that it could not retain such items at cost without sustaining a loss. Any allocation of such costs to the terminated portion of the contract should be made only to the extent that the quantities of the common items on hand, in transit and on order, are in excess of the reasonable quantitative requirements of other work.

15-350.3 Limitations of Certain Costs. In no event shall the aggregate of the amounts allowed in respect of initial costs and preparatory expenses; loss of useful value on special machinery and equipment; experimental, research and development expense; special leases; engineering and development and special tooling, exceed the amount which would have been available from the contract price to cover these items if the contract had been completed, after considering all other costs which would have been required to complete it.



provisions of this paragraph.

15-350.1 Settlement Expenses. The additional costs that arise as the result of termination or cancellation of Government contracts (or subcontracts, including purchase orders), for the convenience of the Government, are allowable. These costs include reasonable costs of settlement, including accounting, legal, clerical, and other expenses reasonably necessary for the preparation of settlement claims and supporting data with respect to the terminated portion of the contract and for the termination and settlement of subcontracts thereunder, including expenses incurred for the purpose of obtaining payment from the Government but only to the extent reasonably necessary for the preparation and presentation of settlement proposals and cost evidence in connection therewith. Settlement expenses include reasonable storage, transportation, and other costs incurred for the protection of property acquired or produced for the contract or in connection with the disposition of such property.

15-350.2 Exclusions. To be excluded from allowable costs in the event of termination are the following:

1. Costs not allocable to the terminated portion of the contract (inventory basis) or to the completed and terminated portions (total cost basis).

2. Costs due to unreasonable delay on the part of the contractor in complying with the clause of the contract entitled "Termination for the Convenience of the Government."

3. Costs incurred as the result of purchasing or producing facilities, materials, or services in excess of the reasonable quantitative requirements of the entire contract.

not result in a reasonably accurate assignment of indirect costs to facilities contracts. Since indirect costs are those which are incurred for common objectives, a grouping of objectives and identification of indirect costs therewith will furnish guidance as to the assignment of indirect costs to the various benefited activities. For example factory accounting and administrative costs may properly be allocated to facilities contracts; while, generally, depreciation on factory production equipment should be excluded. Similarly, any indirect cost incurred solely for the benefit or production should be excluded where the facilities are constructed or installed by a separate service or maintenance department. No selling or distribution expenses (other than engineering expenses incurred in the design, construction, or installation of the facility) will be allocated to the cost of facilities involved. General and administrative costs may be allocated only where the facilities program represents a significant porition of the contractor's work during the period.

(c) The required degree of preciseness in allocating indirect costs to facilities contracts should be related to the materiality of amounts involved. Therefore the foregoing is not intended to require a meticulous identification of such costs. However, it is intended to furnish some criteria for the allocation thereof to facilities contracts on the basis that such contracts should bear the allocable portion of indirect costs incurred for the benefit of the contract. Hence, where the contractor constructs facilities which are generally similar to facilities which he also produces for sale, indirect costs may be allocated in accordance with his established practice. In most other cases in which the contractor performs the facilities construction himself, the decision to do so will have been based upon the fact that he has an already established department

PART 4

Application of Cost Principles
In Facilities Contracts

15-400 Scope of Part. This part sets forth applications of cost principles and standards of Part 2 of this Section in connection with the determination of costs under facilities contracts and under the facilities portion of supply/and research contracts. Generally this Part covers only the allocation of costs to such contracts or facilities portions of supply/ contracts or research contracts. Other Parts of this Section provide guidance as to allowability of particular items of cost and determinations made under this Part should be made in light thereof.

15-410 Direct Cost. The cost of purchased facilities, including costs of acquisition, delivery and placing into condition for use, is allowable at the net purchase or subcontract price. If architectural, engineering, installation, or other collateral services are performed by the contractor's own employees, the direct costs of supplies consumed and labor utilized are allowable. Similarly, if buildings or equipment are constructed, manufactured or rehabilitated by the contractor, the direct costs thereof are allowable.

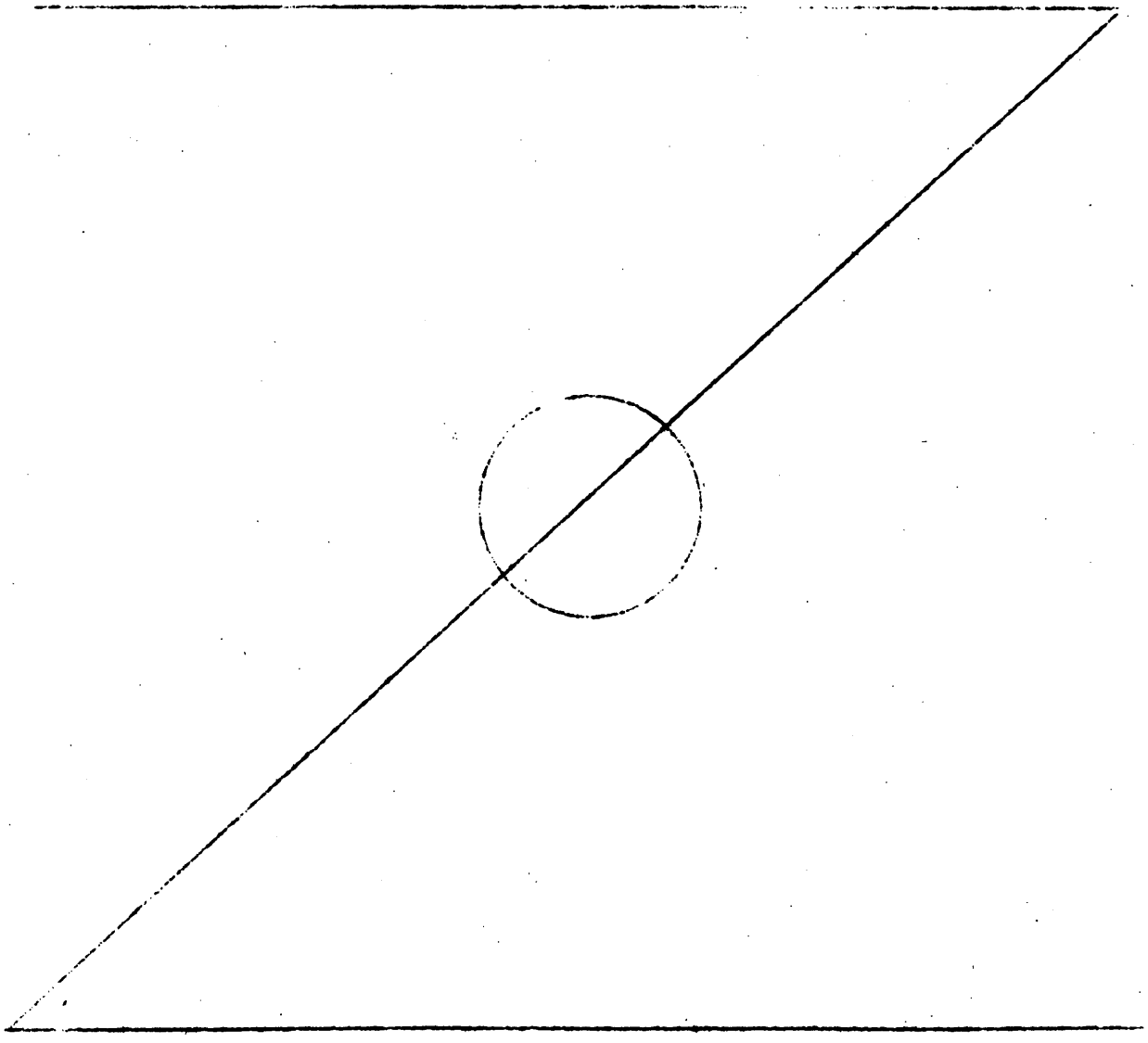
15-420 Indirect Costs.

(a) No indirect costs will be allocated to the cost of facilities purchased by the contractor on an installed (ready to use) basis.

(b) Where the contractor constructs the facilities or incurs additional costs other than the purchase price of purchased facilities, every reasonable effort should be made to direct-cost the items of cost directly assignable to the facilities. Special problems of allocation arise because such work done by the contractor is usually different from that done in connection with its regular production of goods for sale. Hence the contractor's usual method of overhead distribution to products for sale may

or shop for fulfilling similar requirements of his normal operations. For example, a facilities contract involving sheet metal work might be performed by the contractor, if he already has a shop for providing sheet metal items required in his regular production processes and if his normal accounting system in connection therewith provides cost data which are reasonably equitable in light of the foregoing criteria, such costs will be acceptable.

(d) The negotiation of predetermined overhead rates is permissible (see paragraph 2-). Where such predetermined overhead rates are used, they should be developed in consideration of the principles set forth in this part.



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Draft 29 Sep 1953

PART 4

Application of Cost Principles
In Facilities Contracts

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15-400 Scope of Part. This part sets forth applications of cost principles and standards of Part 2 of this Section in connection with the determination of costs under facilities contracts and under the facilities portion of supply and research contracts with commercial organizations. Except as modified by coverage in this Part 4, the cost principles set forth in Part 3 of this Section will be applicable.

15-410 Direct Costs. The cost of structures and equipment obtained by purchase or subcontract is allowable at the purchase or subcontract price, including delivery and installation in accordance with the application of principles as set forth in Parts 3 or 6 of this Section as appropriate. However, if architectural, engineering, installation, or like services are performed by the contractor's own employees, the direct costs of supplies consumed and labor utilized are allowable. Similarly, if buildings or equipment are constructed or manufactured by the contractor, the direct costs thereof are allowable.

15-420 Indirect Costs.

(a) No indirect costs will be allocated to the cost of facilities purchased by the contractor on an installed (ready to use) basis.

(b) Where the contractor constructs the facilities or incurs additional costs other than the purchase price of purchased facilities, indirect costs will be allocable to the facilities contract but only

upon the basis of work actually performed by the contractor. In this event, special problems of allocation arise because such work done by the contractor is usually different from that done in connection with its regular production of goods for sale. Hence the contractor's usual method of overhead distribution to products for sale may not result in a reasonably accurate assignment of indirect costs to facilities contracts.

(c) After all reasonable efforts have been made to direct-cost the items of cost directly assignable to the facilities, there is left the problem of allocating the remaining indirect costs which have been incurred for joint objectives. Hence, a grouping of objectives and identification of indirect costs therewith will furnish guidance as to the assignment of indirect costs to the various benefited activities. For example factory accounting and administrative costs may properly be allocated to facilities contracts; while, generally, depreciation on factory production equipment should be excluded. Similarly, any indirect cost incurred solely for the benefit of production should be excluded where the facilities are constructed or installed by a separate service or maintenance department. No selling or distribution expenses (other than engineering expenses incurred in the design, construction, or installation of the facility) will be allocated to the cost of facilities involved. General and administrative costs may be allocated only where the facilities program represents a significant portion of the contractor's work during the period.

(d) The required degree of preciseness of allocation of indirect costs to facilities contracts should be related to the materiality of amounts involved. Therefore the foregoing is not intended to require

a meticulous identification of such costs. However, it is intended to furnish some criteria for the allocation thereof to facilities contracts on the basis that such contracts should bear the allocable portion of indirect costs incurred for the benefit of the contract. Hence, where the contractor constructs facilities which are generally similar to his usual production for sale, indirect costs may be allocated in accordance with his established practice. In most other cases in which the contractor performs the facilities construction himself, the decision to do so will have been based upon the fact that he has an already established department or shop for fulfilling similar requirements of his normal operations. For example, a facilities contract involving sheet metal work might be performed by the contractor, if he already has a shop for providing sheet metal items required in his regular production processes and his normal accounting system in connection therewith provides cost data which are reasonably equitable in light of the foregoing criteria, such costs will be acceptable.

(e) The negotiation of predetermined overhead rates is permissible (see paragraph 2-). Where such predetermined overhead rates are used, they should be developed in consideration of the principles set forth in this part.

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PART 3 - APPLICATION OF COST PRINCIPLES IN SUPPLY AND RESEARCH CONTRACTS WITH COMMERCIAL ORGANIZATIONS

15-300 Scope of Part. This part states, in some detail, applications of the general cost principles and standards set forth in Part 2 of this Section to supply and research contracts with commercial organizations. It is impracticable and unnecessary to cover every element of cost or possible situation that might arise in a particular case. However, when this part does not furnish specific guidance, the philosophy expressed or implied in the principles and standards comprising Part 2 of this Section and the more detailed discussions of similar or related items in this Part 3 should be followed.

15-310 Manufacturing Costs.

15-311 Materials. The costs of materials (including components), both direct and indirect, used or consumed in performance of Government contracts are allowable on the basis hereinafter outlined. Cost may include such collateral items as transportation, insurance, purchasing, receiving, storage, warehousing and adjustments of inventory accounts reasonably related to the period of contract performance resulting from variations at cost between book and physical inventories. See paragraph 15-311.2 for basis of cost. If the cost of collateral items is included in material costs, no additional allowance therefor may be made in the determination of manufacturing burden. If such items are not included in material costs, they are properly included in overhead.

15-311.1 Material Credits. In establishing material cost, effect shall be given, either directly or as a reduction of total manufacturing

costs, to such items as:

(a) Cash discounts taken. However, if the contractor does not exercise reasonable precautions in taking advantage of cash discounts available, all cash discounts lost may be excluded in determining allowable costs;

(b) Trade discounts, rebates, and allowances on material purchased;

(c) Value of scrap and salvage and materials returned to vendors;

(d) Credits arising from differences between book and physical inventories.

15-311.2 Pricing.

(a) In determining historical costs, any generally recognized method of pricing materials issued from stock may be employed for determining actual cost, provided it has been consistently used by the contractor, is acceptable for internal revenue purposes, and does not discriminate against the Government. However, when materials in inventory at the commencement date of a Government contract have a replacement cost significantly different from book cost, either the contractor or the Government may elect to use such replacement cost in lieu of book cost in pricing materials issued from stock. However, when materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to the contract. Costs of subcontracts for components should be determined similarly; provided that, when subcontracts are performed under contract pricing arrangements other than firm fixed prices, the determination of prices shall conform to this section so far as considerations of costs are concerned.

(b) For purposes of estimating material cost, either current market prices or anticipated acquisition cost may be used, but the basis of pricing must be disclosed. In order to avoid the allowance of contingencies in

cases in which the anticipated replacement cost may be expected to be greater materially than current market, escalation or price-redetermination provisions may be made a part of the contract. However, situations involving changes in material costs which are reasonably certain and determinable, or relatively minor in amount, may warrant recognition being given thereto in making estimates.

(c) In cases in which a contractor has integrated operations involving inter-company or inter-divisional sales or transfers of materials, such materials may be priced to include a profit to the transferor company or division under appropriate circumstances outlined below. In such event, such sales or transfers shall be treated as subcontracts in determining the profit or fee for work performed under the contract of the transferee. In other cases, where the conditions outlined below do not exist, inter-company or inter-divisional sales or transfers of materials shall be stated at cost to the transferor for purposes of contract pricing of the transferee.

(1) When inter-company or inter-divisional sales or transfers of materials are priced in excess of cost, they shall be priced, insofar as possible, upon the basis of the lowest market price determined in consideration of the following:

(i) The price is the transferor's lowest sales price to nonaffiliated customers for the same or a similar item, quantity and quality considered;

(ii) The price for the same or substantially similar items is quoted at reasonable intervals in financial or trade publications;

(iii) The prices of other suppliers for the same or substantially similar items can be established through quotations,

correspondence, or by other means.

(2) In case the transferor is a separate corporation or partnership in which nonaffiliated parties hold a minority interest of 10 percent or more, a reasonable margin of profit on such sales in recognition of the minority interest may be permitted by agreement notwithstanding inability to determine market prices in accordance with paragraph (1) above.

(3) Under special circumstances, inter-company or inter-divisional sales or transfers may be priced to include a profit to the transferor when no evidence exists as to market prices, provided, in the opinion of the contracting officer, the total price paid by the Government for work performed under the contract of the transferee is not increased by such pricing procedures. This departure from the basis of pricing such sales or transfers at market prices determined in accordance with paragraph (1) above or cost to the transferor should be authorized only where all of the following circumstances exist:

(i) The management of the transferring unit is significantly independent (though not necessarily autonomous) of the acquiring unit;

(ii) It is the contractor's long established practice to price intercompany transfers at other than cost and to apply such practice to transfers of commercial work as well;

(iii) Routing of work through the integrated unit is not affected by departure from the cost basis with consequent increase in total actual production costs of the work.

Determination of the foregoing facts in any case may require submission of cost data of the transferor.

15-312 Labor. The cost of obtaining the services of any individual includes the base salary or wage, plus the cost of all fringe benefits. Therefore, both the basic salary or wage and all fringe benefits will be considered in determining the reasonableness of the earnings of an individual in relation to services rendered. Direct labor cost consists of salaries and wages identified specifically with the performance of a contract, job, or product. Labor services utilized for joint objectives may be treated as indirect costs if specific identification is impractical or uneconomical and the results of allocation are equitable. In determining historical costs, labor will generally be charged at actual rates paid by the contractor. However, if it is the contractor's consistent practice to charge for performance of groups of

Determination of the foregoing facts in any case may require submission of cost data of the transferor.

15-312 Labor. The cost of obtaining the services of any individual includes the base salary or wage, plus the cost of all fringe benefits. Therefore, both the basic salary or wage and all fringe benefits will be considered in determining the reasonableness of the earnings of an individual in relation to services rendered. Direct labor cost consists of salaries and wages identified specifically with the performance of a contract, job, or product. Labor services utilized for joint objectives may be treated as indirect costs if specific identification is impractical or uneconomical and the results of allocation are equitable. In determining historical costs, labor will generally be charged at actual rates paid by the contractor. However, if it is the contractor's consistent practice to charge for performance of groups of

labor at an average rate, or to use standard labor rates, with consequent savings in clerical expense or improvement in labor control, such methods may be used, provided labor groupings and the adjustment for cost variances result in a reasonably accurate assessment of total charges. Similarly, when labor costs are required for making cost estimates, the use of standard labor rates and standard time allowances (appropriately adjusted for experience variances) or reliable engineering estimates is acceptable. Ordinarily the use of wage rates higher than current going-rates will not be permitted for estimating purposes. In order to avoid substantial allowances for such contingencies, escalation or price-redetermination clauses are provided. However, situations involving increases in wage rates which are reasonably certain and determinable or relatively minor in amount may warrant recognition being given thereto in making estimates.

15-312.1 Fringe Benefits—Vacations, Holidays, Sick Leave, Military Leave, Pension and Retirement Plans, and Employee Insurance, but Exclude Severance Pays. Compensation of these types is allowable to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment.

The cost of "fringe benefits" is part of the cost of the work performed by the employee while on the job, and must be considered as having a direct relationship to such work. However, in recognition of the different accounting treatments by different contractors accorded fringe benefits, the cost thereof may be allocated to Government contracts on any of the following bases, provided equitable results are achieved:

(a) Each class of compensation is preferably

to be accrued as a cost over the period in which it is earned.

(b) Where it is the contractor's established practice to record the costs at the time of payment, such practice may be acceptable. This is the most commonly used method of accounting for "fringe benefits," but its use might result in inequities in some cases. For example, if a Government contract was performed over the summer months during which most of the contractor's employees took vacations or military leaves, recognition of the cost at time of payment would be inequitable to the Government. On the other hand, if the contract or contracts extended over approximately one year and the proportion of Government work to the contractor's commercial work remained stable, this method might be equitable.

(c) When the costs of any of the elements of fringe benefits are greater or lesser with respect to defense business as compared with nondefense business, such costs should be allocated, so far as feasible and appropriate, between the two classes of business before further allocation of such costs to individual contracts or products. If this method of cost allocation is used, it should be used consistently for all elements of fringe benefits having a different cost relationship of defense business as compared with nondefense business.

(d) It may be practicable to negotiate an equitable rate for fringe

benefits based upon experience for a representative period in lieu of individual consideration for each item. Changed conditions and circumstances would have to be considered in making such a determination. The experience rate would then be applied to the more direct labor costs to determine the allowable costs. The use of such rate should be subject to revision in light of changed conditions.

The cost of pension and retirement plans is covered more fully as the subject of a directive set forth as Appendix ___ to this Section.

15-312.1½ Severance Pay. The cost of severance pay will be considered only to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment. Theoretically, the right to severance pay is earned during the entire period of employment of the individual or, when based upon specified years of service, is earned during those years. In theory, the cost of severance payments should be recorded in the contractor's accounts during the periods in which the employee earned the right to such payments. However, few contractors accrue severance payments because (1) the clerical expense involved in identifying and recording the cost for each employee is not justified; and (2) there is considerable doubt that any substantial payments will have to be made since payment is solely contingent upon future events.

The cost of severance payments may be included in cost estimates only to the extent that such estimates are based upon severance payments actually made over a representative past period. In determining historical costs severance payments actually made are allowable if not in excess of the cost

of such payments over a representative past period. Where the Contractor provides for accruals of severance payments in lieu of recording the cost thereof at the time of payment, such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made over a representative past period. Generally, the cost of severance payments made during the performance of defense contracts should be allocated to all classes of work being performed at the time of payment since it is a reduction of total work which causes the severance. Because of the degree of uncertainty surrounding defense production, the following paragraphs are devoted to the treatment of severance payments anticipated to be necessary upon the completion or termination of defense production.

Where the contractor is an established concern and its level of employment has not been substantially increased with the advent of defense contracts, the contingency of substantial severance payments upon completion or termination of such contracts is so remote that consideration need not be given thereto in making cost estimates or in determining historical costs.

A specific contractual provision may recognize severance pay in either of the following situations:

(1) The contractor is newly established, is producing other than a substantially standard commercial item, and the weight of available evidence indicates that upon completion of defense work the contractor's operations will cease or greatly diminish. Illustrative of this situation is a contractor organized to operate a Government-owned facility.

(2) The contractor is not newly established, is producing other than a substantially commercial item, and its level of employment increased substantially with the advent of defense contracts (particularly where new

facilities or major portions thereof were placed in operation) and the weight of available evidence indicates that upon the completion of defense work the contractor's operations will shrink to approximately the pre-contract award level.

In either case (1) or (2) above the treatment of severance pay by contractual provision should vary with the type of contract. In the case of cost-type contracts and those fixed price contracts the price of which is negotiated upon completion, the contractual provision may provide for recognition of severance payments actually made upon completion or termination.

Where price is determined before completion, estimates of severance pay costs may be included in total estimated cost. Determination of the amount of severance pay to be included in cost estimates is particularly difficult. The amount included should not be the estimated total possible future liability for severance payments since the contractor is expected to give notice of separation in lieu of making severance payments. The amount included should represent a conservative estimate in light of the degree of contingent risk assumed by the contractor. Where agreement is not possible, consideration should be given to the use of a type of contract which would permit recognition of the cost of severance payments upon completion or termination of the contract. Where an allowance for severance pay is provided in a fixed price contract, care must be exercised to prevent duplication of allowance therefor in other contracts.

15-312.2 Premium Payments for Overtime and Extra-Shift Work. Costs of this nature consist of only the premium portion of overtime and extra-shift payments or accruals to employees, not the straight-time portion. Thus, if the rate for overtime work is time-and-one-half of the regular rate, the premium portion is the additional one-half. Similarly, if the wage rate for a second shift is twenty cents an hour above the regular rate, this additional amount is the premium.

Overtime and shift premiums are allowable, but the contractor must disclose and justify overtime other than of an occasional nature. Whenever such overtime allowances are claimed under cost-type contracts, approval of the contracting officer or his authorized representative must be obtained. (See paragraph 12-102.)

Such premiums may be classified as either direct or indirect labor cost, but overtime premiums should be separately stated in either event. When treated as direct labor cost, overtime premiums should not be included in the base for distribution of overhead. The amount of overtime and shift premium cost charged on Government contracts shall not be disproportionate to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant.

15-312.3 Unclaimed Wages. Costs under cost-reimbursement-type contracts should reflect a credit for unclaimed wages based upon agreement as to the amount thereof reasonably expected not to be paid subsequent to the date of settlement. In this event, all unclaimed wage liability rests with the contractor. When such an agreement cannot be reached, the Government will assume liability for payment of unclaimed wages and eliminate all allowances therefor from reimbursement to the contractor.

15-313 Other Manufacturing Expenses:

15-313.01 Allocation of Indirect Manufacturing Expenses. Among the acceptable bases, depending upon circumstances, for allocating indirect manufacturing expenses are direct-labor-cost, direct-labor-hours, machine-hours, and units processed. In more complex manufacturing plants, it is appropriate to departmentalize the plant for purposes of accounting for manufacturing expenses when any given type of defense production is concentrated in departments having a much higher or lower expense rate than the average. Expense departmentalization is also desirable in larger and more complex plants for purposes of expense budgeting and control by the responsible foreman, regardless of the need for a more refined method of expense allocation. When manufacturing expenses are departmentalized, it is necessary to charge service-department expenses (such as the power plant) and factory general expenses (such as taxes, insurance, 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 should be selected for service-department and other expense distributions to productive departments - e.g., kilowatts of connected power load or metered power consumption, in the case of electric power.

When direct-labor dollars expended fairly reflect machine effort, as well as labor effort, in any productive department, it is most simple, as well as appropriate, to use that basis of expense allocation in preference to a direct-labor-hour or machine-hour basis. When there is much automatic or semiautomatic machinery in a productive department, the use of a machine-hour-rate is generally more appropriate for expense allocation. The units-processed-basis of allocation is generally appropriate when a given productive

department processes only one item, or the several items are so similar as to be susceptible to measurement of units processed in terms of a common denominator -- e.g., steel sheets of various gauges processed through a rolling mill.

15-313.02 Allocation of Engineering Expenses. Engineering expenses include such items as the cost of product design, tool design, lay-out of production lines, determination of machine methods and drafting. The principle of direct costing (see paragraph 15-211) would indicate the desirability of charging directly to the benefitted activities (production, facilities, and research and development) all engineering costs which can be directly identified with such activities, leaving only a relatively minor amount of engineering costs (consisting chiefly of engineering administrative expenses) to be allocated to the activities. All engineering costs charged directly or allocated should in turn be assigned to products, product lines, job orders, contracts, etc. Further treatment of various problems in connection with the costing of research and development, tooling, and preproduction expenses is included in this Part (see paragraph ___); facilities contracts are included in Part 4.

15-313.03 Depreciation.

(a) Depreciation accounting is a system of accounting which aims to distribute the cost of tangible capital assets, less estimated salvage value (if any), over their estimated useful life in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, usually of an indirect nature.

(b) Useful life, as above referred to, has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life. In establishing estimated useful life, consideration should be given to all of the factors of wear and tear, obsolescence (both economic and technological), and inadequacy, which are common to the depreciation problem. Of these factors, obsolescence is most often the limiting or controlling one. Obsolescence of facilities, from the standpoint of economic utility, is always a prospect or contingency to be anticipated (differing only in degree, in each instance) with respect to an entire enterprise or an individual plant, as well as groups or individual items of plant and equipment. Costs of depreciation and maintenance are mutually related. Wear and tear may be increased by lack of maintenance or may be made good by maintenance (often indefinitely, so long as it is economical to do so and provided obsolescence or inadequacy has not become eminent). Hence, estimates of useful life of facilities in each case should take into consideration the actual maintenance policy in effect.

(c) Depreciation may be determined by application of any one of the generally accepted methods; however, the selected method and rate of depreciation used should, in the absence of compelling reasons to the contrary, consistently be applied from year to year. Generally, however, depreciation is too intangible to warrant attempts at meticulous estimates by application of rates by individual items of plant and equipment, although such attempts are frequent and will be recognized. Hence, depreciation will generally be determined by groups of facilities for which the factors bearing on estimated useful life are similar. The amount of depreciation written off in any fiscal period may vary with volume of production or be

increased for multishift operation, provided the method followed is consistent with basic objective set forth in subparagraph (b) above. Special methods have been established for determining depreciation on emergency facilities covered by Certificates of Necessity by a special directive set forth in an appendix of this Section.

(d) Depreciation should be based upon original cost of the facilities, whether measured by purchase agreement for a cash consideration, the fair value of securities issued in exchange, or similar appropriate measures, [*although it is permissible that such cost of facilities be adjusted, where desired by the contractor for purposes of depreciation computations for contract pricing, to current price levels by the use of a general price index, provided in such event that the practice will be followed consistently in the future and also provided that otherwise the charge is made at the same annual rates applied to such adjusted costs as would have been appropriately applied on original costs in view of the estimated useful life of the facilities. In other words, no deficiency in actual depreciation provisions in any prior year, based upon current price levels, should be included in the depreciation charge for the current year.] No other basis of determining appreciation in value of facilities may be utilized in determining depreciation for purposes of contract costs; for this purpose the tax basis of facilities values acceptable for internal revenue purposes are applicable.

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*Particular attention is invited to the subject matter between the brackets. It is desired that comment be submitted on this concept, together with substantiation therefor.

Determination of the foregoing facts in any case may require submission of cost data of the transferor.

15-312 Labor. The cost of obtaining the services of any individual includes the base salary or wage, plus the cost of all fringe benefits. Therefore, both the basic salary or wage and all fringe benefits will be considered in determining the reasonableness of the earnings of an individual in relation to services rendered. Direct labor cost consists of salaries and wages identified specifically with the performance of a contract, job, or product. Labor services utilized for joint objectives may be treated as indirect costs if specific identification is impractical or uneconomical and the results of allocation are equitable. In determining historical costs, labor will generally be charged at actual rates paid by the contractor. However, if it is the contractor's consistent practice to charge for performance of groups of

labor at an average rate, or to use standard labor rates, with consequent savings in clerical expense or improvement in labor control, such methods may be used, provided labor groupings and the adjustment for cost variances result in a reasonably accurate assessment of total charges. Similarly, when labor costs are required for making cost estimates, the use of standard labor rates and standard time allowances (appropriately adjusted for experience variances) or reliable engineering estimates is acceptable. Ordinarily the use of wage rates higher than current going-rates will not be permitted for estimating purposes. In order to avoid substantial allowances for such contingencies, escalation or price-redetermination clauses are provided. However, situations involving increases in wage rates which are reasonably certain and determinable or relatively minor in amount may warrant recognition being given thereto in making estimates.

15-312.1 Fringe Benefits—Vacations, Holidays, Sick Leave, Military Leave, Pension and Retirement Plans, and Employee Insurance, but Exclude Severance Pays. Compensation of these types is allowable to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment.

The cost of "fringe benefits" is part of the cost of the work performed by the employee while on the job, and must be considered as having a direct relationship to such work. However, in recognition of the different accounting treatments by different contractors accorded fringe benefits, the cost thereof may be allocated to Government contracts on any of the following bases, provided equitable results are achieved:

(a) Each class of compensation is preferably

to be accrued as a cost over the period in which it is earned.

(b) Where it is the contractor's established practice to record the costs at the time of payment, such practice may be acceptable. This is the most commonly used method of accounting for "fringe benefits," but its use might result in inequities in some cases. For example, if a Government contract was performed over the summer months during which most of the contractor's employees took vacations or military leaves, recognition of the cost at time of payment would be inequitable to the Government. On the other hand, if the contract or contracts extended over approximately one year and the proportion of Government work to the contractor's commercial work remained stable, this method might be equitable.

(c) When the costs of any of the elements of fringe benefits are greater or lesser with respect to defense business as compared with nondefense business, such costs should be allocated, so far as feasible and appropriate, between the two classes of business before further allocation of such costs to individual contracts or products. If this method of cost allocation is used, it should be used consistently for all elements of fringe benefits having a different cost relationship of defense business as compared with nondefense business.

(d) It may be practicable to negotiate an equitable rate for fringe

benefits based upon experience for a representative period in lieu of individual consideration for each item. Changed conditions and circumstances would have to be considered in making such a determination. The experience rate would then be applied to the more direct labor costs to determine the allowable costs. The use of such rate should be subject to revision in light of changed conditions.

The cost of pension and retirement plans is covered more fully as the subject of a directive set forth as Appendix ___ to this Section.

15-312.1½ Severance Pay. The cost of severance pay will be considered only to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment. Theoretically, the right to severance pay is earned during the entire period of employment of the individual or, when based upon specified years of service, is earned during those years. In theory, the cost of severance payments should be recorded in the contractor's accounts during the periods in which the employee earned the right to such payments. However, few contractors accrue severance payments because (1) the clerical expense involved in identifying and recording the cost for each employee is not justified; and (2) there is considerable doubt that any substantial payments will have to be made since payment is solely contingent upon future events.

The cost of severance payments may be included in cost estimates only to the extent that such estimates are based upon severance payments actually made over a representative past period. In determining historical costs severance payments actually made are allowable if not in excess of the cost

of such payments over a representative past period. Where the Contractor provides for accruals of severance payments in lieu of recording the cost thereof at the time of payment, such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made over a representative past period. Generally, the cost of severance payments made during the performance of defense contracts should be allocated to all classes of work being performed at the time of payment since it is a reduction of total work which causes the severance. Because of the degree of uncertainty surrounding defense production, the following paragraphs are devoted to the treatment of severance payments anticipated to be necessary upon the completion or termination of defense production.

Where the contractor is an established concern and its level of employment has not been substantially increased with the advent of defense contracts, the contingency of substantial severance payments upon completion or termination of such contracts is so remote that consideration need not be given thereto in making cost estimates or in determining historical costs.

A specific contractual provision may recognize severance pay in either of the following situations:

(1) The contractor is newly established, is producing other than a substantially standard commercial item, and the weight of available evidence indicates that upon completion of defense work the contractor's operations will cease or greatly diminish. Illustrative of this situation is a contractor organized to operate a Government-owned facility.

(2) The contractor is not newly established, is producing other than a substantially commercial item, and its level of employment increased substantially with the advent of defense contracts (particularly where new

facilities or major portions thereof were placed in operation) and the weight of available evidence indicates that upon the completion of defense work the contractor's operations will shrink to approximately the pre-contract award level.

In either case (1) or (2) above the treatment of severance pay by contractual provision should vary with the type of contract. In the case of cost-type contracts and those fixed price contracts the price of which is negotiated upon completion, the contractual provision may provide for recognition of severance payments actually made upon completion or termination.

Where price is determined before completion, estimates of severance pay costs may be included in total estimated cost. Determination of the amount of severance pay to be included in cost estimates is particularly difficult. The amount included should not be the estimated total possible future liability for severance payments since the contractor is expected to give notice of separation in lieu of making severance payments. The amount included should represent a conservative estimate in light of the degree of contingent risk assumed by the contractor. Where agreement is not possible, consideration should be given to the use of a type of contract which would permit recognition of the cost of severance payments upon completion or termination of the contract. Where an allowance for severance pay is provided in a fixed price contract, care must be exercised to prevent duplication of allowance therefor in other contracts.

15-312.2 Premium Payments for Overtime and Extra-Shift Work. Costs of this nature consist of only the premium portion of overtime and extra-shift payments or accruals to employees, not the straight-time portion. Thus, if the rate for overtime work is time-and-one-half of the regular rate, the premium portion is the additional one-half. Similarly, if the wage rate for a second shift is twenty cents an hour above the regular rate, this additional amount is the premium.

Overtime and shift premiums are allowable, but the contractor must disclose and justify overtime other than of an occasional nature. Whenever such overtime allowances are claimed under cost-type contracts, approval of the contracting officer or his authorized representative must be obtained. (See paragraph 12-102.)

Such premiums may be classified as either direct or indirect labor cost, but overtime premiums should be separately stated in either event. When treated as direct labor cost, overtime premiums should not be included in the base for distribution of overhead. The amount of overtime and shift premium cost charged on Government contracts shall not be disproportionate to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant.

15-312.3 Unclaimed Wages. Costs under cost-reimbursement-type contracts should reflect a credit for unclaimed wages based upon agreement as to the amount thereof reasonably expected not to be paid subsequent to the date of settlement. In this event, all unclaimed wage liability rests with the contractor. When such an agreement cannot be reached, the Government will assume liability for payment of unclaimed wages and eliminate all allowances therefor from reimbursement to the contractor.

15-313 Other Manufacturing Expenses:

15-313.01 Allocation of Indirect Manufacturing Expenses. Among the acceptable bases, depending upon circumstances, for allocating indirect manufacturing expenses are direct-labor-cost, direct-labor-hours, machine-hours, and units processed. In more complex manufacturing plants, it is appropriate to departmentalize the plant for purposes of accounting for manufacturing expenses when any given type of defense production is concentrated in departments having a much higher or lower expense rate than the average. Expense departmentalization is also desirable in larger and more complex plants for purposes of expense budgeting and control by the responsible foreman, regardless of the need for a more refined method of expense allocation. When manufacturing expenses are departmentalized, it is necessary to charge service-department expenses (such as the power plant) and factory general expenses (such as taxes, insurance, 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 should be selected for service-department and other expense distributions to productive departments - e.g., kilowatts of connected power load or metered power consumption, in the case of electric power.

When direct-labor dollars expended fairly reflect machine effort, as well as labor effort, in any productive department, it is most simple, as well as appropriate, to use that basis of expense allocation in preference to a direct-labor-hour or machine-hour basis. When there is much automatic or semiautomatic machinery in a productive department, the use of a machine-hour-rate is generally more appropriate for expense allocation. The units-processed-basis of allocation is generally appropriate when a given productive

department processes only one item, or the several items are so similar as to be susceptible to measurement of units processed in terms of a common denominator -- e.g., steel sheets of various gauges processed through a rolling mill.

15-313.02 Allocation of Engineering Expenses. Engineering expenses include such items as the cost of product design, tool design, lay-out of production lines, determination of machine methods and drafting. The principle of direct costing (see paragraph 15-211) would indicate the desirability of charging directly to the benefitted activities (production, facilities, and research and development) all engineering costs which can be directly identified with such activities, leaving only a relatively minor amount of engineering costs (consisting chiefly of engineering administrative expenses) to be allocated to the activities. All engineering costs charged directly or allocated should in turn be assigned to products, product lines, job orders, contracts, etc. Further treatment of various problems in connection with the costing of research and development, tooling, and preproduction expenses is included in this Part (see paragraph ___); facilities contracts are included in Part 4.

15-313.03 Depreciation.

(a) Depreciation accounting is a system of accounting which aims to distribute the cost of tangible capital assets, less estimated salvage value (if any), over their estimated useful life in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, usually of an indirect nature.

(b) Useful life, as above referred to, has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life. In establishing estimated useful life, consideration should be given to all of the factors of wear and tear, obsolescence (both economic and technological), and inadequacy, which are common to the depreciation problem. Of these factors, obsolescence is most often the limiting or controlling one. Obsolescence of facilities, from the standpoint of economic utility, is always a prospect or contingency to be anticipated (differing only in degree, in each instance) with respect to an entire enterprise or an individual plant, as well as groups or individual items of plant and equipment. Costs of depreciation and maintenance are mutually related. Wear and tear may be increased by lack of maintenance or may be made good by maintenance (often indefinitely, so long as it is economical to do so and provided obsolescence or inadequacy has not become eminent). Hence, estimates of useful life of facilities in each case should take into consideration the actual maintenance policy in effect.

(c) Depreciation may be determined by application of any one of the generally accepted methods; however, the selected method and rate of depreciation used should, in the absence of compelling reasons to the contrary, consistently be applied from year to year. Generally, however, depreciation is too intangible to warrant attempts at meticulous estimates by application of rates by individual items of plant and equipment, although such attempts are frequent and will be recognized. Hence, depreciation will generally be determined by groups of facilities for which the factors bearing on estimated useful life are similar. The amount of depreciation written off in any fiscal period may vary with volume of production or be

increased for multishift operation, provided the method followed is consistent with basic objective set forth in subparagraph (b) above. Special methods have been established for determining depreciation on emergency facilities covered by Certificates of Necessity by a special directive set forth in an appendix of this Section.

(d) Depreciation should be based upon original cost of the facilities, whether measured by purchase agreement for a cash consideration, the fair value of securities issued in exchange, or similar appropriate measures, [*although it is permissible that such cost of facilities be adjusted, where desired by the contractor for purposes of depreciation computations for contract pricing, to current price levels by the use of a general price index, provided in such event that the practice will be followed consistently in the future and also provided that otherwise the charge is made at the same annual rates applied to such adjusted costs as would have been appropriately applied on original costs in view of the estimated useful life of the facilities. In other words, no deficiency in actual depreciation provisions in any prior year, based upon current price levels, should be included in the depreciation charge for the current year.] No other basis of determining appreciation in value of facilities may be utilized in determining depreciation for purposes of contract costs; for this purpose the tax basis of facilities values acceptable for internal revenue purposes are applicable.

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*Particular attention is invited to the subject matter between the brackets. It is desired that comment be submitted on this concept, together with substantiation therefor.

(e) No depreciation will be allowable as such, or as a rental or use charge, on the cost of facilities which are fully depreciated but still in use when a substantial portion of such depreciation was on a basis that represented, in effect, a recovery thereof as a charge against defense contracts or subcontracts in negotiated pricing or statutory renegotiation of contracts. Otherwise, the contractor may compute normal depreciation on the cost of facilities in use without reference to previous depreciation provisions. Fully depreciated facilities will be determined on the basis of relating original cost to accumulated depreciation on such cost, regardless of whether there is an adjustment of current depreciation charges based upon adjusting the cost of facilities to current price levels.

(f) No depreciation may be allowed on facilities which are not in use, except such facilities as are held for reasonable production standby purposes and, when specifically provided by mutual agreement, on facilities representing additional plant capacity reserved for defense production.

15-313.04 Repairs and Maintenance. Repairs and maintenance of facilities (including Government-owned facilities) are allowable elements of contract costs. It is necessary that such expenses exclude expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and made the subject of depreciation. There is, of course, a twilight zone between repairs and maintenance and capital expenditures within which a contractor should be permitted to operate upon the basis of his established accounting practice, if the results are equitable. For example, certain major costs of building alterations and rebuilding or

Determination of the foregoing facts in any case may require submission of cost data of the transferor.

15-312 Labor. The cost of obtaining the services of any individual includes the base salary or wage, plus the cost of all fringe benefits. Therefore, both the basic salary or wage and all fringe benefits will be considered in determining the reasonableness of the earnings of an individual in relation to services rendered. Direct labor cost consists of salaries and wages identified specifically with the performance of a contract, job, or product. Labor services utilized for joint objectives may be treated as indirect costs if specific identification is impractical or uneconomical and the results of allocation are equitable. In determining historical costs, labor will generally be charged at actual rates paid by the contractor. However, if it is the contractor's consistent practice to charge for performance of groups of

labor at an average rate, or to use standard labor rates, with consequent savings in clerical expense or improvement in labor control, such methods may be used, provided labor groupings and the adjustment for cost variances result in a reasonably accurate assessment of total charges. Similarly, when labor costs are required for making cost estimates, the use of standard labor rates and standard time allowances (appropriately adjusted for experience variances) or reliable engineering estimates is acceptable. Ordinarily the use of wage rates higher than current going-rates will not be permitted for estimating purposes. In order to avoid substantial allowances for such contingencies, escalation or price-redetermination clauses are provided. However, situations involving increases in wage rates which are reasonably certain and determinable or relatively minor in amount may warrant recognition being given thereto in making estimates.

15-312.1 Fringe Benefits—Vacations, Holidays, Sick Leave, Military Leave, Pension and Retirement Plans, and Employee Insurance, but Exclude Severance Pays. Compensation of these types is allowable to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment.

The cost of "fringe benefits" is part of the cost of the work performed by the employee while on the job, and must be considered as having a direct relationship to such work. However, in recognition of the different accounting treatments by different contractors accorded fringe benefits, the cost thereof may be allocated to Government contracts on any of the following bases, provided equitable results are achieved:

(a) Each class of compensation is preferably

to be accrued as a cost over the period in which it is earned.

(b) Where it is the contractor's established practice to record the costs at the time of payment, such practice may be acceptable. This is the most commonly used method of accounting for "fringe benefits," but its use might result in inequities in some cases. For example, if a Government contract was performed over the summer months during which most of the contractor's employees took vacations or military leaves, recognition of the cost at time of payment would be inequitable to the Government. On the other hand, if the contract or contracts extended over approximately one year and the proportion of Government work to the contractor's commercial work remained stable, this method might be equitable.

(c) When the costs of any of the elements of fringe benefits are greater or lesser with respect to defense business as compared with nondefense business, such costs should be allocated, so far as feasible and appropriate, between the two classes of business before further allocation of such costs to individual contracts or products. If this method of cost allocation is used, it should be used consistently for all elements of fringe benefits having a different cost relationship of defense business as compared with nondefense business.

(d) It may be practicable to negotiate an equitable rate for fringe

benefits based upon experience for a representative period in lieu of individual consideration for each item. Changed conditions and circumstances would have to be considered in making such a determination. The experience rate would then be applied to the more direct labor costs to determine the allowable costs. The use of such rate should be subject to revision in light of changed conditions.

The cost of pension and retirement plans is covered more fully as the subject of a directive set forth as Appendix ___ to this Section.

15-312.1½ Severance Pay. The cost of severance pay will be considered only to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment. Theoretically, the right to severance pay is earned during the entire period of employment of the individual or, when based upon specified years of service, is earned during those years. In theory, the cost of severance payments should be recorded in the contractor's accounts during the periods in which the employee earned the right to such payments. However, few contractors accrue severance payments because (1) the clerical expense involved in identifying and recording the cost for each employee is not justified; and (2) there is considerable doubt that any substantial payments will have to be made since payment is solely contingent upon future events.

The cost of severance payments may be included in cost estimates only to the extent that such estimates are based upon severance payments actually made over a representative past period. In determining historical costs severance payments actually made are allowable if not in excess of the cost

of such payments over a representative past period. Where the Contractor provides for accruals of severance payments in lieu of recording the cost thereof at the time of payment, such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made over a representative past period. Generally, the cost of severance payments made during the performance of defense contracts should be allocated to all classes of work being performed at the time of payment since it is a reduction of total work which causes the severance. Because of the degree of uncertainty surrounding defense production, the following paragraphs are devoted to the treatment of severance payments anticipated to be necessary upon the completion or termination of defense production.

Where the contractor is an established concern and its level of employment has not been substantially increased with the advent of defense contracts, the contingency of substantial severance payments upon completion or termination of such contracts is so remote that consideration need not be given thereto in making cost estimates or in determining historical costs.

A specific contractual provision may recognize severance pay in either of the following situations:

(1) The contractor is newly established, is producing other than a substantially standard commercial item, and the weight of available evidence indicates that upon completion of defense work the contractor's operations will cease or greatly diminish. Illustrative of this situation is a contractor organized to operate a Government-owned facility.

(2) The contractor is not newly established, is producing other than a substantially commercial item, and its level of employment increased substantially with the advent of defense contracts (particularly where new

facilities or major portions thereof were placed in operation) and the weight of available evidence indicates that upon the completion of defense work the contractor's operations will shrink to approximately the pre-contract award level.

In either case (1) or (2) above the treatment of severance pay by contractual provision should vary with the type of contract. In the case of cost-type contracts and those fixed price contracts the price of which is negotiated upon completion, the contractual provision may provide for recognition of severance payments actually made upon completion or termination.

Where price is determined before completion, estimates of severance pay costs may be included in total estimated cost. Determination of the amount of severance pay to be included in cost estimates is particularly difficult. The amount included should not be the estimated total possible future liability for severance payments since the contractor is expected to give notice of separation in lieu of making severance payments. The amount included should represent a conservative estimate in light of the degree of contingent risk assumed by the contractor. Where agreement is not possible, consideration should be given to the use of a type of contract which would permit recognition of the cost of severance payments upon completion or termination of the contract. Where an allowance for severance pay is provided in a fixed price contract, care must be exercised to prevent duplication of allowance therefor in other contracts.

15-312.2 Premium Payments for Overtime and Extra-Shift Work. Costs of this nature consist of only the premium portion of overtime and extra-shift payments or accruals to employees, not the straight-time portion. Thus, if the rate for overtime work is time-and-one-half of the regular rate, the premium portion is the additional one-half. Similarly, if the wage rate for a second shift is twenty cents an hour above the regular rate, this additional amount is the premium.

Overtime and shift premiums are allowable, but the contractor must disclose and justify overtime other than of an occasional nature. Whenever such overtime allowances are claimed under cost-type contracts, approval of the contracting officer or his authorized representative must be obtained. (See paragraph 12-102.)

Such premiums may be classified as either direct or indirect labor cost, but overtime premiums should be separately stated in either event. When treated as direct labor cost, overtime premiums should not be included in the base for distribution of overhead. The amount of overtime and shift premium cost charged on Government contracts shall not be disproportionate to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant.

15-312.3 Unclaimed Wages. Costs under cost-reimbursement-type contracts should reflect a credit for unclaimed wages based upon agreement as to the amount thereof reasonably expected not to be paid subsequent to the date of settlement. In this event, all unclaimed wage liability rests with the contractor. When such an agreement cannot be reached, the Government will assume liability for payment of unclaimed wages and eliminate all allowances therefor from reimbursement to the contractor.

15-313 Other Manufacturing Expenses:

15-313.01 Allocation of Indirect Manufacturing Expenses. Among the acceptable bases, depending upon circumstances, for allocating indirect manufacturing expenses are direct-labor-cost, direct-labor-hours, machine-hours, and units processed. In more complex manufacturing plants, it is appropriate to departmentalize the plant for purposes of accounting for manufacturing expenses when any given type of defense production is concentrated in departments having a much higher or lower expense rate than the average. Expense departmentalization is also desirable in larger and more complex plants for purposes of expense budgeting and control by the responsible foreman, regardless of the need for a more refined method of expense allocation. When manufacturing expenses are departmentalized, it is necessary to charge service-department expenses (such as the power plant) and factory general expenses (such as taxes, insurance, 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 should be selected for service-department and other expense distributions to productive departments - e.g., kilowatts of connected power load or metered power consumption, in the case of electric power.

When direct-labor dollars expended fairly reflect machine effort, as well as labor effort, in any productive department, it is most simple, as well as appropriate, to use that basis of expense allocation in preference to a direct-labor-hour or machine-hour basis. When there is much automatic or semiautomatic machinery in a productive department, the use of a machine-hour-rate is generally more appropriate for expense allocation. The units-processed-basis of allocation is generally appropriate when a given productive

department processes only one item, or the several items are so similar as to be susceptible to measurement of units processed in terms of a common denominator -- e.g., steel sheets of various gauges processed through a rolling mill.

15-313.02 Allocation of Engineering Expenses. Engineering expenses include such items as the cost of product design, tool design, lay-out of production lines, determination of machine methods and drafting. The principle of direct costing (see paragraph 15-211) would indicate the desirability of charging directly to the benefitted activities (production, facilities, and research and development) all engineering costs which can be directly identified with such activities, leaving only a relatively minor amount of engineering costs (consisting chiefly of engineering administrative expenses) to be allocated to the activities. All engineering costs charged directly or allocated should in turn be assigned to products, product lines, job orders, contracts, etc. Further treatment of various problems in connection with the costing of research and development, tooling, and preproduction expenses is included in this Part (see paragraph ___); facilities contracts are included in Part 4.

15-313.03 Depreciation.

(a) Depreciation accounting is a system of accounting which aims to distribute the cost of tangible capital assets, less estimated salvage value (if any), over their estimated useful life in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, usually of an indirect nature.

(b) Useful life, as above referred to, has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life. In establishing estimated useful life, consideration should be given to all of the factors of wear and tear, obsolescence (both economic and technological), and inadequacy, which are common to the depreciation problem. Of these factors, obsolescence is most often the limiting or controlling one. Obsolescence of facilities, from the standpoint of economic utility, is always a prospect or contingency to be anticipated (differing only in degree, in each instance) with respect to an entire enterprise or an individual plant, as well as groups or individual items of plant and equipment. Costs of depreciation and maintenance are mutually related. Wear and tear may be increased by lack of maintenance or may be made good by maintenance (often indefinitely, so long as it is economical to do so and provided obsolescence or inadequacy has not become eminent). Hence, estimates of useful life of facilities in each case should take into consideration the actual maintenance policy in effect.

(c) Depreciation may be determined by application of any one of the generally accepted methods; however, the selected method and rate of depreciation used should, in the absence of compelling reasons to the contrary, consistently be applied from year to year. Generally, however, depreciation is too intangible to warrant attempts at meticulous estimates by application of rates by individual items of plant and equipment, although such attempts are frequent and will be recognized. Hence, depreciation will generally be determined by groups of facilities for which the factors bearing on estimated useful life are similar. The amount of depreciation written off in any fiscal period may vary with volume of production or be

increased for multishift operation, provided the method followed is consistent with basic objective set forth in subparagraph (b) above. Special methods have been established for determining depreciation on emergency facilities covered by Certificates of Necessity by a special directive set forth in an appendix of this Section.

(d) Depreciation should be based upon original cost of the facilities, whether measured by purchase agreement for a cash consideration, the fair value of securities issued in exchange, or similar appropriate measures, [*although it is permissible that such cost of facilities be adjusted, where desired by the contractor for purposes of depreciation computations for contract pricing, to current price levels by the use of a general price index, provided in such event that the practice will be followed consistently in the future and also provided that otherwise the charge is made at the same annual rates applied to such adjusted costs as would have been appropriately applied on original costs in view of the estimated useful life of the facilities. In other words, no deficiency in actual depreciation provisions in any prior year, based upon current price levels, should be included in the depreciation charge for the current year.] No other basis of determining appreciation in value of facilities may be utilized in determining depreciation for purposes of contract costs; for this purpose the tax basis of facilities values acceptable for internal revenue purposes are applicable.

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*Particular attention is invited to the subject matter between the brackets. It is desired that comment be submitted on this concept, together with substantiation therefor.

(e) No depreciation will be allowable as such, or as a rental or use charge, on the cost of facilities which are fully depreciated but still in use when a substantial portion of such depreciation was on a basis that represented, in effect, a recovery thereof as a charge against defense contracts or subcontracts in negotiated pricing or statutory renegotiation of contracts. Otherwise, the contractor may compute normal depreciation on the cost of facilities in use without reference to previous depreciation provisions. Fully depreciated facilities will be determined on the basis of relating original cost to accumulated depreciation on such cost, regardless of whether there is an adjustment of current depreciation charges based upon adjusting the cost of facilities to current price levels.

(f) No depreciation may be allowed on facilities which are not in use, except such facilities as are held for reasonable production standby purposes and, when specifically provided by mutual agreement, on facilities representing additional plant capacity reserved for defense production.

15-313.04 Repairs and Maintenance. Repairs and maintenance of facilities (including Government-owned facilities) are allowable elements of contract costs. It is necessary that such expenses exclude expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and made the subject of depreciation. There is, of course, a twilight zone between repairs and maintenance and capital expenditures within which a contractor should be permitted to operate upon the basis of his established accounting practice, if the results are equitable. For example, certain major costs of building alterations and rebuilding or

rehabilitating machinery and equipment may reasonably be treated in some instances as either repairs and maintenance expenses or capital expenditures, depending in part upon the contractor's established policy. In making decisions with respect to the alternative accounting treatment of these items, consideration should be given to the materiality of the amounts involved, and the question of the substantial enhancement in value of a contractor's facilities at the expense of the Government for use during periods in which the contractor will have little defense business. In the latter case, for contract pricing purposes, the cost generally should be considered to be of a capital nature and the subject of depreciation. In those instances where it may be appropriate to charge the cost of extraordinary rehabilitation to expense, special care should be taken in equitably allocating the costs to all the benefited classes of work (see 15-313.07 "Preparatory Costs"). Repairs and maintenance costs on facilities which are not in use will not be allowed, except on individual items of machinery and equipment (as distinct from entire plants or significant portions thereof) held for reasonable standby purposes. Repairs and maintenance on additional plant capacity reserved for defense production will be allowed only if specifically provided by contractual agreement.

In some instances, allowance of substantial extraordinary rehabilitation expenses as a charge against defense business may be permitted but will be contingent upon the contractor's written agreement to hold the facilities available for defense work for a stated minimum period.

15-313.05 Profits or Losses on Disposition of Plant and Equipment. In determining contract costs, no recognition will be given to profits or losses on disposition of plant and equipment for the reason that depreciation,

reasonably determined, provides the exclusive charge for the cost of using a contractor's facilities. However, when a contractor has capitalized special purpose facilities acquired solely for performance under defense contracts (rather than charge the costs thereof to specific contracts) and engineering changes or complete or partial termination of contracts finds such facilities not fully depreciated and not reasonably useful for other business of the contractor, an additional cost allowance may be made in determining costs of the terminated contracts for the purpose of contract settlement, provided such facilities are transferred to the Government, if so desired, or an equitable adjustment is made in favor of the Government in recognition of any resale or salvage value estimated for such facilities.

15-313.06 Rentals of Plant and Equipment. Rentals of plant or equipment are allowable if reasonably required for the performance of the contract and if bona fide and reasonable as to rate and duration. Special care should be exercised in determining reasonableness of rentals in cases in which rates were arrived at as a result of less than arm's length bargaining. Rental costs may not be bona fide under the following circumstances:

(a) Rentals are paid to persons, including corporations, affiliated with the contractor.

(b) Rentals are paid to unaffiliated persons, including corporations, upon property formerly owned by the contractor when such property was fully depreciated or substantially fully depreciated before sale or transfer and Government contracts absorbed a significant portion of such depreciation.

In either case (a) or (b), rentals will be limited to a reasonable amount of depreciation, as might be determined if the property were owned by the contractor, plus carrying costs which are not paid by the contractor under

the terms of the lease, including maintenance, taxes, and insurance (but not interest on the investment).

15-313.07 Preparatory Costs, including Engineering. Preparatory costs or expenses, also known as "make-ready costs", are costs specially incurred in preparing to operate under a specific contract or contracts. They include costs of organization and planning, employee recruitment and training, engineering and development (including product design, product specifications, and planning of production processes and layout) and plant alteration and rearrangement. Preparatory costs do not include initial production (starting load) costs which are treated in paragraph 15-313.08 or special tooling which is treated in paragraph 15-313.10.

Preparatory costs, when incurred for the exclusive benefit of Government production, are allocable directly or indirectly to the contracts benefiting from such costs. When preparatory costs benefit other classes of work as well as Government work, an equitable allocation to all benefited classes of work is proper.

Preparatory costs may have been incurred prior to the award of a definitive contract. The amounts of such costs, for purposes of contract cost allowances, are subject to approval of contracting officers based upon advance understandings or upon subsequent negotiation. In such case a specific provision covering the allowability of pre-award preparatory costs should be incorporated in any definitive contract when future pricing or repricing may be based in part upon actual contract costs. Similarly, it is desirable that prior approval of the contracting officer be obtained in the event that unusual charges of this type are to be incurred during the life of the contract. However, the absence of such provision or approval will not preclude consideration of the costs in

subsequent price negotiations or determinations under such contracts.

15-313.08 Initial Production Costs. Initial Production Costs, also known as "starting-load costs", are non-recurring costs that arise in the early stages of production because of the contractor's unfamiliarity or lack of experience with the particular materials, manufacturing processes, or techniques involved. They are to be distinguished from preparatory costs or expenses (also known as "make-ready costs").

Initial production costs may consist of the excessive portion of material costs incurred in the early stages of production, on contracts requiring new products or greatly increased production, as the result of abnormal quantities of materials used or abnormal scrap losses. Initial costs may also consist of the excessive portion of direct-labor costs, plus a proper portion of the related overhead, incurred in the early stages of production due to such causes as excessive defective work resulting from inexperienced labor, idle time and subnormal production occasioned by testing and changing methods of processing, and cost of training employees. The justification for such special costs depends upon their nature and causes, and not merely upon the fact that total production costs are high.

After a reasonable volume of production has been attained and initial manufacturing difficulties have been overcome, unit cost will usually tend to level off, thereby evidencing the end of the initial period of production but not necessarily representing the lowest unit cost eventually attainable during the operation of the entire contract. If, however, these costs continue abnormally high after a contractor has been allowed a reasonable length of time in which to learn how to make a product efficiently, the excessive costs may not properly be allowable for purposes of cost reimbursement or

estimating under cost type contracts, estimating for formal pricing purposes in fixed price contracts, or in establishing costs under terminated contract settlements.

15-313.09 Reconversion Expenses. Reconversion expenses are those connected with restoration of facilities to approximately the same physical arrangement and condition they were in immediately prior to the beginning of defense work, including the removal of Government property. In many cases, reconversion costs, except for the removal of Government property are incurred for the benefit of future production, in which cases such costs should be assessed against such production. However, in a specific case and where all of the circumstances outlined below exist, reconversion costs may be recognized through specific contractual provision.

(a) There must have been a major alteration or rearrangement of facilities at the inception of defense work for the sole purpose of performance of defense contracts, or facilities were newly acquired buildings in which Government machinery and equipment has been installed. In the latter case, only the cost of removing Government property is to be considered.

(b) The necessity of reconversion of facilities to approximately the same physical arrangement and condition they were in immediately prior to the beginning of defense work and the costs thereof must be reasonably certain and determinable.

(c) There is little or no post defense work commercial benefit to the contractor as the result of such alteration or rearrangement.

(d) Neither the particular contract nor any other contract contains an allowance for the use of facilities which would compensate the contractor for reconversion expenses.

Reconversion costs shall be allowed only in pricing those fixed price

contracts in existence or actually being negotiated at the time the costs of conversion were incurred. In the event of subsequent conversions or modifications for additional fixed price contracts, care must be exercised to avoid duplication of allowances for reconversion costs. Specific contractual provisions may be included in cost-reimbursement-type contracts to compensate the contractor for actual reconversion costs incurred in circumstances meeting the above conditions.

15-313.10 Special Tooling. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment.

The cost of special tooling, when acquired for and its usefulness is limited to one or more Government contracts in force or being negotiated at the time of acquisition, is allocable to the specific Government contracts. The cost of tooling which is special to other classes of work will be allocated to such work. The cost of non-special tooling is not subject to direct allocation, but is subject to depreciation, which is treated elsewhere in this Part, except that in the production of standard commercial products such tooling costs may be treated as indirect manufacturing expense on an expenditure basis, in lieu of depreciation, when the resultant charges are reasonably equitable between fiscal years. When the entire cost has been allocated to Government contracts, the asset concerned shall become contractor-acquired Government property and be subject to the provisions of Section XIII and Appendix B, ASPR, applicable to contractor-acquired Government property.

15-313.11 Research and Development. Research and development expenses

may be divided into two major categories -- (1) product research and development, and (2) general research.

(a) Product research and development is that effort which is directed toward the solution of specific problems encountered in the design or production of a particular product which has or is anticipated to have military or commercial use. The current costs are allowable as costs on defense contracts and may be allocated thereto only to the extent applicable to the supplies or services covered by the contracts, and provided such costs are not reimbursed to the contractor under separate research and/or development contracts. No costs of product research and development may be allocated to Department of Defense product research and development contracts other than the direct costs of performing the contract and the proper share of the indirect costs of administering the product research and development program.

(b) General research is all research other than that which is directed toward the solution of specific problems encountered in the design or production of a particular product which has or is anticipated to have military or commercial use. The cost of general research, when reasonable in amount and incurred in accordance with the contractor's established practice, is allocable to all classes of work, including defense work, provided such costs are not reimbursed to the contractor under separate research contracts. Where the contractor's organization is devoted primarily to research work, as distinct from manufacturing, no cost of general research may be allocated to Department of Defense contracts for general research other than the direct costs of performing the contract and the proper share of the indirect costs of administering the research program. No general research costs which were incurred in accounting periods prior to the award of the particular defense contract(s) (including amounts capitalized in

the cost of patents obtained) shall be allocated thereto, nor will the contractor be required to defer research costs incurred during the period of performance of defense contracts to subsequent accounting periods.

(c) At the option of the procuring agency, cost allowances for research and development work may be made contingent upon the contractor agreeing to waive any royalty charges, under all patents previously obtained or which may be obtained in the future from such work, to the extent such royalties are applicable to defense work, either directly or indirectly.

15-313.12 Patents and Royalties.

(a) Amortization of the cost of purchased patents owned by a contractor applicable to products or processes covered by a contract is an allowable element of cost to the extent reasonably allocable to the contract. Research and development costs leading to patents are treated in paragraph 15-313.11.

(b) Royalty costs are allowable if bona fide and reasonable. Special care should be exercised in determining reasonableness of royalties in cases in which amounts were arrived at as a result of less than arm's length bargaining. Royalty costs may not be bona fide under the following circumstances:

(i) Royalties are paid to persons, including corporations, affiliated with the contractor.

(ii) Royalties are paid to unaffiliated persons, including corporations, upon patents formerly owned by the contractor when the costs of such patents or the research and development work thereon were substantially recovered through charges against the costs of defense business.

In either case (i) or (ii) royalties will be limited to such charges as might be determined if the patent were owned by the contractor in accordance with the

provisions of this paragraph and paragraph 15-313.11 relative to research and development.

(c) Care should be exercised in preventing charges for the use of patents when the Government, in fact, already has rights to such patents. (See Section IX, ASPR)

15-313.13 Plant Protection Expenses.

(a) These expenses represent costs incurred in protecting the contractor's personnel and plant against fire, theft, sabotage, espionage, civil disorder, enemy attack, or other violent destructive forces. Plant protection expenses are allowable costs of defense contracts. Normally they will consist of guards' wages and labor costs related thereto, costs of individual equipment, cost of plant protection equipment if of minor amount, and depreciation of plant equipment. To the extent these costs are attributable solely to defense special security requirements, they are allocable entirely to defense contracts. Costs of normal plant protection not resulting from such special requirements, generally, should be indirectly allocated to all classes of work.

(b) A special problem may arise in the case of fixed price contracts, the security classification of which is altered after the contract has been entered into. When such a contract price is negotiated, the contractor is presumed to know the plant protection requirements under the contract and is expected therefore to meet such requirements within the contract price. However, if the security classification of the contract were changed by the Government after entering into the contract, additional costs of plant protection may be allowed the contractor by contract amendment. The additional costs may include not only current costs of an operating nature but also costs of a capital nature if the parties agree that the capital costs are incurred solely because of the

changed security classification of the contract and would not have been necessary from the contractor's point of view. Also, if a classified contract is reclassified downward during its performance thereby permitting a savings in plant protection costs, such savings should, if material, be the subject of a contract amendment passing the savings on to the Government.

(c) Civil defense costs must be allocated to all work of the contractor performed at the particular location where the costs are incurred. When the Government's portion of the output of the particular plant is not material, the reasonableness of the incurred costs need not be questioned. However, since usually past experience will not provide a guide as to reasonableness, civil defense costs should be the subject of specific agreement when the amount of such costs to be allocated to Government contracts is substantial. When this is the case, reasonableness may be judged in light of:

(i) Recommendations and requirements of the duly constituted Governmental authority having jurisdiction over civil defense in the local area.

(ii) The extent of like measures being taken by other businesses within the local area, particularly those not producing under Government contracts.

(iii) The portion of total cost likely to be allocated to Government contracts as furnishing an inducement to the contractor to incur the cost.

15-313.14 Insurance and Bonds.

(a) The net cost of insurance and bonds, after deduction of dividends or other allowances which may be expected, if reasonably necessary to the operation of a business, is an allowable cost on Government contracts to the extent allo-

cable. Some, but not all, of the types of coverage which may be reasonably necessary are property, aircraft, automobile, general liability, product liability, workmen's compensation, employees' group, accident and disability, use and occupancy, and employees' fidelity and surety bonds (including performance bonds).

(b) Insurance on the lives of officers is not an allowable cost, except when premiums are paid in behalf of executives or employees pursuant to specific agreement or established policy whereby such payment may be properly considered as additional compensation (Paragraph 15-330.02).

(c) When a contractor assumes insurable risks of any type, a reasonable provision for losses estimated by the contractor is an allowable cost if such provision is based upon actual loss experience to the extent feasible; or, in the absence of adequate loss experience data, it is not in excess of net costs which would be paid for such insurance if carried by private insurance companies, less agents' commissions and other acquisition and servicing costs.

(d) Where the contract requires review and approval of contractors insurance program by the insurance authorities of the military departments, procurement and audit personnel of the military departments will be governed thereby.

15-313.15 Taxes.

(a) In general, taxes which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for Federal income and excess profits taxes; taxes in connection with financing, refinancing or refunding operations (see paragraph 15-330.05); and special assessments on land which represent capital improvements.

(b) Taxes which are believed to be illegally or erroneously assessed against the contractor, may be allowed as a cost of work performed, provided that the contractor; (1) promptly requests instructions from the contracting officer concerning such taxes; (2) agrees to comply with such instructions; and (3) if so directed by the contracting officer also agrees to take all necessary action in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer, shall be allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs.

(c) Any refund of taxes, penalties or interest thereon shall be credited to contract costs in the proportion in which contract costs absorb the costs of taxes, interest or penalties. If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

(d) Where it becomes evident in negotiating a contract price that a contractor may be required to pay a tax, the legality of which is questionable or in dispute, such tax may be used in negotiating the contract price, provided that the contract contains provisions substantially similar to those set out in subparagraph (b) (1) (2) and (3) above.

15-313.16 Strikes and Lockouts. The situations and conditions surrounding strikes and lockouts are so varied that it is impossible to establish a general principle providing for allowance or disallowance of costs incurred during such occurrences. Each case must be considered on its own merits in the light of the philosophy expressed or implied in the principles and standards expressed in Part 2 of this Section.

15-320 Selling and Distribution Expenses.

15-320.1 Allocation of Selling and Distribution Expenses. Selling and distribution expenses in general are subject to allocation to the cost of defense work to the extent appropriate, considering the methods of selling and distribution to the Government or to prime contractors or subcontractors. Generally, selling and distribution expenses should be allocated between product lines, or to products sold to the respective customer types (where sales methods are different), based on analysis of the cost elements in relation to the sales efforts. In some cases, it may be appropriate to first allocate these expenses in whole or in part as between defense and nondefense business, and then to allocate the expenses applicable to defense business against the individual defense contracts or products. The principle of direct costing is very important in this area. For example, when special defense products are sold to the Government or to defense contractors by separately identifiable employees of the manufacturer, the compensation and expenses of such employees may be appropriately charged to costs of such products. When, in such cases, there is a separate sales organization or identifiable group of representatives engaged in selling to nondefense customers, no portion of compensation and expenses thereof should be charged to defense products. On the other extreme, when standard commercial products are sold at fixed prices direct to the Government or to defense contractors, as well as to numerous customers not engaged either directly or indirectly in defense production, by means of one

established sales organization, the same selling expense per unit of product may be used in cost estimating, except when the quantities expected to be sold are so abnormal in relation to sales effort that the use of historical costs would result in the inclusion of an unreasonable amount of estimated selling expenses. In the latter case,

the fixed selling expenses should be charged to normal nondefense sales, leaving the defense sales chargeable only with a proper share of the variable costs. For an illustration of this principle see paragraph 15-320.5 re advertising.

15-320.2 Salesmen's or Agents' Compensation.

(a) Salesmen's or agents' compensation allocable to defense contracts should be reasonable in the light of the services rendered. If inequitable or exorbitant compensation is paid, it shall be subject to disallowance, to the degree deemed excessive, for the purpose of allocation of costs to defense contracts. For example, when defense business consists of standard commercial products which are sold normally on a commission basis, sudden expansion of defense business may necessitate the adjustment in the amount of compensation allocable to defense contracts.

(b) No fee, commission, percentage, or brokerage fee shall be allowed as a contract cost when contingent upon or resulting from an award of a contract, except amounts paid to bona fide employees or established commercial or selling agencies maintained by the contractor for the purpose of securing business. This provision shall be applied in a manner consistent with representations or agreements of contractors or prospective contractors in the light of ASPR, Section I, Part 5.

15-320.3 General Sales Expenses. These expenses, consisting of salaries and expenses in connection with direction and supervision of all sales efforts, clerical expenses in maintaining sales records and statistics in some cases, and similar overall sales expenses, may be considered to be allocable indirectly to defense products or contracts in some cases based upon the specific facts in each case, provided the basis of allocation is equitable as between defense and nondefense business as a whole in the light of the relative services rendered.

15-320.4 Bidding Expenses. Current bidding expenses of both successful and unsuccessful bids normally will be treated as indirect expenses and apportioned currently to all business of the contractor in which event no bidding expenses of past accounting periods will be chargeable to defense contracts. However, where it is the contractor's established practice to treat bidding expenses by some other method, such method may be acceptable if the results are substantially the same as would have resulted from the application of the method described above.

15-320.5 Advertising. Advertising expenses include the costs of materials, space, time, layout, and expenses of the department which supervises such activities. Advertising expenses are generally incurred to promote the sale of the contractor's regular commercial products and should be assigned thereto. Advertising may be appropriately considered for allocation to the cost of defense contracts in the following cases:

(a) Advertising directed solely towards the recruitment of new employees.

(b) Advertising in trade and technical journals for the purpose of establishing necessary business contacts in connection with the sale of defense products to Government contractors or when such periodicals are believed to be of value in the dissemination of technical information within the contractor's industry.

(c) Publication of catalogs, price lists, and technical pamphlets which aid users of the contractor's products, including the Government or defense contractors, excluding, of course, the cost of such publications prepared for the Government under separate contract consideration.

(d) Advertising for commercial products, other than as in (a) through (c) above, not in excess of the contractor's average annual costs incurred prior to the award of defense contracts established practice, may be allocated to defense prime contracts and subcontracts for such commercial products on the basis that the costs will first be assigned to the contractor's nondefense business in the same amount per unit sold as was assigned to such units prior to obtaining defense business; the amount remaining after such assignment may be allocated to defense prime and subcontracts but not in excess of the amount per unit on nondefense business; provided, however, that when defense sales are merely incidental, such cost allocations may be made on an overall prorata basis.

(e) Advertising costs, other than as in (a) through (c) above, may not be allocated to defense prime contracts and subcontracts for non-commercial products. The sole exception to this rule exists in cases where, in connection with undertaking defense work, the contractor's volume of nondefense work is reduced substantially, and the market demand for the contractor's nondefense work is such that the reduction would not otherwise have occurred. In such cases, in order to maintain good will, the contractor may need to continue to advertise in accordance with the contractor's average annual costs incurred prior to the award of defense contracts. In such event, the excess of reasonable advertising costs over the amount chargeable to nondefense business at per unit rates previously prevailing may be allocated to defense business.

15-320.6 Product Transportation and Delivery Expenses. These expenses,

when required by the terms of a contract, are properly allowable. Whenever significant in amount and provided it is feasible, they should be determined and allocated as a direct cost of the product or contract.

15-320.7 Warehousing Expenses. Whenever a manufacturer maintains and ships products from warehouses strategically located in order to provide better service or reduce transportation costs to customers (as is frequently found with standard commercial products or spare parts), the expenses of warehousing such stocks, including transportation from factory to warehouse, are allowable when fairly allocated to defense sales in relation to total sales of products delivered from such warehouses. On the other hand, where products sold under a defense contract are not delivered or serviced from such warehouses none of the cost of operation thereof is allocable to the contract.

15-320.8 Service and Warranty Expenses. In cases where the contract terms covering sale of defense products include an obligation on the part of the contractors, without additional separate compensation, to provide service in installation, training operators, correcting defects in the product, replacing defective parts, making refunds in case of inadequate performance, etc., the price or cost of the product should include an allowance for the cost of such undertakings. Generally, any warranty of the product as to performance, materials, and workmanship will be for a definite period of time. In the case of cost-reimbursement-type contracts, actual costs of performance to be reimbursed to the contractor will include such of the foregoing costs as must be incurred to comply with the terms of the contract, and the period of performance of the contract will usually not expire until the end of warranty period and completion of performance of any work required by the terms of the warranty. However, in some fixed-price contracts, a warranty may extend for a period of

time considerably beyond delivery. In such cases, it is necessary to estimate the cost of services and warranties, usually as a percentage of produce cost, for purposes of price negotiation. Estimating warranty costs must usually be based upon past experience in similar circumstances. When allowances are made for costs of performance under warranties as product costs, there should be no duplication of the allowance for the risks in figuring allowable profits.

15-320.9 Entertainment Expenses. Entertainment expenses, as such, shall not be considered either directly or indirectly as a cost of performing Government contracts. However, when expenses arise as a result of purchase of meals, local transportation, rental of facilities for meetings, and other incidental costs, and the primary purpose of incurring such costs is the dissemination of technical information or the stimulation of production, such costs are allowable in determining the cost of Government contracts.

15-330 General and Administrative Expenses.

15-330.01 Allocation of 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 input costs (processing costs plus direct material), cost of goods completed, cost of sales, and sales (where no more satisfactory basic is available), provided that equitable results are thereby obtained. In the selection of the particular method or methods of apportionment, special consideration should be given to any such unusual factors as charges of subcontractors and fixed asset improvement programs. All pertinent factors should be reviewed from time to time, especially if and when there is a change in the nature or volume of production, to determine whether the indirect expenses continue to be apportioned equitably.

Where the nature of a contractor's business has not changed basically by a shift to defense production, the presumption is that his former methods, if tested by operation over a considerable period, are satisfactory. However, this is only a presumption and should be reexamined in light of probable increased production. When the business has changed substantially because of such a shift, the contractor's former methods of allocating indirect expenses may be entirely inappropriate and so should be thoroughly reviewed.

15-330.02 Executive Compensation.

(a) Executive compensation consists of all emoluments (including salaries, bonuses, stock options, etc.) paid or accrued for services actually rendered to the contractor by executives, officers, partners, sole proprietors, and others of similar rank and abilities. Such costs are allowable when reasonable in amount in the light of the services rendered. Where the contractor's organization was a going concern for a significant period prior to the award of defense contracts, the amount of compensation established by the contractor will normally be considered reasonable. In other cases and in any case where the amount thereof appears not to have been determined through arm's length bargaining between the employer and the executive special consideration may be required. Arm's length bargaining may be lacking in any one of the following situations among others:

(1) The executive or a member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization; or

(2) Ownership of the contractor is limited to a small cohesive group; or

(3) The volume of Government contracts when related to the contractor's total business is such as to influence the contractor in his determination of executive compensation; or

Determination of the foregoing facts in any case may require submission of cost data of the transferor.

15-312 Labor. The cost of obtaining the services of any individual includes the base salary or wage, plus the cost of all fringe benefits. Therefore, both the basic salary or wage and all fringe benefits will be considered in determining the reasonableness of the earnings of an individual in relation to services rendered. Direct labor cost consists of salaries and wages identified specifically with the performance of a contract, job, or product. Labor services utilized for joint objectives may be treated as indirect costs if specific identification is impractical or uneconomical and the results of allocation are equitable. In determining historical costs, labor will generally be charged at actual rates paid by the contractor. However, if it is the contractor's consistent practice to charge for performance of groups of

labor at an average rate, or to use standard labor rates, with consequent savings in clerical expense or improvement in labor control, such methods may be used, provided labor groupings and the adjustment for cost variances result in a reasonably accurate assessment of total charges. Similarly, when labor costs are required for making cost estimates, the use of standard labor rates and standard time allowances (appropriately adjusted for experience variances) or reliable engineering estimates is acceptable. Ordinarily the use of wage rates higher than current going-rates will not be permitted for estimating purposes. In order to avoid substantial allowances for such contingencies, escalation or price-redetermination clauses are provided. However, situations involving increases in wage rates which are reasonably certain and determinable or relatively minor in amount may warrant recognition being given thereto in making estimates.

15-312.1 Fringe Benefits—Vacations, Holidays, Sick Leave, Military Leave, Pension and Retirement Plans, and Employee Insurance, but Exclude Severance Pays. Compensation of these types is allowable to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment.

The cost of "fringe benefits" is part of the cost of the work performed by the employee while on the job, and must be considered as having a direct relationship to such work. However, in recognition of the different accounting treatments by different contractors accorded fringe benefits, the cost thereof may be allocated to Government contracts on any of the following bases, provided equitable results are achieved:

(a) Each class of compensation is preferably

to be accrued as a cost over the period in which it is earned.

(b) Where it is the contractor's established practice to record the costs at the time of payment, such practice may be acceptable. This is the most commonly used method of accounting for "fringe benefits," but its use might result in inequities in some cases. For example, if a Government contract was performed over the summer months during which most of the contractor's employees took vacations or military leaves, recognition of the cost at time of payment would be inequitable to the Government. On the other hand, if the contract or contracts extended over approximately one year and the proportion of Government work to the contractor's commercial work remained stable, this method might be equitable.

(c) When the costs of any of the elements of fringe benefits are greater or lesser with respect to defense business as compared with nondefense business, such costs should be allocated, so far as feasible and appropriate, between the two classes of business before further allocation of such costs to individual contracts or products. If this method of cost allocation is used, it should be used consistently for all elements of fringe benefits having a different cost relationship of defense business as compared with nondefense business.

(d) It may be practicable to negotiate an equitable rate for fringe

benefits based upon experience for a representative period in lieu of individual consideration for each item. Changed conditions and circumstances would have to be considered in making such a determination. The experience rate would then be applied to the more direct labor costs to determine the allowable costs. The use of such rate should be subject to revision in light of changed conditions.

The cost of pension and retirement plans is covered more fully as the subject of a directive set forth as Appendix ___ to this Section.

15-312.1½ Severance Pay. The cost of severance pay will be considered only to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment. Theoretically, the right to severance pay is earned during the entire period of employment of the individual or, when based upon specified years of service, is earned during those years. In theory, the cost of severance payments should be recorded in the contractor's accounts during the periods in which the employee earned the right to such payments. However, few contractors accrue severance payments because (1) the clerical expense involved in identifying and recording the cost for each employee is not justified; and (2) there is considerable doubt that any substantial payments will have to be made since payment is solely contingent upon future events.

The cost of severance payments may be included in cost estimates only to the extent that such estimates are based upon severance payments actually made over a representative past period. In determining historical costs severance payments actually made are allowable if not in excess of the cost

of such payments over a representative past period. Where the Contractor provides for accruals of severance payments in lieu of recording the cost thereof at the time of payment, such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made over a representative past period. Generally, the cost of severance payments made during the performance of defense contracts should be allocated to all classes of work being performed at the time of payment since it is a reduction of total work which causes the severance. Because of the degree of uncertainty surrounding defense production, the following paragraphs are devoted to the treatment of severance payments anticipated to be necessary upon the completion or termination of defense production.

Where the contractor is an established concern and its level of employment has not been substantially increased with the advent of defense contracts, the contingency of substantial severance payments upon completion or termination of such contracts is so remote that consideration need not be given thereto in making cost estimates or in determining historical costs.

A specific contractual provision may recognize severance pay in either of the following situations:

(1) The contractor is newly established, is producing other than a substantially standard commercial item, and the weight of available evidence indicates that upon completion of defense work the contractor's operations will cease or greatly diminish. Illustrative of this situation is a contractor organized to operate a Government-owned facility.

(2) The contractor is not newly established, is producing other than a substantially commercial item, and its level of employment increased substantially with the advent of defense contracts (particularly where new

facilities or major portions thereof were placed in operation) and the weight of available evidence indicates that upon the completion of defense work the contractor's operations will shrink to approximately the pre-contract award level.

In either case (1) or (2) above the treatment of severance pay by contractual provision should vary with the type of contract. In the case of cost-type contracts and those fixed price contracts the price of which is negotiated upon completion, the contractual provision may provide for recognition of severance payments actually made upon completion or termination.

Where price is determined before completion, estimates of severance pay costs may be included in total estimated cost. Determination of the amount of severance pay to be included in cost estimates is particularly difficult. The amount included should not be the estimated total possible future liability for severance payments since the contractor is expected to give notice of separation in lieu of making severance payments. The amount included should represent a conservative estimate in light of the degree of contingent risk assumed by the contractor. Where agreement is not possible, consideration should be given to the use of a type of contract which would permit recognition of the cost of severance payments upon completion or termination of the contract. Where an allowance for severance pay is provided in a fixed price contract, care must be exercised to prevent duplication of allowance therefor in other contracts.

15-312.2 Premium Payments for Overtime and Extra-Shift Work. Costs of this nature consist of only the premium portion of overtime and extra-shift payments or accruals to employees, not the straight-time portion. Thus, if the rate for overtime work is time-and-one-half of the regular rate, the premium portion is the additional one-half. Similarly, if the wage rate for a second shift is twenty cents an hour above the regular rate, this additional amount is the premium.

Overtime and shift premiums are allowable, but the contractor must disclose and justify overtime other than of an occasional nature. Whenever such overtime allowances are claimed under cost-type contracts, approval of the contracting officer or his authorized representative must be obtained. (See paragraph 12-102.)

Such premiums may be classified as either direct or indirect labor cost, but overtime premiums should be separately stated in either event. When treated as direct labor cost, overtime premiums should not be included in the base for distribution of overhead. The amount of overtime and shift premium cost charged on Government contracts shall not be disproportionate to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant.

15-312.3 Unclaimed Wages. Costs under cost-reimbursement-type contracts should reflect a credit for unclaimed wages based upon agreement as to the amount thereof reasonably expected not to be paid subsequent to the date of settlement. In this event, all unclaimed wage liability rests with the contractor. When such an agreement cannot be reached, the Government will assume liability for payment of unclaimed wages and eliminate all allowances therefor from reimbursement to the contractor.

15-313 Other Manufacturing Expenses:

15-313.01 Allocation of Indirect Manufacturing Expenses. Among the acceptable bases, depending upon circumstances, for allocating indirect manufacturing expenses are direct-labor-cost, direct-labor-hours, machine-hours, and units processed. In more complex manufacturing plants, it is appropriate to departmentalize the plant for purposes of accounting for manufacturing expenses when any given type of defense production is concentrated in departments having a much higher or lower expense rate than the average. Expense departmentalization is also desirable in larger and more complex plants for purposes of expense budgeting and control by the responsible foreman, regardless of the need for a more refined method of expense allocation. When manufacturing expenses are departmentalized, it is necessary to charge service-department expenses (such as the power plant) and factory general expenses (such as taxes, insurance, 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 should be selected for service-department and other expense distributions to productive departments - e.g., kilowatts of connected power load or metered power consumption, in the case of electric power.

When direct-labor dollars expended fairly reflect machine effort, as well as labor effort, in any productive department, it is most simple, as well as appropriate, to use that basis of expense allocation in preference to a direct-labor-hour or machine-hour basis. When there is much automatic or semiautomatic machinery in a productive department, the use of a machine-hour-rate is generally more appropriate for expense allocation. The units-processed-basis of allocation is generally appropriate when a given productive

department processes only one item, or the several items are so similar as to be susceptible to measurement of units processed in terms of a common denominator -- e.g., steel sheets of various gauges processed through a rolling mill.

15-313.02 Allocation of Engineering Expenses. Engineering expenses include such items as the cost of product design, tool design, lay-out of production lines, determination of machine methods and drafting. The principle of direct costing (see paragraph 15-211) would indicate the desirability of charging directly to the benefitted activities (production, facilities, and research and development) all engineering costs which can be directly identified with such activities, leaving only a relatively minor amount of engineering costs (consisting chiefly of engineering administrative expenses) to be allocated to the activities. All engineering costs charged directly or allocated should in turn be assigned to products, product lines, job orders, contracts, etc. Further treatment of various problems in connection with the costing of research and development, tooling, and preproduction expenses is included in this Part (see paragraph ___); facilities contracts are included in Part 4.

15-313.03 Depreciation.

(a) Depreciation accounting is a system of accounting which aims to distribute the cost of tangible capital assets, less estimated salvage value (if any), over their estimated useful life in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, usually of an indirect nature.

(b) Useful life, as above referred to, has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life. In establishing estimated useful life, consideration should be given to all of the factors of wear and tear, obsolescence (both economic and technological), and inadequacy, which are common to the depreciation problem. Of these factors, obsolescence is most often the limiting or controlling one. Obsolescence of facilities, from the standpoint of economic utility, is always a prospect or contingency to be anticipated (differing only in degree, in each instance) with respect to an entire enterprise or an individual plant, as well as groups or individual items of plant and equipment. Costs of depreciation and maintenance are mutually related. Wear and tear may be increased by lack of maintenance or may be made good by maintenance (often indefinitely, so long as it is economical to do so and provided obsolescence or inadequacy has not become eminent). Hence, estimates of useful life of facilities in each case should take into consideration the actual maintenance policy in effect.

(c) Depreciation may be determined by application of any one of the generally accepted methods; however, the selected method and rate of depreciation used should, in the absence of compelling reasons to the contrary, consistently be applied from year to year. Generally, however, depreciation is too intangible to warrant attempts at meticulous estimates by application of rates by individual items of plant and equipment, although such attempts are frequent and will be recognized. Hence, depreciation will generally be determined by groups of facilities for which the factors bearing on estimated useful life are similar. The amount of depreciation written off in any fiscal period may vary with volume of production or be

increased for multishift operation, provided the method followed is consistent with basic objective set forth in subparagraph (b) above. Special methods have been established for determining depreciation on emergency facilities covered by Certificates of Necessity by a special directive set forth in an appendix of this Section.

(d) Depreciation should be based upon original cost of the facilities, whether measured by purchase agreement for a cash consideration, the fair value of securities issued in exchange, or similar appropriate measures, [*although it is permissible that such cost of facilities be adjusted, where desired by the contractor for purposes of depreciation computations for contract pricing, to current price levels by the use of a general price index, provided in such event that the practice will be followed consistently in the future and also provided that otherwise the charge is made at the same annual rates applied to such adjusted costs as would have been appropriately applied on original costs in view of the estimated useful life of the facilities. In other words, no deficiency in actual depreciation provisions in any prior year, based upon current price levels, should be included in the depreciation charge for the current year.] No other basis of determining appreciation in value of facilities may be utilized in determining depreciation for purposes of contract costs; for this purpose the tax basis of facilities values acceptable for internal revenue purposes are applicable.

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*Particular attention is invited to the subject matter between the brackets. It is desired that comment be submitted on this concept, together with substantiation therefor.

(e) No depreciation will be allowable as such, or as a rental or use charge, on the cost of facilities which are fully depreciated but still in use when a substantial portion of such depreciation was on a basis that represented, in effect, a recovery thereof as a charge against defense contracts or subcontracts in negotiated pricing or statutory renegotiation of contracts. Otherwise, the contractor may compute normal depreciation on the cost of facilities in use without reference to previous depreciation provisions. Fully depreciated facilities will be determined on the basis of relating original cost to accumulated depreciation on such cost, regardless of whether there is an adjustment of current depreciation charges based upon adjusting the cost of facilities to current price levels.

(f) No depreciation may be allowed on facilities which are not in use, except such facilities as are held for reasonable production standby purposes and, when specifically provided by mutual agreement, on facilities representing additional plant capacity reserved for defense production.

15-313.04 Repairs and Maintenance. Repairs and maintenance of facilities (including Government-owned facilities) are allowable elements of contract costs. It is necessary that such expenses exclude expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and made the subject of depreciation. There is, of course, a twilight zone between repairs and maintenance and capital expenditures within which a contractor should be permitted to operate upon the basis of his established accounting practice, if the results are equitable. For example, certain major costs of building alterations and rebuilding or

rehabilitating machinery and equipment may reasonably be treated in some instances as either repairs and maintenance expenses or capital expenditures, depending in part upon the contractor's established policy. In making decisions with respect to the alternative accounting treatment of these items, consideration should be given to the materiality of the amounts involved, and the question of the substantial enhancement in value of a contractor's facilities at the expense of the Government for use during periods in which the contractor will have little defense business. In the latter case, for contract pricing purposes, the cost generally should be considered to be of a capital nature and the subject of depreciation. In those instances where it may be appropriate to charge the cost of extraordinary rehabilitation to expense, special care should be taken in equitably allocating the costs to all the benefited classes of work (see 15-313.07 "Preparatory Costs"). Repairs and maintenance costs on facilities which are not in use will not be allowed, except on individual items of machinery and equipment (as distinct from entire plants or significant portions thereof) held for reasonable standby purposes. Repairs and maintenance on additional plant capacity reserved for defense production will be allowed only if specifically provided by contractual agreement.

In some instances, allowance of substantial extraordinary rehabilitation expenses as a charge against defense business may be permitted but will be contingent upon the contractor's written agreement to hold the facilities available for defense work for a stated minimum period.

15-313.05 Profits or Losses on Disposition of Plant and Equipment. In determining contract costs, no recognition will be given to profits or losses on disposition of plant and equipment for the reason that depreciation,

reasonably determined, provides the exclusive charge for the cost of using a contractor's facilities. However, when a contractor has capitalized special purpose facilities acquired solely for performance under defense contracts (rather than charge the costs thereof to specific contracts) and engineering changes or complete or partial termination of contracts finds such facilities not fully depreciated and not reasonably useful for other business of the contractor, an additional cost allowance may be made in determining costs of the terminated contracts for the purpose of contract settlement, provided such facilities are transferred to the Government, if so desired, or an equitable adjustment is made in favor of the Government in recognition of any resale or salvage value estimated for such facilities.

15-313.06 Rentals of Plant and Equipment. Rentals of plant or equipment are allowable if reasonably required for the performance of the contract and if bona fide and reasonable as to rate and duration. Special care should be exercised in determining reasonableness of rentals in cases in which rates were arrived at as a result of less than arm's length bargaining. Rental costs may not be bona fide under the following circumstances:

(a) Rentals are paid to persons, including corporations, affiliated with the contractor.

(b) Rentals are paid to unaffiliated persons, including corporations, upon property formerly owned by the contractor when such property was fully depreciated or substantially fully depreciated before sale or transfer and Government contracts absorbed a significant portion of such depreciation.

In either case (a) or (b), rentals will be limited to a reasonable amount of depreciation, as might be determined if the property were owned by the contractor, plus carrying costs which are not paid by the contractor under

the terms of the lease, including maintenance, taxes, and insurance (but not interest on the investment).

15-313.07 Preparatory Costs, including Engineering. Preparatory costs or expenses, also known as "make-ready costs", are costs specially incurred in preparing to operate under a specific contract or contracts. They include costs of organization and planning, employee recruitment and training, engineering and development (including product design, product specifications, and planning of production processes and layout) and plant alteration and rearrangement. Preparatory costs do not include initial production (starting load) costs which are treated in paragraph 15-313.08 or special tooling which is treated in paragraph 15-313.10.

Preparatory costs, when incurred for the exclusive benefit of Government production, are allocable directly or indirectly to the contracts benefiting from such costs. When preparatory costs benefit other classes of work as well as Government work, an equitable allocation to all benefited classes of work is proper.

Preparatory costs may have been incurred prior to the award of a definitive contract. The amounts of such costs, for purposes of contract cost allowances, are subject to approval of contracting officers based upon advance understandings or upon subsequent negotiation. In such case a specific provision covering the allowability of pre-award preparatory costs should be incorporated in any definitive contract when future pricing or repricing may be based in part upon actual contract costs. Similarly, it is desirable that prior approval of the contracting officer be obtained in the event that unusual charges of this type are to be incurred during the life of the contract. However, the absence of such provision or approval will not preclude consideration of the costs in

subsequent price negotiations or determinations under such contracts.

15-313.08 Initial Production Costs. Initial Production Costs, also known as "starting-load costs", are non-recurring costs that arise in the early stages of production because of the contractor's unfamiliarity or lack of experience with the particular materials, manufacturing processes, or techniques involved. They are to be distinguished from preparatory costs or expenses (also known as "make-ready costs").

Initial production costs may consist of the excessive portion of material costs incurred in the early stages of production, on contracts requiring new products or greatly increased production, as the result of abnormal quantities of materials used or abnormal scrap losses. Initial costs may also consist of the excessive portion of direct-labor costs, plus a proper portion of the related overhead, incurred in the early stages of production due to such causes as excessive defective work resulting from inexperienced labor, idle time and subnormal production occasioned by testing and changing methods of processing, and cost of training employees. The justification for such special costs depends upon their nature and causes, and not merely upon the fact that total production costs are high.

After a reasonable volume of production has been attained and initial manufacturing difficulties have been overcome, unit cost will usually tend to level off, thereby evidencing the end of the initial period of production but not necessarily representing the lowest unit cost eventually attainable during the operation of the entire contract. If, however, these costs continue abnormally high after a contractor has been allowed a reasonable length of time in which to learn how to make a product efficiently, the excessive costs may not properly be allowable for purposes of cost reimbursement or

estimating under cost type contracts, estimating for formal pricing purposes in fixed price contracts, or in establishing costs under terminated contract settlements.

15-313.09 Reconversion Expenses. Reconversion expenses are those connected with restoration of facilities to approximately the same physical arrangement and condition they were in immediately prior to the beginning of defense work, including the removal of Government property. In many cases, reconversion costs, except for the removal of Government property are incurred for the benefit of future production, in which cases such costs should be assessed against such production. However, in a specific case and where all of the circumstances outlined below exist, reconversion costs may be recognized through specific contractual provision.

(a) There must have been a major alteration or rearrangement of facilities at the inception of defense work for the sole purpose of performance of defense contracts, or facilities were newly acquired buildings in which Government machinery and equipment has been installed. In the latter case, only the cost of removing Government property is to be considered.

(b) The necessity of reconversion of facilities to approximately the same physical arrangement and condition they were in immediately prior to the beginning of defense work and the costs thereof must be reasonably certain and determinable.

(c) There is little or no post defense work commercial benefit to the contractor as the result of such alteration or rearrangement.

(d) Neither the particular contract nor any other contract contains an allowance for the use of facilities which would compensate the contractor for reconversion expenses.

Reconversion costs shall be allowed only in pricing those fixed price

contracts in existence or actually being negotiated at the time the costs of conversion were incurred. In the event of subsequent conversions or modifications for additional fixed price contracts, care must be exercised to avoid duplication of allowances for reconversion costs. Specific contractual provisions may be included in cost-reimbursement-type contracts to compensate the contractor for actual reconversion costs incurred in circumstances meeting the above conditions.

15-313.10 Special Tooling. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment.

The cost of special tooling, when acquired for and its usefulness is limited to one or more Government contracts in force or being negotiated at the time of acquisition, is allocable to the specific Government contracts. The cost of tooling which is special to other classes of work will be allocated to such work. The cost of non-special tooling is not subject to direct allocation, but is subject to depreciation, which is treated elsewhere in this Part, except that in the production of standard commercial products such tooling costs may be treated as indirect manufacturing expense on an expenditure basis, in lieu of depreciation, when the resultant charges are reasonably equitable between fiscal years. When the entire cost has been allocated to Government contracts, the asset concerned shall become contractor-acquired Government property and be subject to the provisions of Section XIII and Appendix B, ASPR, applicable to contractor-acquired Government property.

15-313.11 Research and Development. Research and development expenses

may be divided into two major categories -- (1) product research and development, and (2) general research.

(a) Product research and development is that effort which is directed toward the solution of specific problems encountered in the design or production of a particular product which has or is anticipated to have military or commercial use. The current costs are allowable as costs on defense contracts and may be allocated thereto only to the extent applicable to the supplies or services covered by the contracts, and provided such costs are not reimbursed to the contractor under separate research and/or development contracts. No costs of product research and development may be allocated to Department of Defense product research and development contracts other than the direct costs of performing the contract and the proper share of the indirect costs of administering the product research and development program.

(b) General research is all research other than that which is directed toward the solution of specific problems encountered in the design or production of a particular product which has or is anticipated to have military or commercial use. The cost of general research, when reasonable in amount and incurred in accordance with the contractor's established practice, is allocable to all classes of work, including defense work, provided such costs are not reimbursed to the contractor under separate research contracts. Where the contractor's organization is devoted primarily to research work, as distinct from manufacturing, no cost of general research may be allocated to Department of Defense contracts for general research other than the direct costs of performing the contract and the proper share of the indirect costs of administering the research program. No general research costs which were incurred in accounting periods prior to the award of the particular defense contract(s) (including amounts capitalized in

the cost of patents obtained) shall be allocated thereto, nor will the contractor be required to defer research costs incurred during the period of performance of defense contracts to subsequent accounting periods.

(c) At the option of the procuring agency, cost allowances for research and development work may be made contingent upon the contractor agreeing to waive any royalty charges, under all patents previously obtained or which may be obtained in the future from such work, to the extent such royalties are applicable to defense work, either directly or indirectly.

15-313.12 Patents and Royalties.

(a) Amortization of the cost of purchased patents owned by a contractor applicable to products or processes covered by a contract is an allowable element of cost to the extent reasonably allocable to the contract. Research and development costs leading to patents are treated in paragraph 15-313.11.

(b) Royalty costs are allowable if bona fide and reasonable. Special care should be exercised in determining reasonableness of royalties in cases in which amounts were arrived at as a result of less than arm's length bargaining. Royalty costs may not be bona fide under the following circumstances:

(i) Royalties are paid to persons, including corporations, affiliated with the contractor.

(ii) Royalties are paid to unaffiliated persons, including corporations, upon patents formerly owned by the contractor when the costs of such patents or the research and development work thereon were substantially recovered through charges against the costs of defense business.

In either case (i) or (ii) royalties will be limited to such charges as might be determined if the patent were owned by the contractor in accordance with the

provisions of this paragraph and paragraph 15-313.11 relative to research and development.

(c) Care should be exercised in preventing charges for the use of patents when the Government, in fact, already has rights to such patents. (See Section IX, ASPR)

15-313.13 Plant Protection Expenses.

(a) These expenses represent costs incurred in protecting the contractor's personnel and plant against fire, theft, sabotage, espionage, civil disorder, enemy attack, or other violent destructive forces. Plant protection expenses are allowable costs of defense contracts. Normally they will consist of guards' wages and labor costs related thereto, costs of individual equipment, cost of plant protection equipment if of minor amount, and depreciation of plant equipment. To the extent these costs are attributable solely to defense special security requirements, they are allocable entirely to defense contracts. Costs of normal plant protection not resulting from such special requirements, generally, should be indirectly allocated to all classes of work.

(b) A special problem may arise in the case of fixed price contracts, the security classification of which is altered after the contract has been entered into. When such a contract price is negotiated, the contractor is presumed to know the plant protection requirements under the contract and is expected therefore to meet such requirements within the contract price. However, if the security classification of the contract were changed by the Government after entering into the contract, additional costs of plant protection may be allowed the contractor by contract amendment. The additional costs may include not only current costs of an operating nature but also costs of a capital nature if the parties agree that the capital costs are incurred solely because of the

changed security classification of the contract and would not have been necessary from the contractor's point of view. Also, if a classified contract is reclassified downward during its performance thereby permitting a savings in plant protection costs, such savings should, if material, be the subject of a contract amendment passing the savings on to the Government.

(c) Civil defense costs must be allocated to all work of the contractor performed at the particular location where the costs are incurred. When the Government's portion of the output of the particular plant is not material, the reasonableness of the incurred costs need not be questioned. However, since usually past experience will not provide a guide as to reasonableness, civil defense costs should be the subject of specific agreement when the amount of such costs to be allocated to Government contracts is substantial. When this is the case, reasonableness may be judged in light of:

(i) Recommendations and requirements of the duly constituted Governmental authority having jurisdiction over civil defense in the local area.

(ii) The extent of like measures being taken by other businesses within the local area, particularly those not producing under Government contracts.

(iii) The portion of total cost likely to be allocated to Government contracts as furnishing an inducement to the contractor to incur the cost.

15-313.14 Insurance and Bonds.

(a) The net cost of insurance and bonds, after deduction of dividends or other allowances which may be expected, if reasonably necessary to the operation of a business, is an allowable cost on Government contracts to the extent allo-

cable. Some, but not all, of the types of coverage which may be reasonably necessary are property, aircraft, automobile, general liability, product liability, workmen's compensation, employees' group, accident and disability, use and occupancy, and employees' fidelity and surety bonds (including performance bonds).

(b) Insurance on the lives of officers is not an allowable cost, except when premiums are paid in behalf of executives or employees pursuant to specific agreement or established policy whereby such payment may be properly considered as additional compensation (Paragraph 15-330.02).

(c) When a contractor assumes insurable risks of any type, a reasonable provision for losses estimated by the contractor is an allowable cost if such provision is based upon actual loss experience to the extent feasible; or, in the absence of adequate loss experience data, it is not in excess of net costs which would be paid for such insurance if carried by private insurance companies, less agents' commissions and other acquisition and servicing costs.

(d) Where the contract requires review and approval of contractors insurance program by the insurance authorities of the military departments, procurement and audit personnel of the military departments will be governed thereby.

15-313.15 Taxes.

(a) In general, taxes which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for Federal income and excess profits taxes; taxes in connection with financing, refinancing or refunding operations (see paragraph 15-330.05); and special assessments on land which represent capital improvements.

(b) Taxes which are believed to be illegally or erroneously assessed against the contractor, may be allowed as a cost of work performed, provided that the contractor; (1) promptly requests instructions from the contracting officer concerning such taxes; (2) agrees to comply with such instructions; and (3) if so directed by the contracting officer also agrees to take all necessary action in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer, shall be allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs.

(c) Any refund of taxes, penalties or interest thereon shall be credited to contract costs in the proportion in which contract costs absorb the costs of taxes, interest or penalties. If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

(d) Where it becomes evident in negotiating a contract price that a contractor may be required to pay a tax, the legality of which is questionable or in dispute, such tax may be used in negotiating the contract price, provided that the contract contains provisions substantially similar to those set out in subparagraph (b) (1) (2) and (3) above.

15-313.16 Strikes and Lockouts. The situations and conditions surrounding strikes and lockouts are so varied that it is impossible to establish a general principle providing for allowance or disallowance of costs incurred during such occurrences. Each case must be considered on its own merits in the light of the philosophy expressed or implied in the principles and standards expressed in Part 2 of this Section.

15-320 Selling and Distribution Expenses.

15-320.1 Allocation of Selling and Distribution Expenses. Selling and distribution expenses in general are subject to allocation to the cost of defense work to the extent appropriate, considering the methods of selling and distribution to the Government or to prime contractors or subcontractors. Generally, selling and distribution expenses should be allocated between product lines, or to products sold to the respective customer types (where sales methods are different), based on analysis of the cost elements in relation to the sales efforts. In some cases, it may be appropriate to first allocate these expenses in whole or in part as between defense and nondefense business, and then to allocate the expenses applicable to defense business against the individual defense contracts or products. The principle of direct costing is very important in this area. For example, when special defense products are sold to the Government or to defense contractors by separately identifiable employees of the manufacturer, the compensation and expenses of such employees may be appropriately charged to costs of such products. When, in such cases, there is a separate sales organization or identifiable group of representatives engaged in selling to nondefense customers, no portion of compensation and expenses thereof should be charged to defense products. On the other extreme, when standard commercial products are sold at fixed prices direct to the Government or to defense contractors, as well as to numerous customers not engaged either directly or indirectly in defense production, by means of one

established sales organization, the same selling expense per unit of product may be used in cost estimating, except when the quantities expected to be sold are so abnormal in relation to sales effort that the use of historical costs would result in the inclusion of an unreasonable amount of estimated selling expenses. In the latter case,

the fixed selling expenses should be charged to normal nondefense sales, leaving the defense sales chargeable only with a proper share of the variable costs. For an illustration of this principle see paragraph 15-320.5 re advertising.

15-320.2 Salesmen's or Agents' Compensation.

(a) Salesmen's or agents' compensation allocable to defense contracts should be reasonable in the light of the services rendered. If inequitable or exorbitant compensation is paid, it shall be subject to disallowance, to the degree deemed excessive, for the purpose of allocation of costs to defense contracts. For example, when defense business consists of standard commercial products which are sold normally on a commission basis, sudden expansion of defense business may necessitate the adjustment in the amount of compensation allocable to defense contracts.

(b) No fee, commission, percentage, or brokerage fee shall be allowed as a contract cost when contingent upon or resulting from an award of a contract, except amounts paid to bona fide employees or established commercial or selling agencies maintained by the contractor for the purpose of securing business. This provision shall be applied in a manner consistent with representations or agreements of contractors or prospective contractors in the light of ASPR, Section I, Part 5.

15-320.3 General Sales Expenses. These expenses, consisting of salaries and expenses in connection with direction and supervision of all sales efforts, clerical expenses in maintaining sales records and statistics in some cases, and similar overall sales expenses, may be considered to be allocable indirectly to defense products or contracts in some cases based upon the specific facts in each case, provided the basis of allocation is equitable as between defense and nondefense business as a whole in the light of the relative services rendered.

15-320.4 Bidding Expenses. Current bidding expenses of both successful and unsuccessful bids normally will be treated as indirect expenses and apportioned currently to all business of the contractor in which event no bidding expenses of past accounting periods will be chargeable to defense contracts. However, where it is the contractor's established practice to treat bidding expenses by some other method, such method may be acceptable if the results are substantially the same as would have resulted from the application of the method described above.

15-320.5 Advertising. Advertising expenses include the costs of materials, space, time, layout, and expenses of the department which supervises such activities. Advertising expenses are generally incurred to promote the sale of the contractor's regular commercial products and should be assigned thereto. Advertising may be appropriately considered for allocation to the cost of defense contracts in the following cases:

(a) Advertising directed solely towards the recruitment of new employees.

(b) Advertising in trade and technical journals for the purpose of establishing necessary business contacts in connection with the sale of defense products to Government contractors or when such periodicals are believed to be of value in the dissemination of technical information within the contractor's industry.

(c) Publication of catalogs, price lists, and technical pamphlets which aid users of the contractor's products, including the Government or defense contractors, excluding, of course, the cost of such publications prepared for the Government under separate contract consideration.

(d) Advertising for commercial products, other than as in (a) through (c) above, not in excess of the contractor's average annual costs incurred prior to the award of defense contracts established practice, may be allocated to defense prime contracts and subcontracts for such commercial products on the basis that the costs will first be assigned to the contractor's nondefense business in the same amount per unit sold as was assigned to such units prior to obtaining defense business; the amount remaining after such assignment may be allocated to defense prime and subcontracts but not in excess of the amount per unit on nondefense business; provided, however, that when defense sales are merely incidental, such cost allocations may be made on an overall prorata basis.

(e) Advertising costs, other than as in (a) through (c) above, may not be allocated to defense prime contracts and subcontracts for non-commercial products. The sole exception to this rule exists in cases where, in connection with undertaking defense work, the contractor's volume of nondefense work is reduced substantially, and the market demand for the contractor's nondefense work is such that the reduction would not otherwise have occurred. In such cases, in order to maintain good will, the contractor may need to continue to advertise in accordance with the contractor's average annual costs incurred prior to the award of defense contracts. In such event, the excess of reasonable advertising costs over the amount chargeable to nondefense business at per unit rates previously prevailing may be allocated to defense business.

15-320.6 Product Transportation and Delivery Expenses. These expenses,

when required by the terms of a contract, are properly allowable. Whenever significant in amount and provided it is feasible, they should be determined and allocated as a direct cost of the product or contract.

15-320.7 Warehousing Expenses. Whenever a manufacturer maintains and ships products from warehouses strategically located in order to provide better service or reduce transportation costs to customers (as is frequently found with standard commercial products or spare parts), the expenses of warehousing such stocks, including transportation from factory to warehouse, are allowable when fairly allocated to defense sales in relation to total sales of products delivered from such warehouses. On the other hand, where products sold under a defense contract are not delivered or serviced from such warehouses none of the cost of operation thereof is allocable to the contract.

15-320.8 Service and Warranty Expenses. In cases where the contract terms covering sale of defense products include an obligation on the part of the contractors, without additional separate compensation, to provide service in installation, training operators, correcting defects in the product, replacing defective parts, making refunds in case of inadequate performance, etc., the price or cost of the product should include an allowance for the cost of such undertakings. Generally, any warranty of the product as to performance, materials, and workmanship will be for a definite period of time. In the case of cost-reimbursement-type contracts, actual costs of performance to be reimbursed to the contractor will include such of the foregoing costs as must be incurred to comply with the terms of the contract, and the period of performance of the contract will usually not expire until the end of warranty period and completion of performance of any work required by the terms of the warranty. However, in some fixed-price contracts, a warranty may extend for a period of

time considerably beyond delivery. In such cases, it is necessary to estimate the cost of services and warranties, usually as a percentage of produce cost, for purposes of price negotiation. Estimating warranty costs must usually be based upon past experience in similar circumstances. When allowances are made for costs of performance under warranties as product costs, there should be no duplication of the allowance for the risks in figuring allowable profits.

15-320.9 Entertainment Expenses. Entertainment expenses, as such, shall not be considered either directly or indirectly as a cost of performing Government contracts. However, when expenses arise as a result of purchase of meals, local transportation, rental of facilities for meetings, and other incidental costs, and the primary purpose of incurring such costs is the dissemination of technical information or the stimulation of production, such costs are allowable in determining the cost of Government contracts.

15-330 General and Administrative Expenses.

15-330.01 Allocation of 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 input costs (processing costs plus direct material), cost of goods completed, cost of sales, and sales (where no more satisfactory basic is available), provided that equitable results are thereby obtained. In the selection of the particular method or methods of apportionment, special consideration should be given to any such unusual factors as charges of subcontractors and fixed asset improvement programs. All pertinent factors should be reviewed from time to time, especially if and when there is a change in the nature or volume of production, to determine whether the indirect expenses continue to be apportioned equitably.

Where the nature of a contractor's business has not changed basically by a shift to defense production, the presumption is that his former methods, if tested by operation over a considerable period, are satisfactory. However, this is only a presumption and should be reexamined in light of probable increased production. When the business has changed substantially because of such a shift, the contractor's former methods of allocating indirect expenses may be entirely inappropriate and so should be thoroughly reviewed.

15-330.02 Executive Compensation.

(a) Executive compensation consists of all emoluments (including salaries, bonuses, stock options, etc.) paid or accrued for services actually rendered to the contractor by executives, officers, partners, sole proprietors, and others of similar rank and abilities. Such costs are allowable when reasonable in amount in the light of the services rendered. Where the contractor's organization was a going concern for a significant period prior to the award of defense contracts, the amount of compensation established by the contractor will normally be considered reasonable. In other cases and in any case where the amount thereof appears not to have been determined through arm's length bargaining between the employer and the executive special consideration may be required. Arm's length bargaining may be lacking in any one of the following situations among others:

(1) The executive or a member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization; or

(2) Ownership of the contractor is limited to a small cohesive group; or

(3) The volume of Government contracts when related to the contractor's total business is such as to influence the contractor in his determination of executive compensation; or

(4) The services rendered by any individual are clearly disproportionate in a major degree to the compensation paid.

Allowances for compensation of partners or sole proprietors may properly be included in executive compensation even though not actually paid or accrued in the accounts. Where executive compensation is considered to be unreasonable in amount, the excess over the amount considered reasonable will not be included in determining the amount allocable to Government contracts.

In the case of cost type contract, any allowances for compensation for partners or sole proprietors should be incorporated in the contract.

(b) The cost of options to purchase stock of the contractor corporation granted to executives thereof is a part of executive compensation, and, as such, may be allocated to Government contracts, as follows:

(1) The cost of stock options to the grantor corporation is the excess, if any, over the option price of the fair market value of the stock on the date the option is granted to a specific individual.

(2) This cost is to be amortized at an annual rate not to exceed three percent of the fair market value of the stock on the date the option is granted. The period of amortization is to begin with the date that the option is granted in recognition of the fact that the benefits to the corporation extend over a period of years and do not accrue in one year when the option is granted or when it is exercised.

15-330.03 Travel Expense. Travel expense, when incurred for business purposes, is an allowable cost. The cost may represent payment for actual costs incurred, or payment may be on a per diem or mileage basis in lieu of actual cost, or a combination of the two methods may be used, provided the method used does not result in an unreasonable charge.

The mode of travel, accommodation or subsistence shall be in keeping with the contractor's established practice. Should there be no established practice,

the cost shall not exceed an amount commensurate with the nature and responsibilities of the traveler. Costs of entertainment shall not be included.

Special circumstances create situations for which there may be no precedent. For example, costs of transporting entire families from one geographic location to another, and establishing them thereat, may have to be incurred if a competent skilled labor force is to be recruited and maintained. Generally such costs are allowable, but there may be specific instances in which a part or all will be excluded if considered excessive or unnecessary.

15-330.04 Legal, Accounting, and Other Professional Expenses. Costs of professional services, whether performed by the contractor's employees or by other members of the particular profession retained by the contractor, are generally allowable. Such costs must be reasonable in light of services rendered, and payment must not be contingent upon recovery of the cost from the Government.

Such services must have been reasonably required by the business, although not necessarily required solely for the performance of Government contracts. Factors to be considered (among others) when determining the reasonableness or necessity of incurring the cost in a particular case are: (i) past pattern of such costs, particularly in the years prior to the award of Government contracts; (ii) the impact of Government contracts on the size of the contractor's business (i.e., what new problems arise); (iii) the nature and scope of managerial services expected of the contractor's own organization; (iv) the degree of conflict of interests which may exist between the contractor and the U.S. Government; and (v) whether or not the proportion of Government production of the contractor's total production 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 production under Government contracts.

If, in light of the foregoing, it appears that any otherwise allowable costs are not reasonably required by the business or are excessive, the allowable portion will be reduced to an appropriate amount, if any, for purposes of allocation.

15-330.05 Business Organization Expenses. Business organization expenses consist of those ordinary and reasonably necessary expenses which are incurred because of the use of the corporate, partnership, or other form of organization. Recurring business organization expenses are allowable. Examples of such recurring expenses, with respect to a corporate form of organization, are fees paid to members of the board of directors, cost of shareholders meetings, proxy solicitations, preparation and publication of annual reports to shareholders and preparation and submission of required reports to regulatory bodies having jurisdiction. Non-recurring expenses, particularly those directly related to the acquisition of additional capital, are not allowable. Examples of unallowable costs would include legal and professional fees paid in connection with the preparation of a prospectus, costs of preparation and issuance of stock rights, and amortization of "organization expense". Allowable costs shall normally be considered to be reasonable in amount when incurred in accordance with the contractor's established practices, particularly those in effect prior to the award of Government contracts.

15-330.06 Bad Debts. Bad debt losses, whether actual or estimated, arise from the contractor's non-Government business. No allowance for such losses shall be made in costs or prices under Government prime contracts. However, in the case of subcontracts, particularly lower-tier subcontracts several contracts removed from the prime contractor, consideration may be given to a reasonable allowance for bad debt losses not to exceed the rate experienced by the subcontractor in doing business with the same class of customer.

15-330.07 Contributions and Donations. Contributions and donations to

established nonprofit charitable, scientific, and educational organizations are properly allocable to Government contracts; provided that such costs (i) may reasonably be expected to result in future benefits to the contractor through advancing, directly or indirectly, the technology of his industry or increasing the supply of trained manpower available to it; (ii) are in lieu of the cost of similar facilities, which facilities the contractor would otherwise have to provide, as for example, employee medical or recreational facilities; or (iii) are expected of the contractor by the community and it can reasonably be expected that the prestige of the contractor in the community would suffer through the lack of such contributions. In general, item (iii) will not be applied unless it is the practice of most business firms in the same community to make contributions to such organizations.

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.

15-330.08 Trade, Business, and Professional Activities.

(a) Memberships. Costs of membership in trade, business, and professional organizations are allowable when incurred in accordance with the following standards:

(i) Memberships are consistent with the established practice of the contractor, particularly his practice prior to the award of Government contracts. However, if the nature or volume of the contractor's

production has been altered significantly by Government contracts, departure from the prior program may be justified.

(ii) When the organization is a local one and membership would be expected of all similar business firms in the business community. Local organizations must be primarily for trade, business, or professional purposes. Social, cultural, or recreational activities, if any, of such organizations must be incidental.

(iii) If the organization is regional, national, or international in scope, membership therein should be held by a majority of like firms in the same industry.

(b) Subscriptions. The cost of subscriptions to trade, business, professional, or technical periodicals or services is allowable when incurred in accordance with the contractor's established practice and the costs are reasonable in amount.

15-330.09 Employee Morale, Health, and Welfare. Expenses for employee morale, health, and welfare activities, such as employee publications, illness or first aid clinics, improvement of working conditions, and others aimed to improve employer-employee relations or employee performance, may be considered to be allowable if they are reasonable and necessary. The contractor's established practice or custom in the industry or area will be considered in making such determination.

15-330.10 Cafeterias, Commissaries, Dormitories, and Canteens. This class of expense consists of the cost, less revenue, of food, beverages, or living accommodations provided for members of the contractor's organization at their regular duty stations. When reasonably required by the nature of the contractor's operations, plant location, established policies, or employer-employee agreement, such costs shall be allowable. On the other hand, any profit on such activities

shall be considered as a credit to the contractor's overall expenses before allocation to defense contracts, unless such expenses are reduced for all the costs of such activities, including use of facilities, space, and utilities with elimination of such credits from the contractor's general expenses subject to cost allocations to defense business.

15-340 Financial and Other Expenses:

15-340.1 Interest on Borrowed Capital. Profit margins allowable in contract pricing are based, among various factors, upon consideration of normal interest return on total capital employed (including borrowed capital) and compensation for risks (including loss of any capital) except to the extent that risks are the subject of compensation through cost allowances or are assumed by the Government under special forms of contract pricing, when no pricing allowance for such risks should be made. In this way, every contractor should receive nondiscriminatory treatment, whether he furnished his entire capital or borrows a large portion thereof, or whether he is organized in the form of a corporation, a partnership, or a sole proprietorship. Accordingly, interest paid or accrued, regardless of the nature of the obligation which gives rise to the interest cost, is not an allowable item of cost to be charged directly or indirectly to the Government contracts.

15-340.2 Contingencies.

(a) No allowance for future contingencies shall be included in making determinations of historical costs. Costs of events which occurred during the period of contract performance, but the amount of which is currently indeterminable, may be recognized as follows:

1. A mutually agreed upon settlement may be negotiated in lieu of waiting for the exact future determination.

2. The contract may be held open as to the particular item pending the exact determination of the amount of the cost on an actual basis.

Individual paragraphs of this Part contain more specific treatment of contingencies related to the subject matter of such paragraphs, and in such event they will be controlling.

(b) Allowances for specific contingencies which are reasonably certain and determinable may be made in cost estimates for use in negotiating forward prices of fixed price contracts. Other contingencies are not allowable as costs in forward pricing actions, but their possible impact may be considered in establishing contract prices and ceilings in accordance with Part 4, Section III, ASPR.

15-340.3 Termination Costs. The additional costs that arise as the result of termination or cancellation of Government contracts (or subcontracts, including purchase orders), for the convenience of the Government, are allowable. These costs include:

(a) Settlement Expenses: Reasonable costs of settlement, including accounting, legal, clerical, and other expenses reasonably necessary for the preparation of settlement claims and supporting data with respect to the terminated portion of the contract and for the termination and settlement of subcontracts thereunder, including expenses incurred for the purpose of obtaining payment from the Government but only to the extent reasonably necessary for the preparation and presentation of settlement proposals and cost evidence in connection therewith. Settlement expenses include reasonable storage, transportation, and other costs incurred for the protection of property acquired or produced for the contract or in connection with the disposition of such property.

(b) To be excluded from allowable costs in the event of termination are the following:

1. Costs due to unreasonable delay on the part of the contractor in complying with the clause of the contract entitled "Termination for the Convenience of the Government."

2. Costs incurred as the result of purchasing or producing facilities, materials, or services in excess of the reasonable quantitative requirements of the entire contract.

15-340.4 Losses on Other Contracts. A loss sustained by a contractor on any contract is not allowable as a cost of performance of any other contract. Such losses shall include any excess of cost over income under any and all other contracts whether such other contracts are of a supply, research and development, or other nature.

Determination of the foregoing facts in any case may require submission of cost data of the transferor.

15-312 Labor. The cost of obtaining the services of any individual includes the base salary or wage, plus the cost of all fringe benefits. Therefore, both the basic salary or wage and all fringe benefits will be considered in determining the reasonableness of the earnings of an individual in relation to services rendered. Direct labor cost consists of salaries and wages identified specifically with the performance of a contract, job, or product. Labor services utilized for joint objectives may be treated as indirect costs if specific identification is impractical or uneconomical and the results of allocation are equitable. In determining historical costs, labor will generally be charged at actual rates paid by the contractor. However, if it is the contractor's consistent practice to charge for performance of groups of

labor at an average rate, or to use standard labor rates, with consequent savings in clerical expense or improvement in labor control, such methods may be used, provided labor groupings and the adjustment for cost variances result in a reasonably accurate assessment of total charges. Similarly, when labor costs are required for making cost estimates, the use of standard labor rates and standard time allowances (appropriately adjusted for experience variances) or reliable engineering estimates is acceptable. Ordinarily the use of wage rates higher than current going-rates will not be permitted for estimating purposes. In order to avoid substantial allowances for such contingencies, escalation or price-redetermination clauses are provided. However, situations involving increases in wage rates which are reasonably certain and determinable or relatively minor in amount may warrant recognition being given thereto in making estimates.

15-312.1 Fringe Benefits—Vacations, Holidays, Sick Leave, Military Leave, Pension and Retirement Plans, and Employee Insurance, but Exclude Severance Pays. Compensation of these types is allowable to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment.

The cost of "fringe benefits" is part of the cost of the work performed by the employee while on the job, and must be considered as having a direct relationship to such work. However, in recognition of the different accounting treatments by different contractors accorded fringe benefits, the cost thereof may be allocated to Government contracts on any of the following bases, provided equitable results are achieved:

(a) Each class of compensation is preferably

to be accrued as a cost over the period in which it is earned.

(b) Where it is the contractor's established practice to record the costs at the time of payment, such practice may be acceptable. This is the most commonly used method of accounting for "fringe benefits," but its use might result in inequities in some cases. For example, if a Government contract was performed over the summer months during which most of the contractor's employees took vacations or military leaves, recognition of the cost at time of payment would be inequitable to the Government. On the other hand, if the contract or contracts extended over approximately one year and the proportion of Government work to the contractor's commercial work remained stable, this method might be equitable.

(c) When the costs of any of the elements of fringe benefits are greater or lesser with respect to defense business as compared with nondefense business, such costs should be allocated, so far as feasible and appropriate, between the two classes of business before further allocation of such costs to individual contracts or products. If this method of cost allocation is used, it should be used consistently for all elements of fringe benefits having a different cost relationship of defense business as compared with nondefense business.

(d) It may be practicable to negotiate an equitable rate for fringe

benefits based upon experience for a representative period in lieu of individual consideration for each item. Changed conditions and circumstances would have to be considered in making such a determination. The experience rate would then be applied to the more direct labor costs to determine the allowable costs. The use of such rate should be subject to revision in light of changed conditions.

The cost of pension and retirement plans is covered more fully as the subject of a directive set forth as Appendix ___ to this Section.

15-312.1½ Severance Pay. The cost of severance pay will be considered only to the extent that, in each individual case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) circumstances of the particular employment. Theoretically, the right to severance pay is earned during the entire period of employment of the individual or, when based upon specified years of service, is earned during those years. In theory, the cost of severance payments should be recorded in the contractor's accounts during the periods in which the employee earned the right to such payments. However, few contractors accrue severance payments because (1) the clerical expense involved in identifying and recording the cost for each employee is not justified; and (2) there is considerable doubt that any substantial payments will have to be made since payment is solely contingent upon future events.

The cost of severance payments may be included in cost estimates only to the extent that such estimates are based upon severance payments actually made over a representative past period. In determining historical costs severance payments actually made are allowable if not in excess of the cost

of such payments over a representative past period. Where the Contractor provides for accruals of severance payments in lieu of recording the cost thereof at the time of payment, such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made over a representative past period. Generally, the cost of severance payments made during the performance of defense contracts should be allocated to all classes of work being performed at the time of payment since it is a reduction of total work which causes the severance. Because of the degree of uncertainty surrounding defense production, the following paragraphs are devoted to the treatment of severance payments anticipated to be necessary upon the completion or termination of defense production.

Where the contractor is an established concern and its level of employment has not been substantially increased with the advent of defense contracts, the contingency of substantial severance payments upon completion or termination of such contracts is so remote that consideration need not be given thereto in making cost estimates or in determining historical costs.

A specific contractual provision may recognize severance pay in either of the following situations:

(1) The contractor is newly established, is producing other than a substantially standard commercial item, and the weight of available evidence indicates that upon completion of defense work the contractor's operations will cease or greatly diminish. Illustrative of this situation is a contractor organized to operate a Government-owned facility.

(2) The contractor is not newly established, is producing other than a substantially commercial item, and its level of employment increased substantially with the advent of defense contracts (particularly where new

facilities or major portions thereof were placed in operation) and the weight of available evidence indicates that upon the completion of defense work the contractor's operations will shrink to approximately the pre-contract award level.

In either case (1) or (2) above the treatment of severance pay by contractual provision should vary with the type of contract. In the case of cost-type contracts and those fixed price contracts the price of which is negotiated upon completion, the contractual provision may provide for recognition of severance payments actually made upon completion or termination.

Where price is determined before completion, estimates of severance pay costs may be included in total estimated cost. Determination of the amount of severance pay to be included in cost estimates is particularly difficult. The amount included should not be the estimated total possible future liability for severance payments since the contractor is expected to give notice of separation in lieu of making severance payments. The amount included should represent a conservative estimate in light of the degree of contingent risk assumed by the contractor. Where agreement is not possible, consideration should be given to the use of a type of contract which would permit recognition of the cost of severance payments upon completion or termination of the contract. Where an allowance for severance pay is provided in a fixed price contract, care must be exercised to prevent duplication of allowance therefor in other contracts.

15-312.2 Premium Payments for Overtime and Extra-Shift Work. Costs of this nature consist of only the premium portion of overtime and extra-shift payments or accruals to employees, not the straight-time portion. Thus, if the rate for overtime work is time-and-one-half of the regular rate, the premium portion is the additional one-half. Similarly, if the wage rate for a second shift is twenty cents an hour above the regular rate, this additional amount is the premium.

Overtime and shift premiums are allowable, but the contractor must disclose and justify overtime other than of an occasional nature. Whenever such overtime allowances are claimed under cost-type contracts, approval of the contracting officer or his authorized representative must be obtained. (See paragraph 12-102.)

Such premiums may be classified as either direct or indirect labor cost, but overtime premiums should be separately stated in either event. When treated as direct labor cost, overtime premiums should not be included in the base for distribution of overhead. The amount of overtime and shift premium cost charged on Government contracts shall not be disproportionate to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant.

15-312.3 Unclaimed Wages. Costs under cost-reimbursement-type contracts should reflect a credit for unclaimed wages based upon agreement as to the amount thereof reasonably expected not to be paid subsequent to the date of settlement. In this event, all unclaimed wage liability rests with the contractor. When such an agreement cannot be reached, the Government will assume liability for payment of unclaimed wages and eliminate all allowances therefor from reimbursement to the contractor.

15-313 Other Manufacturing Expenses:

15-313.01 Allocation of Indirect Manufacturing Expenses. Among the acceptable bases, depending upon circumstances, for allocating indirect manufacturing expenses are direct-labor-cost, direct-labor-hours, machine-hours, and units processed. In more complex manufacturing plants, it is appropriate to departmentalize the plant for purposes of accounting for manufacturing expenses when any given type of defense production is concentrated in departments having a much higher or lower expense rate than the average. Expense departmentalization is also desirable in larger and more complex plants for purposes of expense budgeting and control by the responsible foreman, regardless of the need for a more refined method of expense allocation. When manufacturing expenses are departmentalized, it is necessary to charge service-department expenses (such as the power plant) and factory general expenses (such as taxes, insurance, 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 should be selected for service-department and other expense distributions to productive departments - e.g., kilowatts of connected power load or metered power consumption, in the case of electric power.

When direct-labor dollars expended fairly reflect machine effort, as well as labor effort, in any productive department, it is most simple, as well as appropriate, to use that basis of expense allocation in preference to a direct-labor-hour or machine-hour basis. When there is much automatic or semiautomatic machinery in a productive department, the use of a machine-hour-rate is generally more appropriate for expense allocation. The units-processed-basis of allocation is generally appropriate when a given productive

department processes only one item, or the several items are so similar as to be susceptible to measurement of units processed in terms of a common denominator -- e.g., steel sheets of various gauges processed through a rolling mill.

15-313.02 Allocation of Engineering Expenses. Engineering expenses include such items as the cost of product design, tool design, lay-out of production lines, determination of machine methods and drafting. The principle of direct costing (see paragraph 15-211) would indicate the desirability of charging directly to the benefitted activities (production, facilities, and research and development) all engineering costs which can be directly identified with such activities, leaving only a relatively minor amount of engineering costs (consisting chiefly of engineering administrative expenses) to be allocated to the activities. All engineering costs charged directly or allocated should in turn be assigned to products, product lines, job orders, contracts, etc. Further treatment of various problems in connection with the costing of research and development, tooling, and preproduction expenses is included in this Part (see paragraph ___); facilities contracts are included in Part 4.

15-313.03 Depreciation.

(a) Depreciation accounting is a system of accounting which aims to distribute the cost of tangible capital assets, less estimated salvage value (if any), over their estimated useful life in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, usually of an indirect nature.

(b) Useful life, as above referred to, has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life. In establishing estimated useful life, consideration should be given to all of the factors of wear and tear, obsolescence (both economic and technological), and inadequacy, which are common to the depreciation problem. Of these factors, obsolescence is most often the limiting or controlling one. Obsolescence of facilities, from the standpoint of economic utility, is always a prospect or contingency to be anticipated (differing only in degree, in each instance) with respect to an entire enterprise or an individual plant, as well as groups or individual items of plant and equipment. Costs of depreciation and maintenance are mutually related. Wear and tear may be increased by lack of maintenance or may be made good by maintenance (often indefinitely, so long as it is economical to do so and provided obsolescence or inadequacy has not become eminent). Hence, estimates of useful life of facilities in each case should take into consideration the actual maintenance policy in effect.

(c) Depreciation may be determined by application of any one of the generally accepted methods; however, the selected method and rate of depreciation used should, in the absence of compelling reasons to the contrary, consistently be applied from year to year. Generally, however, depreciation is too intangible to warrant attempts at meticulous estimates by application of rates by individual items of plant and equipment, although such attempts are frequent and will be recognized. Hence, depreciation will generally be determined by groups of facilities for which the factors bearing on estimated useful life are similar. The amount of depreciation written off in any fiscal period may vary with volume of production or be

increased for multishift operation, provided the method followed is consistent with basic objective set forth in subparagraph (b) above. Special methods have been established for determining depreciation on emergency facilities covered by Certificates of Necessity by a special directive set forth in an appendix of this Section.

(d) Depreciation should be based upon original cost of the facilities, whether measured by purchase agreement for a cash consideration, the fair value of securities issued in exchange, or similar appropriate measures, [*although it is permissible that such cost of facilities be adjusted, where desired by the contractor for purposes of depreciation computations for contract pricing, to current price levels by the use of a general price index, provided in such event that the practice will be followed consistently in the future and also provided that otherwise the charge is made at the same annual rates applied to such adjusted costs as would have been appropriately applied on original costs in view of the estimated useful life of the facilities. In other words, no deficiency in actual depreciation provisions in any prior year, based upon current price levels, should be included in the depreciation charge for the current year.] No other basis of determining appreciation in value of facilities may be utilized in determining depreciation for purposes of contract costs; for this purpose the tax basis of facilities values acceptable for internal revenue purposes are applicable.

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*Particular attention is invited to the subject matter between the brackets. It is desired that comment be submitted on this concept, together with substantiation therefor.

(e) No depreciation will be allowable as such, or as a rental or use charge, on the cost of facilities which are fully depreciated but still in use when a substantial portion of such depreciation was on a basis that represented, in effect, a recovery thereof as a charge against defense contracts or subcontracts in negotiated pricing or statutory renegotiation of contracts. Otherwise, the contractor may compute normal depreciation on the cost of facilities in use without reference to previous depreciation provisions. Fully depreciated facilities will be determined on the basis of relating original cost to accumulated depreciation on such cost, regardless of whether there is an adjustment of current depreciation charges based upon adjusting the cost of facilities to current price levels.

(f) No depreciation may be allowed on facilities which are not in use, except such facilities as are held for reasonable production standby purposes and, when specifically provided by mutual agreement, on facilities representing additional plant capacity reserved for defense production.

15-313.04 Repairs and Maintenance. Repairs and maintenance of facilities (including Government-owned facilities) are allowable elements of contract costs. It is necessary that such expenses exclude expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and made the subject of depreciation. There is, of course, a twilight zone between repairs and maintenance and capital expenditures within which a contractor should be permitted to operate upon the basis of his established accounting practice, if the results are equitable. For example, certain major costs of building alterations and rebuilding or

rehabilitating machinery and equipment may reasonably be treated in some instances as either repairs and maintenance expenses or capital expenditures, depending in part upon the contractor's established policy. In making decisions with respect to the alternative accounting treatment of these items, consideration should be given to the materiality of the amounts involved, and the question of the substantial enhancement in value of a contractor's facilities at the expense of the Government for use during periods in which the contractor will have little defense business. In the latter case, for contract pricing purposes, the cost generally should be considered to be of a capital nature and the subject of depreciation. In those instances where it may be appropriate to charge the cost of extraordinary rehabilitation to expense, special care should be taken in equitably allocating the costs to all the benefited classes of work (see 15-313.07 "Preparatory Costs"). Repairs and maintenance costs on facilities which are not in use will not be allowed, except on individual items of machinery and equipment (as distinct from entire plants or significant portions thereof) held for reasonable standby purposes. Repairs and maintenance on additional plant capacity reserved for defense production will be allowed only if specifically provided by contractual agreement.

In some instances, allowance of substantial extraordinary rehabilitation expenses as a charge against defense business may be permitted but will be contingent upon the contractor's written agreement to hold the facilities available for defense work for a stated minimum period.

15-313.05 Profits or Losses on Disposition of Plant and Equipment. In determining contract costs, no recognition will be given to profits or losses on disposition of plant and equipment for the reason that depreciation,

reasonably determined, provides the exclusive charge for the cost of using a contractor's facilities. However, when a contractor has capitalized special purpose facilities acquired solely for performance under defense contracts (rather than charge the costs thereof to specific contracts) and engineering changes or complete or partial termination of contracts finds such facilities not fully depreciated and not reasonably useful for other business of the contractor, an additional cost allowance may be made in determining costs of the terminated contracts for the purpose of contract settlement, provided such facilities are transferred to the Government, if so desired, or an equitable adjustment is made in favor of the Government in recognition of any resale or salvage value estimated for such facilities.

15-313.06 Rentals of Plant and Equipment. Rentals of plant or equipment are allowable if reasonably required for the performance of the contract and if bona fide and reasonable as to rate and duration. Special care should be exercised in determining reasonableness of rentals in cases in which rates were arrived at as a result of less than arm's length bargaining. Rental costs may not be bona fide under the following circumstances:

(a) Rentals are paid to persons, including corporations, affiliated with the contractor.

(b) Rentals are paid to unaffiliated persons, including corporations, upon property formerly owned by the contractor when such property was fully depreciated or substantially fully depreciated before sale or transfer and Government contracts absorbed a significant portion of such depreciation.

In either case (a) or (b), rentals will be limited to a reasonable amount of depreciation, as might be determined if the property were owned by the contractor, plus carrying costs which are not paid by the contractor under

the terms of the lease, including maintenance, taxes, and insurance (but not interest on the investment).

15-313.07 Preparatory Costs, including Engineering. Preparatory costs or expenses, also known as "make-ready costs", are costs specially incurred in preparing to operate under a specific contract or contracts. They include costs of organization and planning, employee recruitment and training, engineering and development (including product design, product specifications, and planning of production processes and layout) and plant alteration and rearrangement. Preparatory costs do not include initial production (starting load) costs which are treated in paragraph 15-313.08 or special tooling which is treated in paragraph 15-313.10.

Preparatory costs, when incurred for the exclusive benefit of Government production, are allocable directly or indirectly to the contracts benefiting from such costs. When preparatory costs benefit other classes of work as well as Government work, an equitable allocation to all benefited classes of work is proper.

Preparatory costs may have been incurred prior to the award of a definitive contract. The amounts of such costs, for purposes of contract cost allowances, are subject to approval of contracting officers based upon advance understandings or upon subsequent negotiation. In such case a specific provision covering the allowability of pre-award preparatory costs should be incorporated in any definitive contract when future pricing or repricing may be based in part upon actual contract costs. Similarly, it is desirable that prior approval of the contracting officer be obtained in the event that unusual charges of this type are to be incurred during the life of the contract. However, the absence of such provision or approval will not preclude consideration of the costs in

subsequent price negotiations or determinations under such contracts.

15-313.08 Initial Production Costs. Initial Production Costs, also known as "starting-load costs", are non-recurring costs that arise in the early stages of production because of the contractor's unfamiliarity or lack of experience with the particular materials, manufacturing processes, or techniques involved. They are to be distinguished from preparatory costs or expenses (also known as "make-ready costs").

Initial production costs may consist of the excessive portion of material costs incurred in the early stages of production, on contracts requiring new products or greatly increased production, as the result of abnormal quantities of materials used or abnormal scrap losses. Initial costs may also consist of the excessive portion of direct-labor costs, plus a proper portion of the related overhead, incurred in the early stages of production due to such causes as excessive defective work resulting from inexperienced labor, idle time and subnormal production occasioned by testing and changing methods of processing, and cost of training employees. The justification for such special costs depends upon their nature and causes, and not merely upon the fact that total production costs are high.

After a reasonable volume of production has been attained and initial manufacturing difficulties have been overcome, unit cost will usually tend to level off, thereby evidencing the end of the initial period of production but not necessarily representing the lowest unit cost eventually attainable during the operation of the entire contract. If, however, these costs continue abnormally high after a contractor has been allowed a reasonable length of time in which to learn how to make a product efficiently, the excessive costs may not properly be allowable for purposes of cost reimbursement or

estimating under cost type contracts, estimating for formal pricing purposes in fixed price contracts, or in establishing costs under terminated contract settlements.

15-313.09 Reconversion Expenses. Reconversion expenses are those connected with restoration of facilities to approximately the same physical arrangement and condition they were in immediately prior to the beginning of defense work, including the removal of Government property. In many cases, reconversion costs, except for the removal of Government property are incurred for the benefit of future production, in which cases such costs should be assessed against such production. However, in a specific case and where all of the circumstances outlined below exist, reconversion costs may be recognized through specific contractual provision.

(a) There must have been a major alteration or rearrangement of facilities at the inception of defense work for the sole purpose of performance of defense contracts, or facilities were newly acquired buildings in which Government machinery and equipment has been installed. In the latter case, only the cost of removing Government property is to be considered.

(b) The necessity of reconversion of facilities to approximately the same physical arrangement and condition they were in immediately prior to the beginning of defense work and the costs thereof must be reasonably certain and determinable.

(c) There is little or no post defense work commercial benefit to the contractor as the result of such alteration or rearrangement.

(d) Neither the particular contract nor any other contract contains an allowance for the use of facilities which would compensate the contractor for reconversion expenses.

Reconversion costs shall be allowed only in pricing those fixed price

contracts in existence or actually being negotiated at the time the costs of conversion were incurred. In the event of subsequent conversions or modifications for additional fixed price contracts, care must be exercised to avoid duplication of allowances for reconversion costs. Specific contractual provisions may be included in cost-reimbursement-type contracts to compensate the contractor for actual reconversion costs incurred in circumstances meeting the above conditions.

15-313.10 Special Tooling. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment.

The cost of special tooling, when acquired for and its usefulness is limited to one or more Government contracts in force or being negotiated at the time of acquisition, is allocable to the specific Government contracts. The cost of tooling which is special to other classes of work will be allocated to such work. The cost of non-special tooling is not subject to direct allocation, but is subject to depreciation, which is treated elsewhere in this Part, except that in the production of standard commercial products such tooling costs may be treated as indirect manufacturing expense on an expenditure basis, in lieu of depreciation, when the resultant charges are reasonably equitable between fiscal years. When the entire cost has been allocated to Government contracts, the asset concerned shall become contractor-acquired Government property and be subject to the provisions of Section XIII and Appendix B, ASPR, applicable to contractor-acquired Government property.

15-313.11 Research and Development. Research and development expenses

may be divided into two major categories -- (1) product research and development, and (2) general research.

(a) Product research and development is that effort which is directed toward the solution of specific problems encountered in the design or production of a particular product which has or is anticipated to have military or commercial use. The current costs are allowable as costs on defense contracts and may be allocated thereto only to the extent applicable to the supplies or services covered by the contracts, and provided such costs are not reimbursed to the contractor under separate research and/or development contracts. No costs of product research and development may be allocated to Department of Defense product research and development contracts other than the direct costs of performing the contract and the proper share of the indirect costs of administering the product research and development program.

(b) General research is all research other than that which is directed toward the solution of specific problems encountered in the design or production of a particular product which has or is anticipated to have military or commercial use. The cost of general research, when reasonable in amount and incurred in accordance with the contractor's established practice, is allocable to all classes of work, including defense work, provided such costs are not reimbursed to the contractor under separate research contracts. Where the contractor's organization is devoted primarily to research work, as distinct from manufacturing, no cost of general research may be allocated to Department of Defense contracts for general research other than the direct costs of performing the contract and the proper share of the indirect costs of administering the research program. No general research costs which were incurred in accounting periods prior to the award of the particular defense contract(s) (including amounts capitalized in

the cost of patents obtained) shall be allocated thereto, nor will the contractor be required to defer research costs incurred during the period of performance of defense contracts to subsequent accounting periods.

(c) At the option of the procuring agency, cost allowances for research and development work may be made contingent upon the contractor agreeing to waive any royalty charges, under all patents previously obtained or which may be obtained in the future from such work, to the extent such royalties are applicable to defense work, either directly or indirectly.

15-313.12 Patents and Royalties.

(a) Amortization of the cost of purchased patents owned by a contractor applicable to products or processes covered by a contract is an allowable element of cost to the extent reasonably allocable to the contract. Research and development costs leading to patents are treated in paragraph 15-313.11.

(b) Royalty costs are allowable if bona fide and reasonable. Special care should be exercised in determining reasonableness of royalties in cases in which amounts were arrived at as a result of less than arm's length bargaining. Royalty costs may not be bona fide under the following circumstances:

(i) Royalties are paid to persons, including corporations, affiliated with the contractor.

(ii) Royalties are paid to unaffiliated persons, including corporations, upon patents formerly owned by the contractor when the costs of such patents or the research and development work thereon were substantially recovered through charges against the costs of defense business.

In either case (i) or (ii) royalties will be limited to such charges as might be determined if the patent were owned by the contractor in accordance with the

provisions of this paragraph and paragraph 15-313.11 relative to research and development.

(c) Care should be exercised in preventing charges for the use of patents when the Government, in fact, already has rights to such patents. (See Section IX, ASPR)

15-313.13 Plant Protection Expenses.

(a) These expenses represent costs incurred in protecting the contractor's personnel and plant against fire, theft, sabotage, espionage, civil disorder, enemy attack, or other violent destructive forces. Plant protection expenses are allowable costs of defense contracts. Normally they will consist of guards' wages and labor costs related thereto, costs of individual equipment, cost of plant protection equipment if of minor amount, and depreciation of plant equipment. To the extent these costs are attributable solely to defense special security requirements, they are allocable entirely to defense contracts. Costs of normal plant protection not resulting from such special requirements, generally, should be indirectly allocated to all classes of work.

(b) A special problem may arise in the case of fixed price contracts, the security classification of which is altered after the contract has been entered into. When such a contract price is negotiated, the contractor is presumed to know the plant protection requirements under the contract and is expected therefore to meet such requirements within the contract price. However, if the security classification of the contract were changed by the Government after entering into the contract, additional costs of plant protection may be allowed the contractor by contract amendment. The additional costs may include not only current costs of an operating nature but also costs of a capital nature if the parties agree that the capital costs are incurred solely because of the

changed security classification of the contract and would not have been necessary from the contractor's point of view. Also, if a classified contract is reclassified downward during its performance thereby permitting a savings in plant protection costs, such savings should, if material, be the subject of a contract amendment passing the savings on to the Government.

(c) Civil defense costs must be allocated to all work of the contractor performed at the particular location where the costs are incurred. When the Government's portion of the output of the particular plant is not material, the reasonableness of the incurred costs need not be questioned. However, since usually past experience will not provide a guide as to reasonableness, civil defense costs should be the subject of specific agreement when the amount of such costs to be allocated to Government contracts is substantial. When this is the case, reasonableness may be judged in light of:

(i) Recommendations and requirements of the duly constituted Governmental authority having jurisdiction over civil defense in the local area.

(ii) The extent of like measures being taken by other businesses within the local area, particularly those not producing under Government contracts.

(iii) The portion of total cost likely to be allocated to Government contracts as furnishing an inducement to the contractor to incur the cost.

15-313.14 Insurance and Bonds.

(a) The net cost of insurance and bonds, after deduction of dividends or other allowances which may be expected, if reasonably necessary to the operation of a business, is an allowable cost on Government contracts to the extent allo-

cable. Some, but not all, of the types of coverage which may be reasonably necessary are property, aircraft, automobile, general liability, product liability, workmen's compensation, employees' group, accident and disability, use and occupancy, and employees' fidelity and surety bonds (including performance bonds).

(b) Insurance on the lives of officers is not an allowable cost, except when premiums are paid in behalf of executives or employees pursuant to specific agreement or established policy whereby such payment may be properly considered as additional compensation (Paragraph 15-330.02).

(c) When a contractor assumes insurable risks of any type, a reasonable provision for losses estimated by the contractor is an allowable cost if such provision is based upon actual loss experience to the extent feasible; or, in the absence of adequate loss experience data, it is not in excess of net costs which would be paid for such insurance if carried by private insurance companies, less agents' commissions and other acquisition and servicing costs.

(d) Where the contract requires review and approval of contractors insurance program by the insurance authorities of the military departments, procurement and audit personnel of the military departments will be governed thereby.

15-313.15 Taxes.

(a) In general, taxes which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for Federal income and excess profits taxes; taxes in connection with financing, refinancing or refunding operations (see paragraph 15-330.05); and special assessments on land which represent capital improvements.

(b) Taxes which are believed to be illegally or erroneously assessed against the contractor, may be allowed as a cost of work performed, provided that the contractor; (1) promptly requests instructions from the contracting officer concerning such taxes; (2) agrees to comply with such instructions; and (3) if so directed by the contracting officer also agrees to take all necessary action in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer, shall be allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs.

(c) Any refund of taxes, penalties or interest thereon shall be credited to contract costs in the proportion in which contract costs absorb the costs of taxes, interest or penalties. If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

(d) Where it becomes evident in negotiating a contract price that a contractor may be required to pay a tax, the legality of which is questionable or in dispute, such tax may be used in negotiating the contract price, provided that the contract contains provisions substantially similar to those set out in subparagraph (b) (1) (2) and (3) above.

15-313.16 Strikes and Lockouts. The situations and conditions surrounding strikes and lockouts are so varied that it is impossible to establish a general principle providing for allowance or disallowance of costs incurred during such occurrences. Each case must be considered on its own merits in the light of the philosophy expressed or implied in the principles and standards expressed in Part 2 of this Section.

15-320 Selling and Distribution Expenses.

15-320.1 Allocation of Selling and Distribution Expenses. Selling and distribution expenses in general are subject to allocation to the cost of defense work to the extent appropriate, considering the methods of selling and distribution to the Government or to prime contractors or subcontractors. Generally, selling and distribution expenses should be allocated between product lines, or to products sold to the respective customer types (where sales methods are different), based on analysis of the cost elements in relation to the sales efforts. In some cases, it may be appropriate to first allocate these expenses in whole or in part as between defense and nondefense business, and then to allocate the expenses applicable to defense business against the individual defense contracts or products. The principle of direct costing is very important in this area. For example, when special defense products are sold to the Government or to defense contractors by separately identifiable employees of the manufacturer, the compensation and expenses of such employees may be appropriately charged to costs of such products. When, in such cases, there is a separate sales organization or identifiable group of representatives engaged in selling to nondefense customers, no portion of compensation and expenses thereof should be charged to defense products. On the other extreme, when standard commercial products are sold at fixed prices direct to the Government or to defense contractors, as well as to numerous customers not engaged either directly or indirectly in defense production, by means of one

established sales organization, the same selling expense per unit of product may be used in cost estimating, except when the quantities expected to be sold are so abnormal in relation to sales effort that the use of historical costs would result in the inclusion of an unreasonable amount of estimated selling expenses. In the latter case,

the fixed selling expenses should be charged to normal nondefense sales, leaving the defense sales chargeable only with a proper share of the variable costs. For an illustration of this principle see paragraph 15-320.5 re advertising.

15-320.2 Salesmen's or Agents' Compensation.

(a) Salesmen's or agents' compensation allocable to defense contracts should be reasonable in the light of the services rendered. If inequitable or exorbitant compensation is paid, it shall be subject to disallowance, to the degree deemed excessive, for the purpose of allocation of costs to defense contracts. For example, when defense business consists of standard commercial products which are sold normally on a commission basis, sudden expansion of defense business may necessitate the adjustment in the amount of compensation allocable to defense contracts.

(b) No fee, commission, percentage, or brokerage fee shall be allowed as a contract cost when contingent upon or resulting from an award of a contract, except amounts paid to bona fide employees or established commercial or selling agencies maintained by the contractor for the purpose of securing business. This provision shall be applied in a manner consistent with representations or agreements of contractors or prospective contractors in the light of ASPR, Section I, Part 5.

15-320.3 General Sales Expenses. These expenses, consisting of salaries and expenses in connection with direction and supervision of all sales efforts, clerical expenses in maintaining sales records and statistics in some cases, and similar overall sales expenses, may be considered to be allocable indirectly to defense products or contracts in some cases based upon the specific facts in each case, provided the basis of allocation is equitable as between defense and nondefense business as a whole in the light of the relative services rendered.

15-320.4 Bidding Expenses. Current bidding expenses of both successful and unsuccessful bids normally will be treated as indirect expenses and apportioned currently to all business of the contractor in which event no bidding expenses of past accounting periods will be chargeable to defense contracts. However, where it is the contractor's established practice to treat bidding expenses by some other method, such method may be acceptable if the results are substantially the same as would have resulted from the application of the method described above.

15-320.5 Advertising. Advertising expenses include the costs of materials, space, time, layout, and expenses of the department which supervises such activities. Advertising expenses are generally incurred to promote the sale of the contractor's regular commercial products and should be assigned thereto. Advertising may be appropriately considered for allocation to the cost of defense contracts in the following cases:

(a) Advertising directed solely towards the recruitment of new employees.

(b) Advertising in trade and technical journals for the purpose of establishing necessary business contacts in connection with the sale of defense products to Government contractors or when such periodicals are believed to be of value in the dissemination of technical information within the contractor's industry.

(c) Publication of catalogs, price lists, and technical pamphlets which aid users of the contractor's products, including the Government or defense contractors, excluding, of course, the cost of such publications prepared for the Government under separate contract consideration.

(d) Advertising for commercial products, other than as in (a) through (c) above, not in excess of the contractor's average annual costs incurred prior to the award of defense contracts established practice, may be allocated to defense prime contracts and subcontracts for such commercial products on the basis that the costs will first be assigned to the contractor's nondefense business in the same amount per unit sold as was assigned to such units prior to obtaining defense business; the amount remaining after such assignment may be allocated to defense prime and subcontracts but not in excess of the amount per unit on nondefense business; provided, however, that when defense sales are merely incidental, such cost allocations may be made on an overall prorata basis.

(e) Advertising costs, other than as in (a) through (c) above, may not be allocated to defense prime contracts and subcontracts for non-commercial products. The sole exception to this rule exists in cases where, in connection with undertaking defense work, the contractor's volume of nondefense work is reduced substantially, and the market demand for the contractor's nondefense work is such that the reduction would not otherwise have occurred. In such cases, in order to maintain good will, the contractor may need to continue to advertise in accordance with the contractor's average annual costs incurred prior to the award of defense contracts. In such event, the excess of reasonable advertising costs over the amount chargeable to nondefense business at per unit rates previously prevailing may be allocated to defense business.

15-320.6 Product Transportation and Delivery Expenses. These expenses,

when required by the terms of a contract, are properly allowable. Whenever significant in amount and provided it is feasible, they should be determined and allocated as a direct cost of the product or contract.

15-320.7 Warehousing Expenses. Whenever a manufacturer maintains and ships products from warehouses strategically located in order to provide better service or reduce transportation costs to customers (as is frequently found with standard commercial products or spare parts), the expenses of warehousing such stocks, including transportation from factory to warehouse, are allowable when fairly allocated to defense sales in relation to total sales of products delivered from such warehouses. On the other hand, where products sold under a defense contract are not delivered or serviced from such warehouses none of the cost of operation thereof is allocable to the contract.

15-320.8 Service and Warranty Expenses. In cases where the contract terms covering sale of defense products include an obligation on the part of the contractors, without additional separate compensation, to provide service in installation, training operators, correcting defects in the product, replacing defective parts, making refunds in case of inadequate performance, etc., the price or cost of the product should include an allowance for the cost of such undertakings. Generally, any warranty of the product as to performance, materials, and workmanship will be for a definite period of time. In the case of cost-reimbursement-type contracts, actual costs of performance to be reimbursed to the contractor will include such of the foregoing costs as must be incurred to comply with the terms of the contract, and the period of performance of the contract will usually not expire until the end of warranty period and completion of performance of any work required by the terms of the warranty. However, in some fixed-price contracts, a warranty may extend for a period of

time considerably beyond delivery. In such cases, it is necessary to estimate the cost of services and warranties, usually as a percentage of produce cost, for purposes of price negotiation. Estimating warranty costs must usually be based upon past experience in similar circumstances. When allowances are made for costs of performance under warranties as product costs, there should be no duplication of the allowance for the risks in figuring allowable profits.

15-320.9 Entertainment Expenses. Entertainment expenses, as such, shall not be considered either directly or indirectly as a cost of performing Government contracts. However, when expenses arise as a result of purchase of meals, local transportation, rental of facilities for meetings, and other incidental costs, and the primary purpose of incurring such costs is the dissemination of technical information or the stimulation of production, such costs are allowable in determining the cost of Government contracts.

15-330 General and Administrative Expenses.

15-330.01 Allocation of 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 input costs (processing costs plus direct material), cost of goods completed, cost of sales, and sales (where no more satisfactory basic is available), provided that equitable results are thereby obtained. In the selection of the particular method or methods of apportionment, special consideration should be given to any such unusual factors as charges of subcontractors and fixed asset improvement programs. All pertinent factors should be reviewed from time to time, especially if and when there is a change in the nature or volume of production, to determine whether the indirect expenses continue to be apportioned equitably.

Where the nature of a contractor's business has not changed basically by a shift to defense production, the presumption is that his former methods, if tested by operation over a considerable period, are satisfactory. However, this is only a presumption and should be reexamined in light of probable increased production. When the business has changed substantially because of such a shift, the contractor's former methods of allocating indirect expenses may be entirely inappropriate and so should be thoroughly reviewed.

15-330.02 Executive Compensation.

(a) Executive compensation consists of all emoluments (including salaries, bonuses, stock options, etc.) paid or accrued for services actually rendered to the contractor by executives, officers, partners, sole proprietors, and others of similar rank and abilities. Such costs are allowable when reasonable in amount in the light of the services rendered. Where the contractor's organization was a going concern for a significant period prior to the award of defense contracts, the amount of compensation established by the contractor will normally be considered reasonable. In other cases and in any case where the amount thereof appears not to have been determined through arm's length bargaining between the employer and the executive special consideration may be required. Arm's length bargaining may be lacking in any one of the following situations among others:

(1) The executive or a member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization; or

(2) Ownership of the contractor is limited to a small cohesive group; or

(3) The volume of Government contracts when related to the contractor's total business is such as to influence the contractor in his determination of executive compensation; or

(4) The services rendered by any individual are clearly disproportionate in a major degree to the compensation paid.

Allowances for compensation of partners or sole proprietors may properly be included in executive compensation even though not actually paid or accrued in the accounts. Where executive compensation is considered to be unreasonable in amount, the excess over the amount considered reasonable will not be included in determining the amount allocable to Government contracts.

In the case of cost type contract, any allowances for compensation for partners or sole proprietors should be incorporated in the contract.

(b) The cost of options to purchase stock of the contractor corporation granted to executives thereof is a part of executive compensation, and, as such, may be allocated to Government contracts, as follows:

(1) The cost of stock options to the grantor corporation is the excess, if any, over the option price of the fair market value of the stock on the date the option is granted to a specific individual.

(2) This cost is to be amortized at an annual rate not to exceed three percent of the fair market value of the stock on the date the option is granted. The period of amortization is to begin with the date that the option is granted in recognition of the fact that the benefits to the corporation extend over a period of years and do not accrue in one year when the option is granted or when it is exercised.

15-330.03 Travel Expense. Travel expense, when incurred for business purposes, is an allowable cost. The cost may represent payment for actual costs incurred, or payment may be on a per diem or mileage basis in lieu of actual cost, or a combination of the two methods may be used, provided the method used does not result in an unreasonable charge.

The mode of travel, accommodation or subsistence shall be in keeping with the contractor's established practice. Should there be no established practice,

the cost shall not exceed an amount commensurate with the nature and responsibilities of the traveler. Costs of entertainment shall not be included.

Special circumstances create situations for which there may be no precedent. For example, costs of transporting entire families from one geographic location to another, and establishing them thereat, may have to be incurred if a competent skilled labor force is to be recruited and maintained. Generally such costs are allowable, but there may be specific instances in which a part or all will be excluded if considered excessive or unnecessary.

15-330.04 Legal, Accounting, and Other Professional Expenses. Costs of professional services, whether performed by the contractor's employees or by other members of the particular profession retained by the contractor, are generally allowable. Such costs must be reasonable in light of services rendered, and payment must not be contingent upon recovery of the cost from the Government.

Such services must have been reasonably required by the business, although not necessarily required solely for the performance of Government contracts. Factors to be considered (among others) when determining the reasonableness or necessity of incurring the cost in a particular case are: (i) past pattern of such costs, particularly in the years prior to the award of Government contracts; (ii) the impact of Government contracts on the size of the contractor's business (i.e., what new problems arise); (iii) the nature and scope of managerial services expected of the contractor's own organization; (iv) the degree of conflict of interests which may exist between the contractor and the U.S. Government; and (v) whether or not the proportion of Government production of the contractor's total production 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 production under Government contracts.

If, in light of the foregoing, it appears that any otherwise allowable costs are not reasonably required by the business or are excessive, the allowable portion will be reduced to an appropriate amount, if any, for purposes of allocation.

15-330.05 Business Organization Expenses. Business organization expenses consist of those ordinary and reasonably necessary expenses which are incurred because of the use of the corporate, partnership, or other form of organization. Recurring business organization expenses are allowable. Examples of such recurring expenses, with respect to a corporate form of organization, are fees paid to members of the board of directors, cost of shareholders meetings, proxy solicitations, preparation and publication of annual reports to shareholders and preparation and submission of required reports to regulatory bodies having jurisdiction. Non-recurring expenses, particularly those directly related to the acquisition of additional capital, are not allowable. Examples of unallowable costs would include legal and professional fees paid in connection with the preparation of a prospectus, costs of preparation and issuance of stock rights, and amortization of "organization expense". Allowable costs shall normally be considered to be reasonable in amount when incurred in accordance with the contractor's established practices, particularly those in effect prior to the award of Government contracts.

15-330.06 Bad Debts. Bad debt losses, whether actual or estimated, arise from the contractor's non-Government business. No allowance for such losses shall be made in costs or prices under Government prime contracts. However, in the case of subcontracts, particularly lower-tier subcontracts several contracts removed from the prime contractor, consideration may be given to a reasonable allowance for bad debt losses not to exceed the rate experienced by the subcontractor in doing business with the same class of customer.

15-330.07 Contributions and Donations. Contributions and donations to

established nonprofit charitable, scientific, and educational organizations are properly allocable to Government contracts; provided that such costs (i) may reasonably be expected to result in future benefits to the contractor through advancing, directly or indirectly, the technology of his industry or increasing the supply of trained manpower available to it; (ii) are in lieu of the cost of similar facilities, which facilities the contractor would otherwise have to provide, as for example, employee medical or recreational facilities; or (iii) are expected of the contractor by the community and it can reasonably be expected that the prestige of the contractor in the community would suffer through the lack of such contributions. In general, item (iii) will not be applied unless it is the practice of most business firms in the same community to make contributions to such organizations.

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.

15-330.08 Trade, Business, and Professional Activities.

(a) Memberships. Costs of membership in trade, business, and professional organizations are allowable when incurred in accordance with the following standards:

(i) Memberships are consistent with the established practice of the contractor, particularly his practice prior to the award of Government contracts. However, if the nature or volume of the contractor's

production has been altered significantly by Government contracts, departure from the prior program may be justified.

(ii) When the organization is a local one and membership would be expected of all similar business firms in the business community. Local organizations must be primarily for trade, business, or professional purposes. Social, cultural, or recreational activities, if any, of such organizations must be incidental.

(iii) If the organization is regional, national, or international in scope, membership therein should be held by a majority of like firms in the same industry.

(b) Subscriptions. The cost of subscriptions to trade, business, professional, or technical periodicals or services is allowable when incurred in accordance with the contractor's established practice and the costs are reasonable in amount.

15-330.09 Employee Morale, Health, and Welfare. Expenses for employee morale, health, and welfare activities, such as employee publications, illness or first aid clinics, improvement of working conditions, and others aimed to improve employer-employee relations or employee performance, may be considered to be allowable if they are reasonable and necessary. The contractor's established practice or custom in the industry or area will be considered in making such determination.

15-330.10 Cafeterias, Commissaries, Dormitories, and Canteens. This class of expense consists of the cost, less revenue, of food, beverages, or living accommodations provided for members of the contractor's organization at their regular duty stations. When reasonably required by the nature of the contractor's operations, plant location, established policies, or employer-employee agreement, such costs shall be allowable. On the other hand, any profit on such activities

shall be considered as a credit to the contractor's overall expenses before allocation to defense contracts, unless such expenses are reduced for all the costs of such activities, including use of facilities, space, and utilities with elimination of such credits from the contractor's general expenses subject to cost allocations to defense business.

15-340 Financial and Other Expenses:

15-340.1 Interest on Borrowed Capital. Profit margins allowable in contract pricing are based, among various factors, upon consideration of normal interest return on total capital employed (including borrowed capital) and compensation for risks (including loss of any capital) except to the extent that risks are the subject of compensation through cost allowances or are assumed by the Government under special forms of contract pricing, when no pricing allowance for such risks should be made. In this way, every contractor should receive nondiscriminatory treatment, whether he furnished his entire capital or borrows a large portion thereof, or whether he is organized in the form of a corporation, a partnership, or a sole proprietorship. Accordingly, interest paid or accrued, regardless of the nature of the obligation which gives rise to the interest cost, is not an allowable item of cost to be charged directly or indirectly to the Government contracts.

15-340.2 Contingencies.

(a) No allowance for future contingencies shall be included in making determinations of historical costs. Costs of events which occurred during the period of contract performance, but the amount of which is currently indeterminable, may be recognized as follows:

1. A mutually agreed upon settlement may be negotiated in lieu of waiting for the exact future determination.

2. The contract may be held open as to the particular item pending the exact determination of the amount of the cost on an actual basis.

Individual paragraphs of this Part contain more specific treatment of contingencies related to the subject matter of such paragraphs, and in such event they will be controlling.

(b) Allowances for specific contingencies which are reasonably certain and determinable may be made in cost estimates for use in negotiating forward prices of fixed price contracts. Other contingencies are not allowable as costs in forward pricing actions, but their possible impact may be considered in establishing contract prices and ceilings in accordance with Part 4, Section III, ASPR.

15-340.3 Termination Costs. The additional costs that arise as the result of termination or cancellation of Government contracts (or subcontracts, including purchase orders), for the convenience of the Government, are allowable. These costs include:

(a) Settlement Expenses: Reasonable costs of settlement, including accounting, legal, clerical, and other expenses reasonably necessary for the preparation of settlement claims and supporting data with respect to the terminated portion of the contract and for the termination and settlement of subcontracts thereunder, including expenses incurred for the purpose of obtaining payment from the Government but only to the extent reasonably necessary for the preparation and presentation of settlement proposals and cost evidence in connection therewith. Settlement expenses include reasonable storage, transportation, and other costs incurred for the protection of property acquired or produced for the contract or in connection with the disposition of such property.

(b) To be excluded from allowable costs in the event of termination are the following:

1. Costs due to unreasonable delay on the part of the contractor in complying with the clause of the contract entitled "Termination for the Convenience of the Government."

2. Costs incurred as the result of purchasing or producing facilities, materials, or services in excess of the reasonable quantitative requirements of the entire contract.

15-340.4 Losses on Other Contracts. A loss sustained by a contractor on any contract is not allowable as a cost of performance of any other contract. Such losses shall include any excess of cost over income under any and all other contracts whether such other contracts are of a supply, research and development, or other nature.

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PROPOSED REVISION
OF
SECTION XV

Case 53-44

CONTRACT COST PRINCIPLES AND STANDARDS

15-000 Scope of Section. This section sets forth, in general, principles and standards to be applied uniformly (except as expressly qualified) in the determination of historical costs, the preparation and presentation of cost estimates by contractors, and the review, from a cost standpoint, of contractors' pricing proposals of those prime contracts and subcontracts which are subject to negotiation, approval or review within the Department of Defense as indicated in 15-103 and 15-104.

15-001 Effective Date of Section. This section shall be complied with on and after , 1953, although compliance is authorized from the date of its issuance.

PART 1 - APPLICABILITY AND PURPOSE

15-101 Application.

(a) General. These cost principles are to be applied by procurement and audit personnel of the Department of Defense wherever cost data are to be considered in the negotiation and administration of contracts. Where incorporated in a contract (as indicated below) the contract may treat any element of cost more specifically than provided in this Section, so long as there is no inconsistency therewith. Moreover, basic agreements may be negotiated with individual contractors specifying in more detail uniform procedures or practices to be followed by the contractor provided such agreement is consistent with the provisions of this Section.

(b) Cost-Type Contracts. Cost estimates will be developed and evaluated, and reimbursements to the contractor for costs incurred will be determined, through the application of these cost principles and standards. Therefore, Part 2 and either Part 3, 4, 5, or 6 (whichever is appropriate to the type of work called for by the contract) will be incorporated by reference in every cost-type prime contract and every cost-type subcontract thereunder.

(c) Fixed Price Contracts. Cost is but one of several factors to be considered in the negotiation of prices or in negotiating settlements in the event of termination for the convenience of the Government. In considering cost data as a basis for negotiation, the cost principles and standards contained in this Section shall be used as criteria for the evaluation of cost data submitted by contractors in all pricing actions

arising under fixed price contract, including pre-award negotiations, negotiations during or upon completion of the contract, and negotiations in the event of termination for the convenience of the Government. Accordingly, Part 2 and either Part 3, 4, 5, or 6 (whichever is appropriate to the type of work called for by the contract) will be incorporated by reference in the clause of every contract entitled Termination for the Convenience of the Government. Similarly, where future pricing actions are contemplated, the price redetermination or incentive clause shall incorporate by reference the same Parts included in the clause of the contract entitled Termination for the Convenience of the Government.

15-102 Reserved.

15-103 Use of Cost Estimates. The proper use of cost estimates requires the exercise of judgment and discrimination. It is impractical to lay down hard and fast rules which would be completely comprehensive in this area. In general, cost estimates shall be obtained from contractors in all cases except where other valid and adequate pricing criteria exist or the estimates would not materially assist the Contracting Officer in negotiating prices.

(a) Examples of valid, but not necessarily adequate in a particular case, pricing criteria to be considered for the purpose of determining whether cost estimates will be of material assistance include, but are not limited to, the following:

(1) Competitive price proposals.

(2) Published market prices.

(3) Catalog prices, including discounts.

(4) Previous procurement experience on the same or similar items, with computed adjustments of the prices paid where appropriate to make allowance for changes in specification or quantities, or changes in labor, material and other cost indices.

(b) Examples of situations where cost estimates are ordinarily required are as follows:

(1) Under outright fixed-price contracts when there is an absence of competition, prior experience or other valid pricing criteria.

(2) Under fixed-price contracts containing price-redetermination provisions:

a. Negotiation of tentative initial prices.
b. Negotiation of firm prices on a forward basis.
c. In combination with historical costs to arrive at firm prices for both retroactive and prospective application.

(3) Under incentive-type contracts:

a. Negotiation of tentative target costs when firm targets cannot be initially determined.

b. Negotiation of firm target prices and target costs, including those cases where the targets are set during the course of the contract.

(4) Under cost-reimbursement-type contracts:

a. Initial estimates as a basis for establishing fixed fees.
b. Negotiation of fixed overhead rates.

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

a. Contract price ceilings.
b. Contract changes affecting the contract consideration.

15-104 Use of Historical (Actual) Cost. Historical (actual) cost shall be used for the following purposes:

(a) Under cost-reimbursement-type contracts:

(1) Determination of allowable cost.

(2) In combination with cost estimate to negotiate fixed overhead rates (where the contract provides for use of such rates).

(b) Under fixed-price contracts, with retroactive price-redetermination; negotiation of retroactive fixed-prices.

(c) Under incentive-type contracts: determination of final prices after contract completion.

(d) Under contracts terminated for the convenience of the Government: as required by Section VIII hereof.

In addition to the above listing of purposes for which use of historical cost is mandatory, such cost data may be useful in other circumstances and should be applied where appropriate.

15-105 Reserved.

15-106 Implementation by the Military Departments.

(a) This statement of contract cost principles and standards shall be followed in procurement operations within the Department of Defense without modification or expansion in any way except for: (i) the more specific treatment of particular items of cost authorized in paragraph 15-101, and (ii) interim interpretations authorized by (c) of this paragraph. The cost principles and standards contained in this Section are expressed in broad

terms in order that they be sufficiently flexible to meet the requirements of the wide variety of circumstances and conditions prevailing in different industries. Being expressed in broad terms there is considerable latitude for the application of good business judgment to the facts of a particular case by procurement and audit personnel. In order that this latitude not be restricted, any interpretation of these principles and standards made in the course of contract negotiation and administration shall be on a case-by-case basis in light of the specific facts thereof -- no system of written interpretations (other than authorized in (c) hereof) to be followed generally will be permitted.

(b) It is impracticable and unnecessary to include in these costs principles and standards every element of cost or possible situations that might arise. Where specific guidance is lacking, the philosophy expressed or implied in similar or related items should be followed. Nonetheless, revisions and amendments will be necessary. Any expansion of or change in this Section deemed to be desirable by any procurement or audit activity will be forwarded through appropriate channels to the Office of the Secretary of Defense for consideration.

(c) Where considered essential by major procurement and audit activities[1/] of the military departments, temporary interpretations of these cost principles and standards may be issued by such activities. Any such interpretation is subject to the following circumstances, conditions, and instructions:

(1) Its issuance must be considered essential by the issuing authority. In other words, the problem could not have been met adequately by interpretations made on a case-by-case basis prior to consideration by the Office of the Secretary of Defense under (b) hereof.

(2) It must be consistent with these cost principles and standards.

(3) It will expire by its terms not more than six months after issuance and, in any event, upon the issuance of an amendment to these cost principles and standards covering the subject matter of the interpretation.

1/

ARMY	NAVY	AIR FORCE
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15-203.2 Use of Standard Costs in Cost Estimates. Wherever future cost estimates are required, the use, where economically feasible, of modern standard cost methods should be encouraged, because they provide an excellent means of cost estimating and cost analysis, as well as enable more effective control of actual costs during contract performance. Such methods provide for pricing material costs on the basis of bills of materials, labor costs on the basis of studies of time requirements, and overhead costs on the basis of budgeted expenses for the expected volume and types of production, with reasonable allowances for cost variances indicated by experience to be expected for defective work and failure to achieve full efficiency. Such methods generally provide the assurance of accuracy of cost estimates, as well as the means of more effective cost control, when variances of actual costs from standards are measured frequently and recorded in the formal accounts.

15-203.3 Use of Standard Costs in Determining Actual Costs. Wherever contract price negotiations or settlements depend upon actual costs, and contractors have satisfactory standard cost systems, standard costs of products, or parts thereof, with appropriate adjustments for variances from actual costs, may be considered to represent actual costs, provided such costs reasonably reflect the application of the principles and standards set forth in this section. Normally, where adequate standard costs are available for complete end-products, fixed-price contracts should be used.

15-203.4 Use of Job-Order or Process Cost-Accounting Method. The use of either the job-order or process cost-accounting method in determining historical costs of contract performance is acceptable. In any pricing negotiations which require consideration of work in process at an intermediate point in the period of contract performance, special care must be exercised in order to segregate any part of the work in process costs which is not applicable to the completed portion to the cut-off point.

15-203.5 Use of Historical Costs for Purposes of Cost Estimating. Regardless of the method used (standard, job-order or process), unmodified historical cost data, when used in the preparation of cost estimates, may not provide a satisfactory standard of future performance; in this event their use would be undesirable. Where no more satisfactory cost data are available, historical costs may be used in the preparation of estimates provided they are adjusted to eliminate nonrecurring costs and to reflect new conditions, if any, which may be applicable to future production.

15-204 Basis of Application of Principles and Standards to Pricing of Standard Commercial Products. Standard commercial products are those which are normally manufactured and sold in large volume to customers who are neither prime contractors nor subcontractors for defense work, notwithstanding the fact that substantial quantities may be sold to defense contractors or the Government with relatively little or no change in specifications. In general, it will be expected that standard commercial products will be purchased under fixed-price contracts, and that prices will be established without primary reference to the respective contractor's costs. The use of escalation clauses generally should take care of major contingencies which should not be added to estimated costs in contract pricing

(4) Two copies of each interpretation will be forwarded upon issuance to the Office of the Secretary of Defense to be considered as a recommendation of the issuing authority for revision in this Section in accordance with (b) hereof. The Office of the Secretary of Defense will consider the recommendation and will take appropriate action within the six months specified in (c)(3) hereof.

(5) Any such interpretation deemed by the Office of the Secretary of Defense to be unnecessary or inconsistent with this Section will be rescinded by the issuing authority upon receipt of notice to that effect.

15-107 Deviations. The authority to deviate, as provided in paragraph 1-108 of this Regulation, is further restricted in respect to this Section 15, to permit such deviations only on a specific contract basis.

PART 2 - GENERAL PRINCIPLES AND STANDARDS FOR DETERMINATION OF COSTS

15-201 Composition of Total Cost. The total cost of work performed or to be performed under a contract or subcontract to which these principles are applicable is the net sum of (a) the allowable direct costs reasonably incident to the performance of the contract or subcontract, (b) the properly allocable portion of allowable indirect costs, and (c) less applicable income and other credits. According to the circumstances involved, these costs may be stated either in terms of the aggregate for an entire contract or in terms of individual units of products or services covered by the contract with equal application of these principles and standards.

15-202 Factors Determining Allowability of Costs. Factors to be considered in determining the allowability of costs include (a) conformity with the meaning of total cost outlined in paragraph 15-201; (b) reasonableness in the amounts of particular elements of costs; (c) [Reserved]; (d) application of generally accepted accounting principles and practices; (e) avoidance of duplication of allowances for the same price component in both cost and profit; (f) exclusions of specific elements of costs as a matter of public or business policy, as set forth in this section; and (g) exercise of good business judgment in incurrence of the cost.

15-203 Actual and Estimated Costs. Costs used in negotiating contracts, or in making settlements thereunder, may be either of a historical nature (actual costs) or may be estimates of future costs, in whole or in part, whichever is appropriate for the specific type of contract pricing as indicated in paragraphs 15-103 and 15-104.

15-203.1 Applicability of Cost Principles to Determination of Cost Estimates as Well as Actual Costs. In general, the same cost principles apply to making cost estimates as to determination of actual costs. Therefore, this Section will consider the cost principles set forth herein as applicable interchangeably to either cost estimates or actual costs, except as may be indicated specifically to the contrary.

be considered in determining either costs or profit (or fee). Major factors to be considered in this respect include prolonged delivery schedules, unstable market conditions for material or labor, or uncertainty as to cost of performance. Depending upon the type of contract, either the contractor or the Government may assume such risks. Where the Government assumes all the risk of cost increases or additional unknown costs, or a substantial share thereof (as it generally does when these risks are great) through the use of cost-reimbursement-type contracts, escalation or price-redetermination clauses, or incentive-type contracts, the profit allowance for contingencies should be reduced to the extent appropriate. In negotiation of prices under outright fixed-price contracts, risks of loss or other cost increases, other than those reasonably certain and determinable, should be recognized in profit margins rather than in allowances for contingent increases in cost. However, no hard and fast line may be drawn here, but it is important that such allowances not be duplicated. For example, a contractor's cost estimates may properly include reasonable estimates of cost applicable to normally experienced defective work in manufacturing processes. Where reasonably certain and determinable contingencies are recognized in cost estimates, such contingencies should not be considered as elements of risk in determining the allowable profit. There are other factors having a similar bearing on cost and profit determination; for example, in contracting for construction under cost-reimbursement-type contracts, it is customary practice to exclude general, administrative and financial expenses from costs, but to allow instead for these factors as a part of the fixed fee.

15-208 Reserved.

15-209 Special Provisions Relating to Cost Determinations, Including Limitations. Because of the need for standards of reasonableness in determining either estimated or actual costs of performance of specific contracts, including the application of business and public policies, a considerable portion of this Section, namely Part 3, is devoted to standards of allowability of specific elements of costs under supply and research contracts with commercial organizations. Moreover, because of unusual accounting practices or problems involved in determining costs under facilities contracts, construction contracts and research and development contracts with non-profit institutions, Parts 4, 5, and 6 respectively, are devoted thereto.

15-210 Direct vs. Indirect Costs. Every acceptable method of cost accounting or estimating embodies the principle of direct costing of certain materials and subcontract work. Direct costing of productive labor is general practice. Other expenses may be costed directly sometimes, but generally many of them are allocated to products, job orders, or contracts, etc. on an arithmetical basis in ratio to appropriate measures of performance — for this reason, such allocated expenses are termed "indirect costs."

15-211 Principle of Direct Costing. Every major item of cost (actual or estimated) should be identified with the unit being costed, whether it be the product, a job order, or a contract, when such items of cost do not,

of such products. However, in those instances where cost analyses for standard commercial products are required in firm price negotiations under fixed-price contracts, these principles and standards will be applicable to the extent appropriate. Care must be used in such cases in order not to impose impractical requirements on contractors for cost estimates -- to meet which requirements might result in work entirely disproportionate to the amounts involved. Cost analyses in such cases may sometimes be based upon other data than current cost estimates -- for example, when a manufacturer has no cost data for a specific standard commercial product, he may have available for analysis, historical sales, costs and profit data on a group of products, including the specific one subject to price negotiation.

15-205 Application of Generally Accepted Accounting Principles. It is to be understood that generally accepted accounting principles with respect to product or contract costs are nowhere codified or reduced to rigid formulae. Such principles permit the use of alternative practices or conventions, particularly in different types of business activities; yet in the main there are generally accepted limits in principle regarding accounting practices, the violation of which would not be condoned by the accounting profession. To the extent there is a twilight zone between accepted and non-accepted practices, it is desirable that definite understandings be reached between the contracting parties. This section covers a number of subjects of this nature, so far as they can be covered for general application. Yet inevitably there will be many occasions where specific contractual provisions or supplementary interpretations of the contract terms in the application of cost principles will be needed. (See paragraphs 15-105 and 15-106.)

15-205½ Relation of Generally Accepted Accounting Principles to Internal Revenue Code. General accepted accounting principles are observed, in the main, in the Internal Revenue Code and Treasury regulations governing deductions for business costs in determining income subject to Federal income tax. For this reason the Internal Revenue Code and Treasury regulations may provide some guidance as to whether the contractor's costs are set forth in accordance with generally accepted accounting principles. However, provisions for the Internal Revenue Code and Treasury regulations shall not be controlling for this purpose; in fact Part 3 of this Section contains a number of examples of deviations therefrom required or permitted to be observed in determining contract costs.

15-206 Contractor's Accounting System. Subject to the observance of the cost principles set forth in this section, any system of accounts and any method of cost accounting or estimating will be acceptable, if they are in accord with generally accepted accounting principles and practices and if they produce equitable results under the particular circumstances.

15-207 Relation of Contract Costs and Profits. The use of actual or estimated costs in procurement pricing is only one phase of establishing the total price or monetary consideration under a contract. The determination of reasonable profit is another important phase. These two phases of pricing are mutually dependent to the extent that certain factors may

and variable expenses and upon estimating variable expenses by cost centers in proportion to anticipated levels of production or work loads; such budgets provide the best means for estimating expense rates. Historical indirect expenses, or expense rates, should not be used indiscriminately as the equivalent of budgeted rates for this purpose without adjustment for nonrecurring expenses and adjustment of the portion of the rates representing fixed expenses when substantial changes in production or work loads are expected.

(b) The use of a fixed indirect expense rate negotiated prior to the expiration of a significant portion of the period to which such rate applies in lieu of the determination of historical indirect expense is acceptable where mutually agreeable to the contracting parties provided there is reasonable assurance that the results would be equitable when compared with actual rates. Consideration of cost elements in negotiating such rates must be consistent with the provisions of this Section concerning cost allowability and allocability. When predetermined expense rates are used the contract should specifically state the types of items which are to be treated as direct costs. The contractor must exclude from direct costs any cost element included in predetermined expense rates in order to avoid duplicate charges.

in fact, have substantially proportionate applicability to more than one class of work. This principle may often be applicable to such elements of expense (when of major consequence), as travel, commissions, advertising, engineering services, etc., as well as the normal items of materials and productive labor. This principle should be applied equally to the costing of both defense and nondefense products or services by any contractor who is engaged in mixed production. There are no absolute rules by which to determine which items or elements of cost should be direct costed. In applying the principle, any contractor must follow a consistent pattern of costing if the results are to be equitable. In some instances, this principle may be applied by direct costing only the major items of a given cost element to all products, leaving minor items, if appropriate, subject to indirect cost allocations.

15-212 Indirect Costs. Indirect costs, which have the character of common or joint costs, usually consist of indirect materials, indirect labor, and other items. These costs generally are grouped in classes, as follows:

(a) Manufacturing (shop, laboratory) expenses (often termed "manufacturing overhead" or "burden"), which are incurred in fabricating the article or service rendered;

(b) Engineering expenses to extent not included in (a) or (c);

(c) Selling and distribution expenses, incurred in marketing the products manufactured;

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

(e) Financial and other expenses.

15-213 Methods of Allocation of Indirect Costs. No general rules regarding allocation of indirect costs to products, job orders, or contracts can be stated for all individual cases, because the nature of the particular operations and the actual conditions in each instance determine the most suitable method or methods to be employed. Any method of allocation of indirect costs will be acceptable if it is in accord with generally accepted accounting principles and practices and if it produces equitable results under the particular circumstances.

15-213.1 Use of Predetermined Rates for Indirect Expenses (Overhead Costs).

(a) Indirect expenses must always be predicted for purposes of cost estimates. This involves determination by the contractor of expense rates in accordance with whatever method or methods of expense allocation are followed. In accordance with the aim of encouraging the use of standard costs (paragraph 15-203.2), contractors should be encouraged to use accepted standard cost methods of budgeting based upon distinguishing between fixed

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June 20, 1955

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Rear Admiral L. H. Thomas, S.C., U.S.N.
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Dear Admiral Thomas:

We appreciate the invitation to submit comments on proposed revisions to Part 2, Section XV, of the Armed Services Procurement Regulation. This response takes into account your original letter of April 11, 1955, and your subsequent letter of May 25 extending to June 20 the deadline for submission of industry comments on this proposed change.

General Comments

Before considering the specific provisions of this proposed revision to ASPR, we should like to discuss the revision generally with emphasis upon its total effect and upon certain broad principles of procurement which are involved in the proposed restatement of cost principles applicable to cost-reimbursement type contracts.

Resultant Improvement in Proposed Regulations

In general, the proposed revision to Part 2, Section XV, of ASPR appears to be an improvement over the present regulatory language which it is designed to amend. The proposed amendment is well written, generally clear in its language, and is to be commended for its inclusion of certain contract cost items not heretofore specifically covered in procurement regulations. Moreover, we find useful the new pattern of the regulation which includes as to each item of cost a definition, a statement as to the extent of allowability or unallowability, and a specific indication as to whether or not special contract provisions are required to make the item allowable as a contract cost.

We ask that you express our appreciation for this improvement to the government officials participating in this effort to revise and expand this section of basic procurement regulations which has a direct impact on the public interest and is therefore of the gravest concern to both industry and government. We should like to point out, however, that the proposed revision represents only a start

in the direction of a new approach to contract cost principles, and we hope that our specific suggestions will provide some bench marks for further revision prior to final publication.

Scope of Application of Proposed Contract Cost Principles

We note from your letter of April 11 the view of the Department of Defense that the provisions of DOD Instruction No. 4105.11 (which specifically cancelled permissive authority to employ ASPR cost principles as a "working guide" in the negotiation of prices under fixed price contracts) together with this proposed revision are sufficient to meet the objections of industry as to past misapplication of such cost principles to negotiated fixed price contracts. We should be inclined to agree were it not for one circumstance which, in our judgment, requires further clarification.

It is our understanding that military audit agencies continue to be guided by an internal audit instruction (Joint Letter No. 12, August 5, 1949) authorizing the application of Section XV, Cost Principles, in the preparation of advisory audit reports and the segregation of costs in accordance with the prescribed audit format. Although the publication of DOD Directive 4105.11 is an entirely appropriate step, it appears to have been addressed primarily to contracting officers and contract negotiators rather than audit personnel. Accordingly, we urge that the proposed revision of Section XV, ASPR, be expanded to include--under "scope of part"--an express prohibition against the use of cost principles laid down therein in connection with all phases of the negotiation of fixed price contracts including audit review. We recommend further that internal audit instructions of the Department of Defense be appropriately revised for the purpose of calling this prohibition to the particular attention of military auditors.

In this connection, we feel obliged to remind you of the Institute's view that, all too frequently, in establishing procurement policy the subject of audit is ignored and the procurement policy established is contravened by audit practices. Our views on this subject are spelled out in more detail on page 16 of the enclosed copy of the MAPI statement entitled, "The Government Contract--How to Use it Most Effectively in the Public Interest".

ASPR Cost Principles vs. Generally Accepted Commercial Accounting Principles

Although this proposed revision to ASPR makes frequent reference to the application of generally accepted accounting principles and, indeed, establishes such application as a standard for the determination of cost allowability, the principles proposed, as in the past, do not in fact agree with general commercial accounting practice in many important respects. Certain expenses, generally considered to be normal costs of doing business, are expressly disallowed by these cost principles.

Quite aside from the illogicality of employing as a test of cost eligibility a standard to which this whole body of cost principles does not itself adhere, we believe that this incompatibility of military contract cost principles with commercial accounting practice is frequently inequitable, uneconomic from the over-all standpoint of the government, and, in some measure at least, wholly unjustified.

15-201 Basic Principles and Standards

(b) Subsections (iii) and (iv) of this paragraph should be deleted because they tend to second-guess the contractor. In selecting a contractor the government indicates its intent to rely on the contractor's judgment and abilities. Thereafter, the allowability of costs incurred should be based on the other factors listed in subsections (i), (ii) and (v) of this paragraph.

15-202.2 Direct Labor -- This paragraph provides that the cost of direct labor includes "salaried and wages specifically identifiable with and properly chargeable to" performance of the contract. I presume the word "salaried" should be "salaries." But more important, this kind of language places too much of a burden on contractors in proving their costs because, in this instance, it establishes two standards of allowability that must be met. It should be sufficient if the item is properly chargeable to the work in accordance with proper accounting principles.

15-203 Indirect Costs

(b) The fourth sentence, beginning with "any significant change...," is unnecessary and confusing and should be deleted. It also should be made clear that selection of the most appropriate method of allocation of such costs is not left to the auditor.

15-203.1 Indirect Manufacturing and Production Expenses -- The fourth sentence of this paragraph should be reworded to read: "The contractor may departmentalize or otherwise establish cost centers in order to distribute equitably the indirect costs."

15-203.2 Indirect Engineering Expenses -- Deletion of the second sentence, first paragraph, under this heading is recommended because the specific engineering activities set forth in this paragraph are not uniformly treated as engineering activities throughout industry. In the event the sentence is retained, the words "or any other engineering activities" should be added to the end of the sentence.

15-203.3 Selling and Distribution Expenses -- This paragraph should be rewritten to recognize that minimum marketing costs related to the contractor's government business should be allowable because they often are necessary costs of doing business with the government.

15-203.4 General and Administrative Expenses -- In the second sentence, the words "provided equitable results are thereby obtained" should be deleted and the words "provided the method conforms with generally accepted accounting principles" should be substituted. The wording of the third and four sentences is not clear and might unduly

emphasize the factors listed and restrict the auditor in the exercise of his judgment. Therefore, it is recommended that they be deleted.

15-203.5 Base Period for Allocation of Indirect Expenses -- This paragraph should be revised to recognize the base period employed by the contractor's accounting system. The general criterion should be whether or not the period employed, when combined with the method of allocation, is equitable to both parties.

15-204.1 Advertising -- Although advertising expenses may not be directly related in every instance to a particular government contract, it is quite probable that the government nevertheless may be the beneficiary of lower costs of production which are made possible by the volume of business the contractor obtains by means of his advertising. In several instances, the proposed revisions recognize the principle that certain indirect costs required to keep the business of a company going are allocable to government contracts. Therefore, it is strongly recommended that institutional advertising expenses -- designed to promote the name of a company rather than one of its products -- be considered a reimburseable item, on an allocated basis. It also is recommended that there be added to the two types of allowable advertising costs: (1) Invitations for submitting bid proposals by prospective subcontractors and vendors, and (2) Community advertising placed with local media primarily to stimulate production and to promote employer-employee and employer-community relations.

15-204.3 Bidding Expenses -- It is conceivable that a question may arise relative to allowable costs incurred in connection with the presentation of bid information. It therefore is felt that insertion of the words "and presenting" after the word "preparing" in the first sentence and after the word "development" in the same sentence will clarify the intent of this paragraph. There also is need for clarification of the prohibition, in the second sentence, on charging past bidding expenses by allocation. In almost every instance, bidding expense would be incurred prior to the period chargeable to the government contract. Under the circumstances, this prohibition in effect denies the recovery of bidding expense except as additional bidding expense on future contracts might be incurred during the accounting period chargeable to the government contract. We also wonder whether it was intended that bidding expense be allocated to "all business of the contract," as the revised Section XV states, or whether it should be "all bid business of the contractor."

15-204.5 Civil Defense -- The last sentence of this subsection should be deleted. Because of the changing situation in civil defense, it is possible and even probable that a contractor may be placed in the position of having to cooperate with local government authorities by contributing substantially to some local civil defense project for the good of the community. Such an expense should be an allowable item of cost even though it may not be specifically provided for in the contract.

15-204.6 Compensation for Personal Services --The major shortcoming of this detailed and somewhat confusing portion of the Section XV revisions is its reflection of the unsound principle that compensation for personal services, whether immediate or deferred and whether in cash, stock or other property, should be limited by any arbitrary criteria such as a percentage of base compensation or the extent of a contractor's government business. Use of either yardstick not only is arbitrary but discriminatory. The only proper criterion should be that established by the federal tax laws and general business practice, namely, that the compensation be reasonable, under all the circumstances, for the personal services actually rendered. We therefore recommend deletion of sub-paragraph (3) (e) in its entirety.

We also recommend deletion of sub-section (c) on Page 1509, which would disallow, as an item of cost, the cost of options to purchase stock of the contractor corporation. The Board of Contract Appeals has ruled that these costs are allowable. Furthermore, many companies have found that programs of this type give an employee the feeling of working for himself, a stockholder, and thereby encourage continuity of employment which, in turn is reflected in lower production costs to customers -- including the government.

A third objectionable feature of Paragraph 204.6 is the failure to recognize, for cost determination purposes, the carryover features of the Internal Revenue Code. (Sub-section 2-ii, Page 1510.)

15-204.8 Contributions and Donations -- Insert comma after "charitable."

15-204.9 Depreciation -- The major deficiency of this portion of Section XV -- the failure to take into account the new Internal Revenue Code provisions regarding the manner of charging depreciation -- was offset, in part, by the May 12 Defense Department announcement of an interim cost interpretation paragraph (15-602) that embodied the rapid write-off privileges of the Code. It is essential that paragraphs 15-204.9 and 15-602 be consolidated prior to publication of the final revisions to Part 2, Section XV.

15-204.10 Employee Morale, Health and Welfare -- The language of this paragraph may be subject to a restricted interpretation by government administrative and audit personnel because of the very limited number of examples that are cited in the second sentence. Among the many others that could be cited are bond purchasing plans, length-of-service awards, athletic and recreational programs, housing advisory service and other employee counseling services.

15-204.15 Initial Production Costs -- The second sentence of paragraph two under this heading should be deleted. In view of the fact that paragraph 15-201b states that all costs must be reasonable, the statement that certain costs will be subject to disallowance if theycontinue "to an unwarranted extent" would appear to invite controversy -- particularly when there is no definition of "unwarranted."

15-204.16 Insurance Indemnification -- This entire section implies that allowance of costs will be predicated very largely upon prior approval by the government of insurance coverage. Such prior approval is impractical to obtain during contract negotiations. The insurance coverage dictated by common business prudence and in effect at the time of undertaking a contract is a normal business expense and should be allowed in full.

(b) There is need for clarification of what "government required" means in this subsection. Does this mean required by law, by an agency or department of government, by a contracting officer, or does the term embrace all of these? Another provision of this subsection says the costs of government required insurance are allowable within the limitations of "premium rates approved by the government." In view of our national policy that the regulation of insurance rates is a state function, this provision seems to be inconsistent with that policy. Still another provision of this subsection says costs allowed for use and occupancy insurance will, in principle, be limited so as to exclude coverage of profit, interest, federal income taxes and any other items of expense unallowable under this part of the Regulations. This is a completely impractical prohibition because there is no practical way of determining how much of the cost of such insurance is attributable to coverage of profit and interest.

(c) This subsection should be revised to recognize that there may be instances where a contractor who is obligated to deliver under the terms of a contract would find himself in a position where insurance on government-owned property under his management would be essential to his own protection -- regardless of whether it is required by the government.

(f) Use of the word "contingent" in this subsection could invite misinterpretation. It is a basic principle of insurance that it protects against contingent losses.

(g) "Indemnification", as used in the title of this paragraph and in this subsection, should be defined or deleted.

15-204.22 Materials and Supplies

(a) At the end of this subsection, add the following sentence: "In computing materials costs, consideration will be given to reasonable overruns, spoilage and defective work."

(b) Combine the second and third sentences by replacing the period after the word "allowances" with a comma. The reference to lost discounts in the final sentence of this subsection is too strict and should be modified to provde that the contractor will be excused for failure to take cash discounts unless he has failed to have an adequate system for processing invoices subject to discount or unless the discount was lost due to negligence on the part of the contractor in hiring or retaining inefficient employees.

(e) The flat disallowance of "write-downs" of values, as stated in this subsection, is inequitable because it is an accepted accounting practice to recognize that due to technological advances, engineering changes, defects, shelf-wear, etc., 100 percent utilization of stock inventories seldom with be realized.

(f) The first sentence of this subsection should be modified to permit the inclusion of "handling and purchasing costs."

15-204.27 PENSION AND RETIREMENT PLANS

(a) The fourth sentence of this subsection is inconsistent with the current Treasury Department position and requires explanation.

(b) The requirement in this subsection that the military pass upon the allowability of all pension plans prior to contract finalization is impractical. It should be modified to restrict military consideration of plans already approved by the Internal Revenue Service to "consideration of cost and allocability."

(c) The second sentence of this subsection should be deleted for the same reason deletion of paragraph 15-204.6e was recommended. Both would discriminate against companies with government business in excess of 25% of their total volume of business.

(d) This subsection should be modified to require compliance with the carryover provisions of the Internal Revenue Code with respect to pension and retirement cost determinations.

15-204.28 Plant Protection Expenses -- This paragraph should be revised further to recognize a third class of plant protection expenses that should be allowable -- the costs of clearing personnel to handle classified work, the acquisition of special cabinets and safes for storage purposes, etc., as required by many defense contracts.

15-204.29 Pre-Contract Costs -- The first and last sentences of this subsection appear to be contradictory. They should be revised further to make it clear that such costs will be allowed when authority therefor is specifically set forth in the contract.

15-204.31 Profits and Losses on Disposition of Plant Equipment or Other Capital Assets -- The flat exclusion of such profits and losses cannot be justified. This subsection should be modified to exclude them from contract costs -- except to the extent that such gains or losses adjust depreciation on assets acquired for government business.

15-204.32 Reconversion Expenses -- This subsection limits the allowable costs to those related to the removal of government property and then only if specifically provided for in the contract. It should be modified to recognize that most expenditures of this type are not made until well after completion of the government work which occasioned them. It also should permit accruals based on estimates and subject to adjustment at a later date.

15-204.35 Research and Development

General Research -- This subsection should be revised further to eliminate the stipulation that a contractor must agree to divulge to the government the results of any independent general research before the costs of such research can be considered a reimburseable item. The government should be entitled to such information only insofar as such research is applicable to the contract involved. Further revision of this subsection also is necessary to delete the stipulation that such expenses shall not be allowable for companies with more than 25% government business -- unless specifically authorized in the contract.

Related Research -- The last sentence of this subsection of Paragraph 15-204.35 should be revised further to specify that no portion of such research will be allowable under cost type research and development contracts "unless specifically provided for in the contract."

Subsection (c) of this paragraph also should be revised further to specify that research and development costs incurred in accounting periods prior to the award of a contract will be allowed "only to the extent specifically authorized by the contract."

Sincerely yours,

Theron J. Rice

Theron J. Rice, Manager
National Defense Department

2003/2329

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.

GENERAL COMMENTS

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.

15-204.35 - 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).

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.

RADIO-ELECTRONICS-TELEVISION MANUFACTURERS ASSOCIATION

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NATIONAL 8-3902

June 20, 1955

Rear Admiral L. H. Thomas, SC, USN
Staff Director
Purchasing & Contracting
Policies Division
Office of the Assistant Secretary
of Defense
Washington 25, D. C.

Dear Admiral Thomas:

I refer to your letter of April 11 forwarding to us for consideration and comment a copy of the proposed revision to Part 2, Section XV, of the Armed Service Procurement Regulation.

Owing to the deep and abiding interest of the electronics industry in the cost principles applicable to government contracts, this Association has devoted intensive and time-consuming study to the terms of the proposed revision. The Association is thoroughly in accord with your objective to include more equitable coverage of some cost items incurred by contractors, and to clarify cost determination under the Section to promote uniformity in its application. Our Committee feels that the proposed revision appears to have achieved this objective in part. In some cases, however, we discovered in the proposed revision certain omissions from the existing regulation which are not easily explainable and which are therefore likely to cause misunderstanding and confusion in the future. In other cases, we thought the revision went into such detail as to make it partake of a check-off list that will tend to crystallize lower echelon thinking to the exclusion of equally valid alternatives. Our detailed comments follow:

15-200 SCOPE OF PART

We recommend that this opening paragraph be amplified to make it

6.85

clear that the entire section has no application to other than cost-type contracts. We are aware that a policy to this effect was enunciated in Department of Defense Instruction #4105. Nevertheless, since this Instruction is an internal directive of the Department of Defense cancelling an earlier Munitions Board Instruction it seems to us too informal and temporary an expedient to establish firm and unequivocal policy for the entire procurement establishments of the three military services. We accordingly recommend that language be inserted in the opening paragraph of Part 2 of the Section making it unmistakably clear that the Section only applies to cost-type contracts.

We also recommend that the former wording of 15-101 excluding Section XV for use in negotiating pre-determined overhead rates, except as a guide, be added to 15-200.

15-201 BASIC PRINCIPLES AND STANDARDS

a. No comment.

b. We recommend deletion of (iii). The present language endows the cost inspector with authority outside the scope of his proper functions and well beyond his experience and capacity. If retained in the regulation it will stimulate unnecessary interference in management decisions.

c. and d. No comment.

General: We also recommend that somewhere in 15-201 be included the same language on the use of normal or standard costs for determining provisional or interim payments as is contained in the present 15-201. Some of our member companies are apprehensive that non-inclusion of the present provisions will jeopardize the continuation of their present use.

15-202 DIRECT COSTS

In the next to last sentence after the word, "consistently" we

recommend that the following language be inserted: "...within each separate unit engaged in mixed production". This change should take care of large companies with several operating divisions which are engaged in the manufacture of different product lines and possess virtual operating autonomy.

15-202.1 DIRECT MATERIALS

We prefer the language of the present section 202.1. Our Committee considered that the advantages gained by the greater brevity of the revised 202.1 were more than offset by the comprehensive detail and clear-cut provision for overruns, spoilage, etc., set forth in the existing regulation.

15-202.2 DIRECT LABOR

We urge inclusion of language making provision for the use of average labor rates under appropriate circumstances.

15-202.3 OTHER DIRECT COSTS

In the last sentence, line 3, change the word "similar" to "the same". Our Committee felt that the word "similar" was too vague and speculative, and vested too much discretion in the cost inspector to make unauthorized cost deletions.

15-203 INDIRECT COSTS

(a) No comment.

(b) We recommend deletion of the last two sentences of (b). The enumeration of specific changes seems to our Committee to be an unnecessary amplification, carrying with it the danger that it will be used as a check-off list by the cost inspector.

15-203.1 INDIRECT MANUFACTURING AND PRODUCTION EXPENSES

In the first sentence of 203.1 change the words "necessary to" to "incurred in". The present language is unnecessarily broad and subject to conflicting interpretations by the Government and the Contractor.

At the beginning of the third sentence add the words "Examples of" to make it clear that the items are inclusive but not limited thereto.

15-203.2 INDIRECT ENGINEERING EXPENSES

At the end of the first sentence add "...and such other related costs as the contractor consistently charges to overhead". Our Committee felt that the first sentence as written failed to take into account other legitimate costs habitually charged to engineering overhead under reputable accounting methods.

15-203.3 SELLING AND DISTRIBUTION EXPENSES

The proposed revision restates the hoary and fallacious concept that selling to the Government involves no marketing expense on the part of the contractor. Our Committee strongly considers that this fiction has outlived its usefulness; it is time for the government to recognize that a variety of perfectly legitimate selling expenses are incurred by every reputable contractor who sells his products to the Government. This is especially true of the more established suppliers of military equipment who must of necessity maintain close and effective liaison with the purchaser. Although marketing in the ordinary commerical sense is certainly not necessary for doing business with the government, the proposed language fails to recognize any form of non-commercial marketing expenses. We, therefore, recommend that the paragraph as presently written be changed as follows:

First, change the second sentence to read, "There may be an allocation to government work of those expenses in this category including but not limited to, administrative, technical, consulting and other services, which are for the purpose of negotiating, administering and servicing government contracts".

Second, delete the rest of the paragraph.

15-203.4 GENERAL AND ADMINISTRATIVE EXPENSES

We recommend that everything in this paragraph after the second sentence be deleted. There are innumerable other factors which should

receive consideration in determining the equitability of G and A. Different large companies use different methods and smaller companies may make entirely different allocations. Moreover, cost patterns, inventory variations and establishment of theoretical ratios may have little or no relevancy to the practices of companies which do both commercial and military business or which are new to the government contract field.

15-203.5 BASE PERIOD FOR ALLOCATION OF INDIRECT EXPENSES

As presently written this paragraph seems to presuppose that each contractor has only one government contract. What happens if a contractor has half a dozen contracts of different types, extending for different base periods? We believe the entire paragraph should be deleted since the matter appears to be adequately covered in Paragraph 15-203(b).

15-204 APPLICATIONS OF BASIC COST PRINCIPLES AND STANDARDS TO SELECTED ITEMS OF COST.

In the next to last sentence we recommend that you strike everything after the word "Standards". Our Committee felt that to include similar or related items would broaden the treatment to the point of complete uncertainty.

We also recommend that the words "This paragraph and ..." precede the last sentence for the sake of complete clarity.

15-204.1 ADVERTISING

We recommend that a subparagraph (3) be inserted to cover institutional advertising. Such advertising does not offer the product for sale commercially and may not appear exclusively in trade and technical journals. We also recommend that the word "only" be deleted from (a).

15-204.2 BAD DEBTS

No comment.

15-204.3 BIDDING EXPENSE

We recommend that in the second sentence the words "all business" be changed to "the applicable business". In the case of companies doing both commercial and government business it is sometimes customary to exclude certain expenses solely incurred for one type of business from the accounts of the other. This works both to the advantage of the government and the contractor.

15-204.4 CAFETERIAS, DINING ROOMS AND OTHER FOOD SERVICES

It should be recognized that the sale of inexpensively priced lunches to employees in a company dining room or cafeteria has become standard operating practice for all large companies and most small ones; it is a form of fringe benefit which employees expect. We, therefore, see no reason why it should be singled out for special and discriminatory treatment, especially since food services of this kind are by their very nature almost immune from any possible misallocation or abuse. We, therefore, recommend that in the third sentence everything after the word "allowable" be stricken and the sentence ended with a period; we also request that the entire last sentence of the paragraph be deleted.

15-204.5 CIVIL DEFENSE

We recommend that the words "on the contractor's premises pursuant to suggestions or requirements of civil defense authorities..." in the third sentence be deleted. In the atomic age shelters and other civil defense measures are not necessarily located on the contractor's premises.

The last sentence of the paragraph should also be deleted as it fails to make into account supervening circumstances and the overriding

authority of local, civil and federal authorities to require different kinds of civil defense measures and financial contributions.

15-204.6 COMPENSATION FOR PERSONAL SERVICES

a. In the first sentence add after "includes" the following: "...all renumeration paid or set aside such as". Also insert the word "incentive and" before "deferred compensation, etc." The sentence as presently written fails to take into account reserve funds set aside for salaries, wages and bonuses.

b. In the third line it seems probable that the drafter meant corporate "officers", not "officials"; we are also uncertain what is meant by "executives".

We recommend deletion of (iii) as being absolutely speculative and not relatable to any known standard or criterion. Some companies with little or no government business pay their executives far more than do other companies with a preponderant government business, (Viz. the chemical industry vs. the electronics industry): small companies in the non-defense category often pay more than large companies in the defense one, and vice-versa. Has anyone in the Defense Department made a study of executive compensation in different industries? Have they read the recent articles in the Harvard Business Review on the subject?

c. Delete the word "not" and make reasonableness the test, as it is anyway throughout this section.

d. In the first line delete the word "production". Some officers and employees perform services which may not fall exactly within the production category yet which are of inestimable importance to the company.

(1) Insert the words "or practice adopted or" in the third line after "established plan". This will take care of smaller companies

which have a practice of paying bonuses rather than an established plan, and will also permit the establishment of such a plan or practice by a growing company.

(2) Add "...when considered in light of total compensation" to end of sentence. Overall compensation should be the test rather than any one component thereof.

(3) No comment.

(4) We recommend that everything after the words "salary classification" be deleted. The reason for this recommendation is that many small companies have management incentive plans which might be considered unreasonably restricted for purpose of this paragraph. The government has other safeguards here which can be availed of to guard against abuse.

(5) No comment.

(6) Insert "stockholders" after "officer" to make it clear that officer stockholders is the group aimed at.

(7) We recommend deletion of this sentence as being redundant.

e.

(1) No comment.

(2) Delete: "Except as provided in (3) below." Explanation follows:

(i) No comment.

(ii) We suggest deletion of everything in e. after the first sentence. Our Committee feels that any plan approved by the Internal Revenue Service must be acceptable to the military department for accounting and cost allocation purposes or hopeless confusion will result.

(3) We request deletion of this paragraph in its entirety. Our committee considers that the 75% test in 3 (i) is absolutely

unrealistic and has no relevance to the merit or lack of merit of any particular profit-sharing plan; it would be wholly inequitable during any emergency when the ratio of government business to commerical business may suddenly increase since it penalizes the patriotic supplier. Furthermore, there is no criterion for establishing what is meant by government business; does the term mean current sales only, or does it include back-log?

(NOTE: The Defense Department amendment of May 25 arrived after our Committee met to consider the revision. While we cannot say with certainty how the Committee would react to the amendment we believe it would still be objectionable for the same reasons as stated above, since the principle remains unaltered.)

f.

(1) through (4). No comment.

g. We recommend that this subparagraph be rewritten as follows: "For the purpose of determining reasonableness, the employer contribution under profit sharing plans and stock bonus plans shall be subject to the same provisions as provided for in the Internal Revenue Code". The same standards prescribed by the Internal Revenue Services for employer contributions must be accepted by the military services or absolute chaos will result.

h. No comment.

15-204.7 CONTINGENCIES

We think the first sentence could be better expressed as follows: "This type of charge is allowable only if it results from the creation and maintenance of reserves to provide for events whose occurrence can be reasonably foretold with respect to time and intensity". Our Committee felt that the sentence should be rephrased in the positive, but without any reference to assurance of an event happening, which removes it from the category of a contingency.

15-204.8 CONTRIBUTIONS AND DONATIONS

We suggest that a comma be inserted after "charitable" in the

second line.

15-204.9 DEPRECIATION

a. No comment.

b. Our Committee noted that for some time the "declining balance" and other methods of establishing depreciation have been recognized by the provisions of the Internal Revenue Code. To make it clear that where such recognition exists the military services should likewise accord recognition we recommend that the words "...including those methods recognized by the Internal Revenue Code (subject to the limitations set forth in subparagraph e. below)" be inserted after "accounting principles" in line 5, second sentence.

c. We recommend that this paragraph be revised to give positive authorization for depreciation charges as follows: "c. Charges for depreciation on idle or excess facilities will normally be allowed on such facilities as are reasonably necessary for standby purposes". In companies producing both commercial and military type equipment it would be difficult to show that a standby facility is exclusively for one or the other. In actual fact they are for both - and would be so used, depending on the degree of national mobilization.

d. We recommend that the following language be added to the end of the paragraph"...except that depreciation may continue to be charged until such time as the unrecognized depreciation has been absorbed".

e. We recommend that the second sentence of this paragraph be revised as follows: "After the expiration of the emergency period for the facilities concerned, where a determination of "true depreciation" has been made, the remaining balance of the cost of such facility over the amount of "true depreciation" recognized previously in costs will be recognized as allowable, subject to paragraph 15-204.12". This will take care of depreciation requirements over and above accelerated

amortization.

15-204.10 EMPLOYEE MORALE, HEALTH AND WELFARE

No comment.

15-204.11 ENTERTAINMENT EXPENSE

We request that the words "except in reasonable amounts and when related to necessary business meetings" be added at the end of the second sentence.

15-204.12 EXCESS FACILITIES

We recommend that the words "contract performance" be deleted from line 3 of the first sentence. This will make the paragraph conform to the wording of 204.9 c.

15-204.13 FINES AND PENALTIES

No comment.

15-204.14 FRINGE BENEFITS

No comment.

15-204.15 INITIAL PRODUCTION COSTS

We request deletion of the last sentence of the second paragraph. In the constantly advancing state of the military electronics art, what qualification does the cost inspector possess to decide whether the contractor has had reasonable time to make the product efficiently? If the Government is dissatisfied it should terminate the contract -- not disallow costs incurred in good faith during the course of performance.

15-204.16 INSURANCE INDEMNIFICATION

a. No comment.

b. We recommend that b. be rewritten as follows: "Costs of Government required insurance are allowable. Costs of other insurance, except that applicable to Government-owned property, are allowable provided

(1) the insurance has been approved by the military department concerned pursuant to a contractual requirement, or (2) in the absence of such approval requirement, the types of coverage, extent of coverage and rates are reasonable under the circumstances. Costs allowed for use and occupancy insurance will be allowable except coverage relating to profit, interest, federal income taxes, and any other items of expense unallowable under this part".

c., d., and e. No comment.

f. We suggest that mention be made of the interrelation of this subparagraph to related provisions in ASPR VII.

g. We request that "if" be substituted for "only to the extent expressly".

15-204.17 INTEREST AND OTHER FINANCIAL EXPENSES

RETMA has a continuing interest in obtaining recognition from the Defense Department and the General Accounting Office of the allowability of certain kinds of interest, especially when the contractor has relied on his own efforts in financing his performance of Government contracts. A memorandum on this subject is in process of preparation and will be submitted to the Assistance Secretary of Defense (Comptroller) within the next few weeks.

In any event, we consider it essential that this paragraph as finally written be absolutely consistent in form and content with existing Defense Department contract financing policies, especially on progress payments and Defense loans. The interest problem is so interrelated with contract financing that no policy for one should be adopted that is inconsistent with the other.

15-204.18 LABOR RELATIONS

No comment.

15-204.19 LOSSES ON OTHER CONTRACTS

This paragraph is inconsistent with the Court of Claims decision in Bell Aircraft Corp., v. United States, 100 F. Supp. 661 (Ct. Cls. 1051) aff'd per curiam, 344 U.S. 860 (1952), where a Government contractor was allowed to capitalize losses on experimental contracts and allocate them as costs to other Government contracts. We suggest that the paragraph be rewritten to permit allowability of such losses whenever permitted by sound accounting practices.

15-204.20 MAINTENANCE AND REPAIRS

a. No comment.

b. No comment.

15-204.21 MANUFACTURING AND PRODUCTION ENGINEERING

We request that the words "provided such division results in an equitable distribution, Viz.," be inserted immediately before (i) and at the end of the preceding sentence.

15-204.22 MATERIALS AND SUPPLIES

a. No comment.

b. We request that this subparagraph be changed to read as follows: "Cost of materials and supplies shall be suitably adjusted for applicable portions of income and other credits. Such income and other credits include trade discounts, refunds, rebates and allowances, cash discounts taken (to the extent that such discounts are in excess of interest paid) and credits for scrap, salvage and materials returned to vendors."

c. No comment.

d. Insert the words "or regularly manufactured and sold by the contractor through commercial channels" after "stock" in the first line.

e. In the view of our members, flat disallowance of "write-down" of values of inventories is not equitable. 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 original cost. Where the contractor can demonstrate that the methods used to reduce the values of inventories are logical, and have been applied consistently, and that prudence was exercised in acquiring the stocks involved, such inventory valuations should be allowed to the extent allocable to Government Business.

f. We suggest insertion of "non-affiliated" before "customer" in line 7; some company divisions purchase from each other at special prices.

15-204.23 ORGANIZATION EXPENSES

No comment.

15-204.24 OTHER BUSINESS EXPENSES

No comment.

15-204.25 OVERTIME, EXTRA PAY SHIFT AND MULTI-SHIFT PREMIUMS

The paragraph as presently written shows a tendency to consider shift premiums as out of the ordinary and not to be authorized without special permission. In actual fact multi-shift operations, and premium pay for unpopular shifts, is standard operating procedure for many companies; provision is often made for them in union contracts. We recommend that a little (a) precede the paragraph as now written; that all mention of shift payments and shift premiums be deleted therefrom; and that a new subparagraph (b) be added to read as follows: "Shift premiums in accordance with the contractors' practices and procedures are allowable".

In addition, our Committee noted several deficiencies in the provisions for overtime. We feel that all indirect labor (i.e., janitors, plant maintenance staff, administrative and service personnel, etc.) should be permitted necessary overtime without special authorization. Emergency overtime for direct labor should be permitted without written authorization. The contractor should not have to run the risk of cost disallowances whenever he makes arrangements for necessary overtime without a written chit from the contracting officer. Provision should also be made for predetermined overhead rates.

15-204.26 PATENT EXPENSES

We request that the next to last sentence commence with "Charges ...", deleting "all other patent expenses..." The present wording disallows an unspecified category of costs.

15-204.27 PENSION AND RETIREMENT PLANS

a. We recommend that the fourth and fifth sentences be deleted. They presuppose that legitimate pension plans are not conditioned on profits. In many cases they are, especially in smaller companies; sometimes corporate by-laws suspend payments into the pension fund during bad years and authorize the deficiency to be made up in profitable years.

b. Strike everything after "Military Department" in the first sentence. No consideration seems to have been given to the potential chaos created by allowing one branch of the Government to disallow what another has approved. An IRS approved plan should always be acceptable to the military services. We also request that the present second and third sentences be deleted and the following new second sentence be inserted after "Military Departments": "Consideration of the plans by the Military Department will be limited to consideration of cost and allocability thereof and will be the responsibility of the Department to which audit cognizance will be assigned".

c. We request that the first sentence be changed to read, "The cost of pension and retirement plans approved by the Internal Revenue Service are allowable except as otherwise determined to be unallowable under this paragraph". The rest of the subparagraph may stand.

d. No comment.

e. We request that the last sentence of this paragraph e. be deleted. It conflicts with the contractor's arrangements under the

Internal Revenue Code and penalizes government contractors in relation to their commercial competitors.

f. In the second sentence we suggest substitution of the words "may be" for "is usually" before "necessary"; there is no hard and fast rule in such cases. Also, immediately after the end of the second sentence we request the insertion of a new sentence to read as follows: "Where the contractor can demonstrate that reasonable provision has been made for the effect of such reversionary credits in his method of determining pension contributions, no special provision for these credits is required". The beginning of the succeeding sentence should then be changed from "Under these circumstances..." to "Otherwise..."

We further recommend that the last sentence of f. and the succeeding subparagraphs (1) and (2) be deleted in their entirety. They spell out in detail two or three of a great many methods of making such arrangements and will tend to crystallize lower echelon thinking and make them suspicious of equally legitimate but different procedures.

g. Change the last two lines to read as follows: "...pension and retirement plans will be considered on an individual case basis and are allowable subject to the usual tests of reasonableness and allocability."

15-204.28 PLANT PROTECTION EXPENSES

Our Committee was uncertain whether this paragraph applied solely to the physicalprotection of plants and facilities or embraced the whole spectrum of industrial security. There was a general feeling that as presently written only relatively minor expenditures appeared to be covered; the paragraph is silent on such major cost items as security clearances, automatic detection devices, accommodations for

classified documents, etc. Yet there is nowhere else in ASPR XV where the latter items logically fit.

15-204.29 PRECONTRACT COSTS

We request that the last sentence be rewritten as follows: "Such costs will be allowed when authority therefor is specifically set forth in the contract and may be limited to a period of time".

15-204.30 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER

Our Committee felt that the scope and extent of Government regulations, the changing requirements of contract clauses, and shifting Government interpretation of such clauses make it necessary that the contractor avail himself of professional assistance. Whether such assistance is separately engaged or comes from the contractor's staff should be irrelevant. Nor should past cost patterns, impact of Government business, etc., be determing factors in judging allowability. We suggest that subparagraph a. be rewritten as follows:

"a. This item includes the cost of professional services rendered by the members of the particular profession, either as part of the contractor's organization or separately engaged. These costs are allowable when reasonable and should be allocated in accordance with the principles set forth in 15-201."

b. We suggest that b. be deleted in its entirety as unnecessary amplification tending to crystallize lower echelon thinking to the exclusion of other legitimate alternatives.

c. We request that the word "unsuccessful" be inserted before "defense" and "prosecution" in line 4.

15-204.31 PROFITS AND LOSSES, etc.

We concur with the present wording but suggest the addition of the following to the last sentence; "...except to the extent that such gains or losses adjust depreciation on assets acquired for

Government business, or unless specifically provided for in the contract.

15-204.32 RECONVERSION EXPENSES

Our Committee felt that this paragraph should be rewritten to permit certain kinds of reconversion expenses, such as restoration of facilities to pre-Defense work condition, whenever substantial changes in plant and facilities have been effected at Government behest or pursuant to the specialized requirements of defense production.

15-204.33 RECRUITING EXPENSE

No comment.

15-204.34 RENTALS OF PLANT AND EQUIPMENT

We recommend deletion of subparagraph b. and correction of subparagraph a. by insertion of the words "and (ii)" between "...under (i)" and "above..." in the first line.

15-204.35 RESEARCH AND DEVELOPMENT

a. No Comment.

b. (1) We recommend deletion of (iii) on the ground that it is an exorbitant and overreaching demand on the part of the government. We also request deletion of (iv) for the same reasons as set forth earlier under 204.6e (3), to-wit: no logical basis for differentiating between customers over and under 75%; no logical basis for the 75% figure in the first place; and no criterion in the regulation for determining what constitutes Government business, e.g. current sales, sales plus backlog, or past history of Government business.

It seems to us that the last sentence of (1), relating to predetermined overhead rates, should also be deleted; it is merely another cost item and is adequately covered elsewhere.

(2) We request revision of the second sentence of (2) by insertion of the words "and development" between "...reimbursed to a contractor)" and "may, if allocated..." on line 7; we also request substitution of the word "related" for "all" later in the same line, and deletion of "production" in the following line. We recommend deletion of the last sentence of this subparagraph since there is no valid reason why under certain circumstances and in some fields of application part of related research costs should not be allocated to R and D contracts.

We request deletion of all of c. Under certain circumstances capitalized development costs and a pro-rata share of patent costs should be allowable.

15-204.36 ROYALTY PAYMENTS

The words "or proprietory or technical information" should be inserted after "patents" at the end of the first sentence, and after "patent (s)" in lines 1 and 3 of the second sentence. We request that the second sentence end after "allowable" on line 3.

15-204.37 SERVICE AND WARRANTY EXPENSES

We request that consideration be given to including in this Section a clause which would give the contractor the right to include these expenses as an allowable cost where it has been the contractor's practice to include these expenses in the normal course of business.

15-204.38 SEVERANCE PAY

Our Committee felt that the paragraph as presently written could have inequitable results. It should be rewritten to provide for allowability on either an actual or an accrual basis.

15-204.39 SPECIAL TOOLING

We recommend that the entire paragraph be deleted and in lieu thereof a simple statement be inserted to the effect that special tooling is allowable subject to the terms and conditions prescribed for its

acquisition in Section XIII of ASPR.

15-204.40 TAXES

No comment.

15-204.41 TRADE, BUSINESS AND PROFESSIONAL ACTIVITIES

No comment.

15-204.42 TRAINING EXPENSES

We request that sub-paragraph c. of this paragraph be deleted in its entirety; there is no valid reason for differentiating between costs of on-the-job-training and training in educational institutions since the expense of the former may be as great or greater than the latter.

We suggest that a. and b. be combined into one paragraph, the latter being added as a last sentence to the former with the words "which are limited to on the job training" deleted.

We also suggest deletion of "director of " and "and" in line 3 of the first sentence; the term "training staff" should include its head or heads.

15-204.43 TRANSPORTATION EXPENSES

No comment.

15-204.44 TRAVEL EXPENSES

We recommend deletion of d. There is no definition of "premium" transportation in the regulation, and the term is generally unknown in industry. Companies are entitled to have their personnel travel by whatever means they see fit.

The foregoing concludes our comments on the proposed revision of Part 2, ASPR XV. We urge that these comments, together with those of the other industry groups and associations consulted be carefully studied before any final revision of the regulation is attempted. The cost principles applicable to Government contracts touch every aspect

of the contractor's performance; stringent or unrealistic requirements can play havoc with a contractor's internal accounting system and with his ability to competently perform.

Very truly yours,

E. E. McClaran, (per C.M.P.)

E. E. McClaran
Controller,
Eitel-McCullough, Inc.

Chairman, RETMA
Accounting and Cost Principles
Task Committee

Chamber of Commerce of the United States

1615 H STREET, N.W. • WASHINGTON 6, D.C.
NAtional 8-2380

June 17, 1955

Rear Admiral L. H. Thomas, USN
Staff Director
Purchasing and Contracting Policies Division
Department of Defense
The Pentagon
Washington 25, D. C.

Dear Admiral Thomas:

The Chamber of Commerce of the United States appreciates the opportunity to submit its comments and recommendations regarding the proposed revisions to Part II, Section XV, of the Armed Services Procurement Regulations, which prescribes a set of administrative cost principles that are applicable to cost-reimbursement type contracts.

In view of the fact that cost-reimbursement type contracts now account for approximately one-fourth of all defense procurement, we regard this ASPR revision as one of the most important since the Armed Services Procurement Act was enacted eight years ago.

And despite the recent directive that these cost principles no longer may be used as a working guide by contracting officers in the negotiation of prices under fixed-price contracts, it is inevitable that they will have some influence on such negotiations.

Copies of your April 11 letter and enclosure were sent by us to the more than 100 members of our Committees on National Defense and Taxation and our Manufacture Department Committee. In addition, we solicited the recommendations of our Insurance and Domestic Distribution Departments on provisions of particular interest to them. Comments also were received from some of our trade association members. All of these expressions of opinion were evaluated against the background of our policy declarations on Defense Procurement.

Time did not permit the reproduction and distribution of your May 25 letter, in which you extended the deadline for submission of our Section XV comments and requested that such comments cover further revisions to paragraph 15-204.6e. However, our comments will cover these changes, as well as those which accompanied your April 11 letter.

General Comments

Despite certain deficiencies of a rather serious nature, the proposed revisions to Section XV represent, on the whole, a step for-

ward in the administration of government contracts. For example they:

1. Are written in a business rather than legal language and are much more detailed than are the present Cost Principles.

2. Reflect belated acceptance of many modern business practices.

3. Provide for a more realistic allowance of certain cost items.

4. Permit inclusion of many additional elements of cost that are not now allowed.

On the other hand, the proposed provisions:

1. Leave too much latitude for administrative determination. For example, the introduction of phrases such as: "as are reasonably necessary" leaves much to be determined by government auditors who, in the past, frequently have not demonstrated a willingness to accept certain normal and proper business practices and procedures.

2. Perpetuate unwarrented distinctions between the principles governing government contract accounting and those governing tax and general corporate accounting.

3. Continue to disallow certain elements of cost which are an inherent part of doing business, and would disallow several important categories of expenditures which, under present regulations and rulings by the Board of Contract Appeals, are acceptable as items of reimburseable cost.

4. Discriminate against business concerns whose government business is in excess of 25% of its total volume. A cost that is allowable for a contractor with less than 25% government business should be just as allowable for contractors doing a higher percentage of government business.

5. Include a number of blanket stipulations that should be matters for consideration in specific contract negotiations.

Specific Comments and Recommendations

The Chamber's comments and recommendations on specific provisions of the proposed revisions to Section XV are as follows:

15-200 Scope of Part -- This paragraph should be amplified to state that this part of Section XV does not apply to fixed-price type contracts, including price redetermination and incentive types, and that where contracts provide for predetermined overhead rates the principles set forth shall be used only as a basis for negotiating such rates.

Items for special consideration.--There are a number of cost items which the proposed revision of Section XV, ASPR, continues to disallow, not only in contravention of normally accepted commercial accounting principles, but in seeming violation of the proposed revision's own general standard of reasonableness in determining the allowability of contract cost. We refer specifically to advertising, general selling and distribution expenses, and entertainment expenses.

Although we shall have more to say on each of these subjects in our specific recommendations which follow, we should like to register our general view that the allowance of such costs should be made a matter of special negotiation, dependent upon the individual circumstances of each case. In general, these expenses are customary costs of doing business and are expecially related to the continuing growth and vigor of a business enterprise and as such contribute materially to the whole of a company's productive potential. Although not perhaps directly allocable to any government contract work, the government may nevertheless be the beneficiary of substantially lower productive costs made possible by the volume and scale of operations the contractor has attained through this type of expense.

Certainly, there are individual contract situations (e.g., the entertainment of government officials) where it would be inappropriate and, we believe, unwise policy to allow expenses of these types as a reimbursable contract cost. But to disallow categorically all of such expenses (with the minor exception permitted in the case of advertising) is, we believe, quite unjustifiable and clearly not in the government's long-run interest.

Factors Affecting the Allowability of Costs

We do not question the apparent objective of greater clarification implicit in the enumeration of two additional factors affecting the allowability of contract costs. We do, however, take strong exception to the probable results of applying newly created tests for determination of cost allowability which involve "the exercise of good business judgment in the incurrence of cost" and "significant deviations in the established practices of the contractor which substantially increase the contract costs".

In the first place, the proposed revision retains the overriding test of reasonableness, which should be sufficient to protect the government's interest. To add a new and most nebulous criterion, the application of which would necessarily be even more imprecise and nebulous in character, involving retrospective review and reversal of business judgments made under then existing circumstances, will lead only to confusion, inequity, and a temptation to be uncertain in judgment in the first instance.

In the initial award of a defense contract, a contractor's general reputation, management know-how, responsibility and productive efficiency are presumably surveyed with care. It is totally contrary to good contracting policy, in the interest of government as well as the contractor, to superimpose upon this general review authority a criterion involving retroactive review of individual business judgments with respect to the incurrence of costs. This is

particularly true in view of the fact that a post audit is removed, and necessarily so, from the existing circumstances which underlie the business judgment at the time that it is executed.

Likewise, we believe, the second of the factors to which we have called attention is unnecessary in the light of pre-existing tests of general reasonableness and the application of generally accepted accounting principles and practices. We recommend, therefore, that both of these newly established standards for cost determination be eliminated from the proposed revision.

Use of Standard Costs

The proposed regulation appears to be completely silent on the use of standard costs and variances from those costs. Throughout the text of the new draft there is an implication that an actual cost system is to be maintained, at least for all direct elements of cost involved. On the other hand, repeated reference is made to the acceptability of a contractor's standard practice--which may, of course, include the use of standard costs--and we recommend, therefore, that the use of such a cost system be expressly authorized by appropriate language in the new regulation.

Specific Recommendations

The following specific recommendations apply to pertinent subject and paragraph headings, as indicated below:

Direct Costs (Paragraph 15-202)

Revised Subparagraphs 15-202.1 and 15-202.2 are somewhat less specific in respect to allowances for reasonable overruns, spoilage, defective work, use of average labor rates, et cetera, than are the corresponding provisions of ASPR which they are intended to supplant. We recommend, therefore, a continuance of the present provisions of the regulation or an appropriate revision and expansion of language in the newly proposed subparagraphs.

In the case of "other direct costs", Subparagraph 15-202.3, we recommend a revision of the last sentence to read as follows: "When, however, items ordinarily chargeable as indirect costs are charged to a government contract as direct costs, such items must be eliminated from the overhead allocation." (Underscoring supplied.) This suggestion arises from the fact that a single contractor may charge a normally indirect cost to a government contract as a direct cost in one factory but as an indirect cost in another factory, depending both upon circumstances and contract provisions.

Indirect Costs (Paragraph 15-203)

We have a number of specific comments and recommendations with reference to the various types of indirect costs discussed in the proposed revision.

Indirect engineering expenses.--The language of this subparagraph of the proposed revision does not appear to recognize the position of a manufacturer who sells to the government an article essentially identical to his regular civilian output and on which the incurrence of indirect engineering

expense is taking place continually. It is perfectly possible for a manufacturer of this type to have no direct engineering man-hours expended on items sold to the government, but to deny him reimbursement of the allocable portions of certain regular engineering costs which apply to commercial-type items sold to the government is, we believe, wholly indefensible. We urge, therefore, that the regulation take expressly into account this not unusual situation and authorize the allowance as a contract cost of indirect engineering expenses under such circumstances.

We recommend further that the first sentence of this subparagraph be amended by deletion of the word "chiefly" and the addition of the following: "and such other related costs as the contractor consistently charges to engineering overhead". Such amendments would avoid any possibility of interpretation restricting cost allowability to the three general categories of expense specifically identified in the presently proposed language.

Selling and distributions expenses.—This item of contract cost is one to which we have already addressed a general comment, and, in accordance with that general observation, we reiterate our objection to the proposition that "Generally, such expenses are not considered to be allowable...". It is true that the language of the proposed revision appears to represent a partial liberalization of present practice with reference to the allowance of such cost under the government contract. Nevertheless, the allowance of any such cost is made dependent upon a reasonable definition of benefits to contracts in question and clearly prohibits the expenses of "pure selling".

We disagree with the philosophy that selling and distribution expenses are generally unnecessary in obtaining government business, and urge the following specific revisions in the proposed language of Subparagraph 15-202.3: First, elimination in its entirety of the second sentence and the word "active" at the beginning of the third sentence; second, deletion of the words "rather than pure selling" at the conclusion of the third sentence; and third, complete elimination of the last sentence.

General and Administrative Expenses (Subparagraph 15-203.4).—Although the enumeration of factors to be considered in reaching equitable results in the allocation of general and administrative expenses was undoubtedly intended to be a clarification of present provisions, we feel that this attempt at further specification of matters for review in such allocations may only lead to further confusion. We would recommend, therefore, that all of subparagraph 15-203.4 following the second paragraph be deleted. The result would be to bring the allocation of such expenses into line with normal commercial accounting practices and, in addition, avoid any possible overemphasis on the use of factors specifically enumerated. Moreover, it is not entirely clear to us just how the factors of inventory levels and ratios might affect the equitable distribution of general and administrative expenses.

Applications of Basic Cost Principles and Standards to Selected Items of Cost (Paragraph 15-204)

Our specific comments and recommendations with reference to individual items of cost treated in this proposed revision to Section XV, ASPR, appear below.

Advertising (Subparagraph 15-204.1).—This is another of the cost items to which we have made reference in our comments above. The proposed revision to ASPR restricts the allowance of advertising cost to institutional advertising in trade and technical journals and to help-wanted advertising. At the risk of appearing repetitious, we wish to reiterate that institutional advertising, regardless of the media employed, is a real cost of doing business, and the pro rata share of such cost should be allocated to cost-type government contracts along with other general and administrative expenses.

This too narrow restriction on the allowance of advertising cost appears to overlook completely 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.

In general, we emphasize again that advertising, whether institutional or product-line, is an item of expense which should be made the subject of special negotiation in determining its allowability as a government-contract cost. Specifically, general, institutional and educational advertising should be evaluated in individual cases in the light of its direct and indirect benefits to government business. Product advertising is a selling and distribution expense from which the government has long derived demonstrable benefits in the form of productive capacity and should, we believe, be allowable, subject to the safeguard of individual negotiation, as an item of selling and distribution expense.

Bidding Expense (Subparagraph 15-204.3).—The liberalization in allowance of this type of contract cost may be more apparent than real. In almost every instance bidding expense applicable to a particular contract would have been incurred in a prior accounting period with the result that the proposed subparagraph denies the recovery of bidding expense except as to expense of this type relating to future contracts. We recommend, therefore, the consideration of allowing as an item of cost chargeable to a cost reimbursement type contract the contractor's bidding expense directly pertinent to that contract.

Cafeteria, Dining Rooms and Other Food Services (Subparagraph 15-204.4).—We recommend that the last sentence of the proposed subparagraph be deleted in its entirety. Quite aside from the question of who shall

determine the intent of furnishing food services at a loss, there would seem to be a clear inconsistency between this restriction and the general allowance as a contract cost of "employee morale, health and welfare" expenses by Subparagraph 15-204.10. Losses sustained in the operation of food services for the benefit of employees is, of course, no more than a form of fringe benefit and should, we believe, be allocated to all of the contractor's production, including government work, without the necessity of negotiating a special contract provision.

Civil Defense (Subparagraph 15-204.5).--If as a matter of public policy the government desires the widespread support by industry of civil defense programs--and we believe this is clearly the case--we are unable to understand the restriction on allowability of such costs to expenditures made on the contractor's premises and the express prohibition against reimbursement for contributions to local civil defense funds. Many government contractors enter actively into the civil defense programs of their respective communities including not only direct financial contributions but the loan of equipment and personnel. A categorical disallowance of costs so incurred cannot fail to discourage active participation by manufacturing companies in local civil defense programs. At the very least, we suggest that the items now disallowed by the proposed subparagraph be made matters for special negotiation in the light of all attendant circumstances.

Compensation for Personal Services (Subparagraph 15-204.6).--We have a number of basic objections to the language of proposed subparagraph 15-204.6. Our objections relate not only to specific disallowances required by the language of the proposed subparagraph but to the application in this area of arithmetical formulae which are entirely inconsistent with the general test of reasonableness laid down by the regulation for the determination of cost allowability.

We assume that subparagraph a. permits reimbursement for incentive type compensation whether of the immediate or deferred distribution type. However, we believe that the initial sentence should be clarified to explicitly allow reimbursement for such compensation.

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. Moreover, this express prohibition appears to be inconsistent with the allowance by subparagraph 15-204.6.f of stock bonuses as a contract cost.

Turning now to subparagraph d. of this important section of the proposed regulation, we note the inclusion of "production incentives" as an item of allowable cost and the exclusion of "management incentives". Whether or not

the latter type of incentive payment may be read into the general language employed is, of course, a matter of interpretation. We recommend that such payments be expressly allowed subject to the usual tests of reasonableness and normal business practice, for the reasons we have suggested below under our discussion of profit-sharing plans.

We are pleased that contributions to profit-sharing plans are being given express treatment as a contract cost. We do not agree, howevever, with some of the restrictions written into this section of the regulation. By way of general discussion, it appears to us that a variety of considerations not recognized in the proposed subparagraph should go into the determination of the allowability as a contract cost of contributions to profit-sharing plans. The reasonableness of such contributions in the light of total compensation should be a principal consideration. In addition, the purposes of the profit-sharing plan and the question of whether or not contributions of this type are a normal and regular part of the contractor's system of compensation must be given due weight in every case. For these reasons, we cannot agree with the 15 percent-of-total-basic-compensation test for general application.

There is the widest variation in industry as among profit-sharing and stock-bonus plans and their relationship to straight salaries, and the imposition of an arbitrary percentage limitation of this type would, in our opinion, almost certainly produce erratic and inequitable results. The determination of compensation for personal services is a matter for executive judgment, and we repeat 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.

Finally, we note in your letter of May 25 that the previous limitation of 75 percent of nongovernment business on the allowability as a contract cost of contributions to profit-sharing plans has now been modified. This, we believe, is a step in the right direction, particularly as it relates to the numerous companies whose percentage of government business may fluctuate from time to time above or below this fixed limit. Nonetheless, the amended language persists in the use of a strict percentage limitation which necessarily fails to take into account the general test of reasonableness under all the circumstances. We repeat our suggestion that this is an attempt to lay down arbitrary standards in an area of the widest possible variation. We think such a limitation not only unwise but undoubtedly productive of inequitable results.

Contingencies (Subparagraph 15-204.7).--To avoid any possible misinterpretation of the provisions of this subparagraph, we suggest the insertion of the word "reasonably" after the phrase "an event whose occurrence cannot be" appearing in the first sentence. We would suggest also the addition of the following sentence: "Where it can be established that a liability exists, a reasonable estimate will be allowed in determining the costs of the contract."

Depreciation (Subparagraph 15-204.9).--We assume that the ASPR cost interpretation of depreciation appearing in the Department of Defense press release of May 12 has the effect of at least partially altering the import of

this proposed subparagraph. Our comment, therefore, is addressed both to the release and to the proposed language of this subparagraph as we assume it to now be amended.

We note from the May 12 release that depreciation allowances authorized by Section 167 of the Internal Revenue Code of 1954 are acceptable as contract costs subject to their acceptability for tax purposes and the further proviso that the costing of defense contracts is consistent with the costing of the contractor's nondefense work and is so reflected in his books of account. We trust that this express provision will be spelled out in detail in the final publication of this proposed revision to ASPR. In addition to a clear statement of the allowability of depreciation authorized by the new Internal Revenue Code, we believe the regulation in subparagraph b. should be reworded to avoid any possible inference that the words "consistent application" are intended to deny (1) the adoption of the sum-of-the-years'-digits or the declining-balance method, or (2) the permissible switch under the new Internal Revenue Code from a declining-balance to a straight-line method of depreciation at any time during the life of a depreciable asset.

Subparagraph c denies the allowance as a contract cost of depreciation on idle facilities. As a practical matter, a defense contractor producing the same item for civilian and military use is unable to determine the amount of depreciation on idle facilities allocable to military work and thus considered nonallowable. Moreover, depreciation on stand-by facilities is a cost factor invariably present in manufacturing operations except in the most abnormal and short-lived periods of full capacity. As a consequence, the depreciation of idle facilities is an ever present cost of doing business, and the allowance of such costs should be recognized by these regulations.

We suggest finally that under subparagraph e the second sentence be reworded to read as follows: "After the expiration of the emergency period for the facilities concerned where a determination of 'true depreciation' has been made, the balance of the cost of such facility over the amount of 'true depreciation' recognized in costs will be depreciated over its remaining useful life and will be the only amount recognized as allowable cost, subject to paragraph 15-204.12". This suggested change has as its object the assurance of a full recovery of cost in all cases.

Excess Facilities (Subparagraph 15-204.12).--Our comments with reference to the allowance of depreciation on idle facilities apply with equal force to the allowance of the costs of maintaining and housing idle and excess facilities. These are normal costs of doing business and should, we believe, be allowed in normal circumstances.

Initial Production Costs (Subparagraph 15-204.15).--We recommend the elimination of that sentence in this subparagraph which reads, "In cases where these costs continue to an unwarranted extent after the contractor has been allowed reasonable time to learn to make the product efficiently, the excessive costs will be subject to disallowance." This suggestion arises from our feeling that the real point involved is covered sufficiently by the preceding sentence and that the inclusion of this sentence is an open invitation for the substitution of a post audit recommendation in a matter that is properly one for management judgment. Moreover, the government is at all times armed with the power of terminating the contract for the convenience of the government.

Insurance and Indemnification (Subparagraph 15-204.16).--It is our belief that insurance coverage, dictated by business prudence and in effect at the time of undertaking a government contract, is a normal business expense and should be fully allowable for contract cost purposes. The total effect of this subparagraph is to throw the contractor upon the mercy and wisdom of the government in approving an insurance program since, on the one hand, the allowance of insurance premiums as a contract cost is made to depend upon advance approval by the military department involved and, on the other hand, the contractor is denied recovery for any uninsured loss. This would appear to be another case in which the over-all test of reasonableness of coverage and rates is sufficient for the full protection of the government's interest.

The disallowance of the cost of use and occupancy insurance, insofar as it covers profit, interest, et cetera, is, we submit, completely doctrinare inasmuch as there is no practical way of determining generally how much of the cost of such insurance is attributable to coverage of loss for profits and interest.

Materials and Supplies (Subparagraph 15-204.22).--We have two specific comments with reference to this subparagraph.

Any generally recognized method of pricing materials issued from stock is acceptable for contract costing purposes provided the method is consistently applied and the results obtained are equitable. This provision of Subparagraph d is unfortunately watered down by the implication that a special agreement between the contractor and the government is required to allow the use of LIFO inventory costing. LIFO is a generally accepted method of inventory pricing. The results obtained from it are equitable and where it is consistently applied there is, we submit, no reason for a special contractual agreement authorizing its use. We urge that this be made clear in the language of the regulation.

The principal emphasis in Subparagraph f under "Materials and Supplies" is upon the use of a cost basis in the transfer of materials and supplies between plants, divisions or organizations under the same corporate control. This may be proper in some cases. If, however, a multi-plant or multi-division contractor has a well established plan for the pricing of sales or transfers between plants, divisions, et cetera, we believe that the operations of such a system should be recognized for contract cost

purposes subject to the limitation, of course, that transfer prices so charged may not exceed the sales price to the most favored customer or the competitive price of the item from other suppliers. This rather customary method of pricing inter-plant or inter-division transfers is limited by the language of the proposed subparagraph to the sale or transfer of items regularly manufactured and sold through commercial channels by the transferor. We believe this restriction should be eliminated and that the present emphasis upon cost alone as a basis of transfer should be altered by appropriate language revision.

Overtime, Extra Pay Shift and Multi-Shift Premiums (Subparagraph 15-204.25).--Although generally unobjectionable, this portion of the proposed regulation overlooks two possibilities which we believe it should consider. First, it ignores the situation where a manufacturer's production lines contain identical products intended for both civilian and military customers. Under this type of operation it is, we believe, completely impractical to require a separation of overtime premiums on those items intended for delivery under military contracts.

Our second observation has reference to the fact that the proposed language fails to differentiate between overtime and shift premium payments to direct labor and indirect labor. As an example, most manufacturing plants employ guards on a 3-shift, 7-day schedule. Under the terms of the proposed regulation it would be necessary to obtain prior approval for shift premiums paid to such guards even though the cost is simply a distributive charge into burden for all departments. Capital goods companies inform us that military auditors frequently take exception to all indirect overtime and shift premiums. We recommend, therefore, that the proposed subparagraph be reworded in part to read as follows: "Cost of overtime and shift premiums for direct labor is allowable only to the extent expressly provided for in the contract or otherwise authorized by the government. Cost of overtime and shift premiums for indirect labor is allowable without prior approval, if reasonable, and the cost is allowable on a pro rata basis to commercial as well as government work."

Pension and Retirement Plans (Subparagraph 15-204.27).--By the terms of this subparagraph, pension and retirement plans, subject to the approval of the Internal Revenue Service, must have such approval before consideration will be given them by the military department concerned. The regulation provides further, however, that approval by the Internal Revenue Service does not necessarily assure the allowance of contributions to such plans as a contract cost by the military. The conclusion is, of course, that the military department involved will pass upon the allowability of the costs of any pension plan prior to contract finalization. This, we believe, is a completely impractical requirement.

Plant Protection Expenses (Subparagraph 15-204.28).--All plant protection expenses should, in our opinion, be considered fully allowable. We have two objections to the segregation of plant expense stipulated by the language of this subparagraph. First, where a contractor is engaged in the performance of a number of classified government contracts at one location, it would be most difficult, if not impossible, to allocate special plant protection costs to each contract involved. Secondly, and

again where a single contractor holds a number of government contracts, it would be impractical for the contractor to develop an individual overhead rate for each of the government contracts.

Precontract Costs (Subparagraph 15-204.29).--The provisions of this subparagraph should be considered in relation to the provisions of Subparagraph 15-204.32, "Reconversion Expenses". Both types of cost are disallowed by this proposed revision to procurement regulations. It would seem that equity requires the allowance of one or the other as a necessary contract cost. At the very least, we believe that precontract costs and reconversion expenses should be made matters for special consideration under the circumstances of each case rather than being categorically disallowed.

Rentals of Plant and Equipment (Subparagraph 15-204.34).--We question if subparagraph b is required in this case, particularly in the light of the test of reasonableness laid down by subparagraph a. Taken together, the effect of subparagraphs a and b, as now written, is to penalize companies which have sale and leaseback arrangements as contrasted with companies holding conventional leases. We think it would be a rare case to find a conventional lease where the rental rate was equivalent to "normal costs, such as depreciation, taxes, insurance, and maintained expenses" attributable to the facilities leased. We repeat that subparagraph a should be deleted from the regulation.

"Research and Development" (Subparagraph 15-204.35).--In general 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 costs so incurred should be allowed as a government contract cost without requiring as a condition of such allowance an agreement that the contractor divulge to the government the results of independent general research.

Ordinarily the government's contribution to the support of pure research by industry under cost-reimbursement type contracts is relatively limited and yet under the proposed regulations the government seeks the full product of such research with no guarantee that knowledge so divulged may not be made available to others./1 The recent report of the Hoover Commission, recommending a greater rather than lesser expenditure of public funds on research and development, appears to lend credence to the theory that any addition to the general fund of scientific knowledge is an asset to the National Defense program. If there are extreme cases in which the government feels obliged to require a complete divulgence of the results of such research, we recommend that such disclosures be made the matter of special contract negotiations.

1/ Our views on the acquisition of a manufacturer's technical data by the government are set forth at length in our letter of January 3, 1955, copy attached.

Once again we find the 75 per cent non-government business test applies. The objections we have set out above in connection with the application of this test to "compensation for personal services" apply equally in this instance. By way of reiteration, we object generally to the imposition of the fixed percentage limitation as a test for the determination of allowability as a contract cost. At the very least, we believe the test should be modified as it has been in the prior case in conformity with your letter of May 25.

If, as a condition to the allowance of general research expenses as a contract cost, the government insists upon the divulgence of the results of such research, then we believe that the language of the proposed regulation requires clarification. The manner and time of divulging this information is not made clear. Does the language used mean that the contractor assumes an affirmative duty to supply the government with the results of its full research, or does it mean that the contractor simply agrees, if asked, to keep the government informed?

Finally, we are unable to agree with the exclusion from allowability under research and development contracts of costs arising from "related research" conducted with the contractor. It seems to us that there is as much possibility of benefit accruing to a research and development contract as might accrue to a cost-type production contract and, as a consequence, no distinction should be made as to the allowability of costs so incurred.

Taxes (Subparagraph 15-204.40).--Although we have no disagreement in principle, we are constrained to suggest the impracticability, in some cases, of the refunds required under subparagraph c. In the absence of performance under defense contracts at the time of tax refunds, it appears that the practicability of determining the proper amount of such refunds allocable to contracts performed as much as 10 years earlier is highly questionable.

Training Expenses (Subparagraph 15-204.42).--We believe that the disallowance of the costs of training in educational institutions except to the extent specifically provided by contract is unnecessary and, from the government's standpoint, unwise. In many cases it is impossible to foresee at the time of the negotiation of a cost-type contract what training requirements may be involved. In a very real sense the benefits of such training accrue to the government through improved contract performance and net cost reductions. Again, employee educational programs conducted by employers are by now so well established as to make of them a normal cost of doing business. Accordingly, we recommend that subparagraph c be amended to read: "Costs of training in educational institutions will be allowable where the program is available to all employees, the training period is during hours not paid by the contractor, and the cost is distributed on a pro rata basis between commercial and government work". As for training programs which do not meet these specific criteria, they might very properly be left to the discretion of the contracting officer in individual cases.

Travel Expenses (Subparagraph 15-204.44).--We recommend the elimination of subparagraph d which authorizes the allowance of the cost of premium transportation only where such costs are shown to be necessary to performance of the contract. We assume the word "premium" has reference to the choice of air travel rather than rail or to the distinction between differing types of sleeper accommodations. Barring wholly unreasonable expenditures--which are, of course, governed by the general tests applying to all costs incurred under government contracts--this is largely a matter of personnel administration and employee relations, and this restriction should be eliminated from the regulation.

General Conclusions

In concluding we should like to draw your attention again to three basic propositions which are implicit in our approach to the proposed revision of contract cost principles.

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 costs of doing business.

Equally as important, however, as the basic criterion we have suggested is the procedure or 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—in which we feel such expenses as advertising, profit sharing, etc., fall—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 comments and recommendations respecting the proposed revision to the ASPR. May we again express our appreciation for this opportunity to offer our comments on such an important section of procurement regulations. If we can be of any further assistance or if you would desire to discuss these matters directly with representatives of this office, please do not hesitate to call upon us.

Cordially,

Charles Stewart
President

CWS:c
Enclosures

NATIONAL SECURITY INDUSTRIAL ASSOCIATION
Incorporated

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

20 June 1955

Rear Admiral L. H. Thomas, SC, USN
Staff Director
Purchasing and Contracting Policies Division
Office of the Assistant Secretary of Defense
(Supply and Logistics)
The Pentagon
Washington 25, D. C.

Dear Admiral Thomas:

The National Security Industrial Association greatly appreciates the opportunity to review the proposed revision of Part 2 of Section XV of the Armed Services Procurement Regulation, dated March 23, 1955. Because of the vital interest this draft has to the members of NSIA it has been intensively reviewed and our comments are submitted in the expectation that they will receive serious consideration. The enclosed comments have been prepared by the Accounting and Auditing Task Committee and have been reviewed by the NSIA Procurement Advisory Committee, which consists of 156 members, representative of American industry, both large and small, and of every major segment of suppliers to the Military Establishment.

It is the very frank opinion of all members of the reviewing committees that the proposed draft revision is so drastic and contains so many objectionable features, that it should not be released until there has been a full and complete across-the-table discussion between representatives of the Department of Defense and of American business as to the basic principles involved.

It is apparent that wherever the draft adheres to cost principles some encouraging and constructive progress has been made. The proposal has liberalized the treatment accorded contributions and donations and it now specifically covers a number of cost items which do not appear in the current Section XV of ASPR. The inclusion of the latter, however, merely represents a formal recognition of costs which have been recognized as allowable in the past.

The proposal falls far short of following "generally accepted accounting principles and practices," even more so than the current Section XV. An unjustifiable disinclination on the part of the Government to share in the normal costs of doing business, from which the Government derives clear and demonstratable benefits, still pervades this draft. Most of the expenses in the unallowable categories are normal and regular costs of doing business and they, as well as those costs which can be directly allocated to a particular contract, contribute to the productive ability of any business enterprise. All of the enterprise's customers, including the Government, share in benefits which derive from a firm's productive capacity and efficiency and these benefits are no less real because they are indirect.

The failure of the proposed draft to recognize "generally accepted accounting principles" is pointedly indicated in the following respects:

(1) The draft would require the imposition of hindsight judgment of military audit personnel in reviewing the reasonableness of management decisions. The clue to this is set forth in Section 15-201.b(iii). This provision should not be made any part of a document used for cost determination.

(2) Throughout the proposed draft there is interjected a requirement that the auditor evaluate the equities of the situation, in addition to his usual function of measuring the reasonableness of the amount and the proper allocability of the item. Section XV should be limited to indicate types and amounts of cost which are or are not allowable in cost type contracts and it should not be made an audit manual for the various services.

(3) In the treatment of compensation for personal services and research and development expense, the Section arbitrarily discriminates against concontractors with more than 25% government business. If the specific cost items are reasonable in amount and properly allocated to all of the contractor's business, the cost item should be an allowable cost, regardless of the degree of government business. The proposed procedure would discriminate particularly against small business and against the individual employees of any company with more than 25% government business.

(4) In the attempt to "define, delineate and clarify cost determinations of individual items," the draft has entered into a detailed treatment which apparently is an attempt to cover peculiar circumstances of "special cases" this results in arbitrary, unilateral and artificial determinations of allowable costs which is not consistent with sound business practice and is very unfair to government contractors. These unjustified and inequitable restrictions and limitations appear throughout the draft of which the paragraph on compensation is a glaring example. It would be more logical and equitable to cover these special situations at the time of negotiation of original contract terms.

(5) In many cases the determination of allowable costs has been conditioned upon authorization by special contract provision or by written authorization of the contracting officer, which is wholly unsatisfactory and unrealistic. This would involve special negotiations on individual items which would not only be time consuming but also costly in contract negotiations.

The draft also fails to cover certain subjects contained in the present Section XV including the use of standard costs, the use of predetermined overhead rates, moving and rearrangement expenses, relocation expense, subsistence and housing of employees, commissions of bona fide sales representatives, and the cost-sharing of research projects with educational or other non-profit institutions.

In the attached report the members of our Accounting and Auditing Committee have treated each section individually, setting forth first their comment regarding the Section and suggesting where applicable a proposed revision in which deletions are indicated by strike-outs and new material indicated by underlining.

While an effort has been made to state the position of the committee and its reasoning in each section of comment, we firmly believe that it would be highly desirable to schedule a joint industry-military conference for discussion of the basic principles involved and the treatment of individual items. We strongly recommend that this be done and are prepared to send representatives to such a meeting.

Cordially,

Frank L. Fuller

Frank L. Fuller
Committee Executive/for

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

Enclosures: 10 copies

cc: All members:
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Accounting & Auditing Committee

NSIA - Accounting and Auditing Committee

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June 20, 1955

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Rear Admiral L. H. Thomas, S.C., U.S.N.
Staff Director, Purchasing & Contracting Policies Division
Office of the Assistant Secretary of Defense (S & L)
Washington 25, D. C.

Dear Admiral Thomas:

We appreciate the invitation to submit comments on proposed revisions to Part 2, Section XV, of the Armed Services Procurement Regulation. This response takes into account your original letter of April 11, 1955, and your subsequent letter of May 25 extending to June 20 the deadline for submission of industry comments on this proposed change.

General Comments

Before considering the specific provisions of this proposed revision to ASPR, we should like to discuss the revision generally with emphasis upon its total effect and upon certain broad principles of procurement which are involved in the proposed restatement of cost principles applicable to cost-reimbursement type contracts.

Resultant Improvement in Proposed Regulations

In general, the proposed revision to Part 2, Section XV, of ASPR appears to be an improvement over the present regulatory language which it is designed to amend. The proposed amendment is well written, generally clear in its language, and is to be commended for its inclusion of certain contract cost items not heretofore specifically covered in procurement regulations. Moreover, we find useful the new pattern of the regulation which includes as to each item of cost a definition, a statement as to the extent of allowability or unallowability, and a specific indication as to whether or not special contract provisions are required to make the item allowable as a contract cost.

We ask that you express our appreciation for this improvement to the government officials participating in this effort to revise and expand this section of basic procurement regulations which has a direct impact on the public interest and is therefore of the gravest concern to both industry and government. We should like to point out, however, that the proposed revision represents only a start

in the direction of a new approach to contract cost principles, and we hope that our specific suggestions will provide some bench marks for further revision prior to final publication.

Scope of Application of Proposed Contract Cost Principles

We note from your letter of April 11 the view of the Department of Defense that the provisions of DOD Instruction No. 4105.11 (which specifically cancelled permissive authority to employ ASPR cost principles as a "working guide" in the negotiation of prices under fixed price contracts) together with this proposed revision are sufficient to meet the objections of industry as to past misapplication of such cost principles to negotiated fixed price contracts. We should be inclined to agree were it not for one circumstance which, in our judgment, requires further clarification.

It is our understanding that military audit agencies continue to be guided by an internal audit instruction (Joint Letter No. 12, August 5, 1949) authorizing the application of Section XV, Cost Principles, in the preparation of advisory audit reports and the segregation of costs in accordance with the prescribed audit format. Although the publication of DOD Directive 4105.11 is an entirely appropriate step, it appears to have been addressed primarily to contracting officers and contract negotiators rather than audit personnel. Accordingly, we urge that the proposed revision of Section XV, ASPR, be expanded to include--under "scope of part"--an express prohibition against the use of cost principles laid down therein in connection with all phases of the negotiation of fixed price contracts including audit review. We recommend further that internal audit instructions of the Department of Defense be appropriately revised for the purpose of calling this prohibition to the particular attention of military auditors.

In this connection, we feel obliged to remind you of the Institute's view that, all too frequently, in establishing procurement policy the subject of audit is ignored and the procurement policy established is contravened by audit practices. Our views on this subject are spelled out in more detail on page 16 of the enclosed copy of the MAPI statement entitled, "The Government Contract--How to Use it Most Effectively in the Public Interest".

ASPR Cost Principles vs. Generally Accepted Commercial Accounting Principles

Although this proposed revision to ASPR makes frequent reference to the application of generally accepted accounting principles and, indeed, establishes such application as a standard for the determination of cost allowability, the principles proposed, as in the past, do not in fact agree with general commercial accounting practice in many important respects. Certain expenses, generally considered to be normal costs of doing business, are expressly disallowed by these cost principles.

Quite aside from the illogicality of employing as a test of cost eligibility a standard to which this whole body of cost principles does not itself adhere, we believe that this incompatibility of military contract cost principles with commercial accounting practice is frequently inequitable, uneconomic from the over-all standpoint of the government, and, in some measure at least, wholly unjustified.

15-201 Basic Principles and Standards

(b) Subsections (iii) and (iv) of this paragraph should be deleted because they tend to second-guess the contractor. In selecting a contractor the government indicates its intent to rely on the contractor's judgment and abilities. Thereafter, the allowability of costs incurred should be based on the other factors listed in subsections (i), (ii) and (v) of this paragraph.

15-202.2 Direct Labor -- This paragraph provides that the cost of direct labor includes "salaried and wages specifically identifiable with and properly chargeable to" performance of the contract. I presume the word "salaried" should be "salaries." But more important, this kind of language places too much of a burden on contractors in proving their costs because, in this instance, it establishes two standards of allowability that must be met. It should be sufficient if the item is properly chargeable to the work in accordance with proper accounting principles.

15-203 Indirect Costs

(b) The fourth sentence, beginning with "any significant change...," is unnecessary and confusing and should be deleted. It also should be made clear that selection of the most appropriate method of allocation of such costs is not left to the auditor.

15-203.1 Indirect Manufacturing and Production Expenses -- The fourth sentence of this paragraph should be reworded to read: "The contractor may departmentalize or otherwise establish cost centers in order to distribute equitably the indirect costs."

15-203.2 Indirect Engineering Expenses -- Deletion of the second sentence, first paragraph, under this heading is recommended because the specific engineering activities set forth in this paragraph are not uniformly treated as engineering activities throughout industry. In the event the sentence is retained, the words "or any other engineering activities" should be added to the end of the sentence.

15-203.3 Selling and Distribution Expenses -- This paragraph should be rewritten to recognize that minimum marketing costs related to the contractor's government business should be allowable because they often are necessary costs of doing business with the government.

15-203.4 General and Administrative Expenses -- In the second sentence, the words "provided equitable results are thereby obtained" should be deleted and the words "provided the method conforms with generally accepted accounting principles" should be substituted. The wording of the third and four sentences is not clear and might unduly

emphasize the factors listed and restrict the auditor in the exercise of his judgment. Therefore, it is recommended that they be deleted.

15-203.5 Base Period for Allocation of Indirect Expenses -- This paragraph should be revised to recognize the base period employed by the contractor's accounting system. The general criterion should be whether or not the period employed, when combined with the method of allocation, is equitable to both parties.

15-204.1 Advertising -- Although advertising expenses may not be directly related in every instance to a particular government contract, it is quite probable that the government nevertheless may be the beneficiary of lower costs of production which are made possible by the volume of business the contractor obtains by means of his advertising. In several instances, the proposed revisions recognize the principle that certain indirect costs required to keep the business of a company going are allocable to government contracts. Therefore, it is strongly recommended that institutional advertising expenses -- designed to promote the name of a company rather than one of its products -- be considered a reimburseable item, on an allocated basis. It also is recommended that there be added to the two types of allowable advertising costs: (1) Invitations for submitting bid proposals by prospective subcontractors and vendors, and (2) Community advertising placed with local media primarily to stimulate production and to promote employer-employee and employer-community relations.

15-204.3 Bidding Expenses -- It is conceivable that a question may arise relative to allowable costs incurred in connection with the presentation of bid information. It therefore is felt that insertion of the words "and presenting" after the word "preparing" in the first sentence and after the word "development" in the same sentence will clarify the intent of this paragraph. There also is need for clarification of the prohibition, in the second sentence, on charging past bidding expenses by allocation. In almost every instance, bidding expense would be incurred prior to the period chargeable to the government contract. Under the circumstances, this prohibition in effect denies the recovery of bidding expense except as additional bidding expense on future contracts might be incurred during the accounting period chargeable to the government contract. We also wonder whether it was intended that bidding expense be allocated to "all business of the contract," as the revised Section XV states, or whether it should be "all bid business of the contractor."

15-204.5 Civil Defense -- The last sentence of this subsection should be deleted. Because of the changing situation in civil defense, it is possible and even probable that a contractor may be placed in the position of having to cooperate with local government authorities by contributing substantially to some local civil defense project for the good of the community. Such an expense should be an allowable item of cost even though it may not be specifically provided for in the contract.

15-204.6 Compensation for Personal Services --The major shortcoming of this detailed and somewhat confusing portion of the Section XV revisions is its reflection of the unsound principle that compensation for personal services, whether immediate or deferred and whether in cash, stock or other property, should be limited by any arbitrary criteria such as a percentage of base compensation or the extent of a contractor's government business. Use of either yardstick not only is arbitrary but discriminatory. The only proper criterion should be that established by the federal tax laws and general business practice, namely, that the compensation be reasonable, under all the circumstances, for the personal services actually rendered. We therefore recommend deletion of sub-paragraph (3) (e) in its entirety.

We also recommend deletion of sub-section (c) on Page 1509, which would disallow, as an item of cost, the cost of options to purchase stock of the contractor corporation. The Board of Contract Appeals has ruled that these costs are allowable. Furthermore, many companies have found that programs of this type give an employee the feeling of working for himself, a stockholder, and thereby encourage continuity of employment which, in turn is reflected in lower production costs to customers -- including the government.

A third objectionable feature of Paragraph 204.6 is the failure to recognize, for cost determination purposes, the carryover features of the Internal Revenue Code. (Sub-section 2-ii, Page 1510.)

15-204.8 Contributions and Donations -- Insert comma after "charitable."

15-204.9 Depreciation -- The major deficiency of this portion of Section XV -- the failure to take into account the new Internal Revenue Code provisions regarding the manner of charging depreciation -- was offset, in part, by the May 12 Defense Department announcement of an interim cost interpretation paragraph (15-602) that embodied the rapid write-off privileges of the Code. It is essential that paragraphs 15-204.9 and 15-602 be consolidated prior to publication of the final revisions to Part 2, Section XV.

15-204.10 Employee Morale, Health and Welfare -- The language of this paragraph may be subject to a restricted interpretation by government administrative and audit personnel because of the very limited number of examples that are cited in the second sentence. Among the many others that could be cited are bond purchasing plans, length-of-service awards, athletic and recreational programs, housing advisory service and other employee counseling services.

15-204.15 Initial Production Costs -- The second sentence of paragraph two under this heading should be deleted. In view of the fact that paragraph 15-201b states that all costs must be reasonable, the statement that certain costs will be subject to disallowance if theycontinue "to an unwarranted extent" would appear to invite controversy -- particularly when there is no definition of "unwarranted."

15-204.16 Insurance Indemnification -- This entire section implies that allowance of costs will be predicated very largely upon prior approval by the government of insurance coverage. Such prior approval is impractical to obtain during contract negotiations. The insurance coverage dictated by common business prudence and in effect at the time of undertaking a contract is a normal business expense and should be allowed in full.

(b) There is need for clarification of what "government required" means in this subsection. Does this mean required by law, by an agency or department of government, by a contracting officer, or does the term embrace all of these? Another provision of this subsection says the costs of government required insurance are allowable within the limitations of "premium rates approved by the government." In view of our national policy that the regulation of insurance rates is a state function, this provision seems to be inconsistent with that policy. Still another provision of this subsection says costs allowed for use and occupancy insurance will, in principle, be limited so as to exclude coverage of profit, interest, federal income taxes and any other items of expense unallowable under this part of the Regulations. This is a completely impractical prohibition because there is no practical way of determining how much of the cost of such insurance is attributable to coverage of profit and interest.

(c) This subsection should be revised to recognize that there may be instances where a contractor who is obligated to deliver under the terms of a contract would find himself in a position where insurance on government-owned property under his management would be essential to his own protection -- regardless of whether it is required by the government.

(f) Use of the word "contingent" in this subsection could invite misinterpretation. It is a basic principle of insurance that it protects against contingent losses.

(g) "Indemnification", as used in the title of this paragraph and in this subsection, should be defined or deleted.

15-204.22 Materials and Supplies

(a) At the end of this subsection, add the following sentence: "In computing materials costs, consideration will be given to reasonable overruns, spoilage and defective work."

(b) Combine the second and third sentences by replacing the period after the word "allowances" with a comma. The reference to lost discounts in the final sentence of this subsection is too strict and should be modified to provde that the contractor will be excused for failure to take cash discounts unless he has failed to have an adequate system for processing invoices subject to discount or unless the discount was lost due to negligence on the part of the contractor in hiring or retaining inefficient employees.

(e) The flat disallowance of "write-downs" of values, as stated in this subsection, is inequitable because it is an accepted accounting practice to recognize that due to technological advances, engineering changes, defects, shelf-wear, etc., 100 percent utilization of stock inventories seldom with be realized.

(f) The first sentence of this subsection should be modified to permit the inclusion of "handling and purchasing costs."

15-204.27 PENSION AND RETIREMENT PLANS

(a) The fourth sentence of this subsection is inconsistent with the current Treasury Department position and requires explanation.

(b) The requirement in this subsection that the military pass upon the allowability of all pension plans prior to contract finalization is impractical. It should be modified to restrict military consideration of plans already approved by the Internal Revenue Service to "consideration of cost and allocability."

(c) The second sentence of this subsection should be deleted for the same reason deletion of paragraph 15-204.6e was recommended. Both would discriminate against companies with government business in excess of 25% of their total volume of business.

(d) This subsection should be modified to require compliance with the carryover provisions of the Internal Revenue Code with respect to pension and retirement cost determinations.

15-204.28 Plant Protection Expenses -- This paragraph should be revised further to recognize a third class of plant protection expenses that should be allowable -- the costs of clearing personnel to handle classified work, the acquisition of special cabinets and safes for storage purposes, etc., as required by many defense contracts.

15-204.29 Pre-Contract Costs -- The first and last sentences of this subsection appear to be contradictory. They should be revised further to make it clear that such costs will be allowed when authority therefor is specifically set forth in the contract.

15-204.31 Profits and Losses on Disposition of Plant Equipment or Other Capital Assets -- The flat exclusion of such profits and losses cannot be justified. This subsection should be modified to exclude them from contract costs -- except to the extent that such gains or losses adjust depreciation on assets acquired for government business.

15-204.32 Reconversion Expenses -- This subsection limits the allowable costs to those related to the removal of government property and then only if specifically provided for in the contract. It should be modified to recognize that most expenditures of this type are not made until well after completion of the government work which occasioned them. It also should permit accruals based on estimates and subject to adjustment at a later date.

15-204.35 Research and Development

General Research -- This subsection should be revised further to eliminate the stipulation that a contractor must agree to divulge to the government the results of any independent general research before the costs of such research can be considered a reimburseable item. The government should be entitled to such information only insofar as such research is applicable to the contract involved. Further revision of this subsection also is necessary to delete the stipulation that such expenses shall not be allowable for companies with more than 25% government business -- unless specifically authorized in the contract.

Related Research -- The last sentence of this subsection of Paragraph 15-204.35 should be revised further to specify that no portion of such research will be allowable under cost type research and development contracts "unless specifically provided for in the contract."

Subsection (c) of this paragraph also should be revised further to specify that research and development costs incurred in accounting periods prior to the award of a contract will be allowed "only to the extent specifically authorized by the contract."

Sincerely yours,

Theron J. Rice

Theron J. Rice, Manager
National Defense Department

2003/2329

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.

GENERAL COMMENTS

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.

15-204.35 - 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).

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.

RADIO-ELECTRONICS-TELEVISION MANUFACTURERS ASSOCIATION

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NATIONAL 8-3902

June 20, 1955

Rear Admiral L. H. Thomas, SC, USN
Staff Director
Purchasing & Contracting
Policies Division
Office of the Assistant Secretary
of Defense
Washington 25, D. C.

Dear Admiral Thomas:

I refer to your letter of April 11 forwarding to us for consideration and comment a copy of the proposed revision to Part 2, Section XV, of the Armed Service Procurement Regulation.

Owing to the deep and abiding interest of the electronics industry in the cost principles applicable to government contracts, this Association has devoted intensive and time-consuming study to the terms of the proposed revision. The Association is thoroughly in accord with your objective to include more equitable coverage of some cost items incurred by contractors, and to clarify cost determination under the Section to promote uniformity in its application. Our Committee feels that the proposed revision appears to have achieved this objective in part. In some cases, however, we discovered in the proposed revision certain omissions from the existing regulation which are not easily explainable and which are therefore likely to cause misunderstanding and confusion in the future. In other cases, we thought the revision went into such detail as to make it partake of a check-off list that will tend to crystallize lower echelon thinking to the exclusion of equally valid alternatives. Our detailed comments follow:

15-200 SCOPE OF PART

We recommend that this opening paragraph be amplified to make it

6.85

clear that the entire section has no application to other than cost-type contracts. We are aware that a policy to this effect was enunciated in Department of Defense Instruction #4105. Nevertheless, since this Instruction is an internal directive of the Department of Defense cancelling an earlier Munitions Board Instruction it seems to us too informal and temporary an expedient to establish firm and unequivocal policy for the entire procurement establishments of the three military services. We accordingly recommend that language be inserted in the opening paragraph of Part 2 of the Section making it unmistakably clear that the Section only applies to cost-type contracts.

We also recommend that the former wording of 15-101 excluding Section XV for use in negotiating pre-determined overhead rates, except as a guide, be added to 15-200.

15-201 BASIC PRINCIPLES AND STANDARDS

a. No comment.

b. We recommend deletion of (iii). The present language endows the cost inspector with authority outside the scope of his proper functions and well beyond his experience and capacity. If retained in the regulation it will stimulate unnecessary interference in management decisions.

c. and d. No comment.

General: We also recommend that somewhere in 15-201 be included the same language on the use of normal or standard costs for determining provisional or interim payments as is contained in the present 15-201. Some of our member companies are apprehensive that non-inclusion of the present provisions will jeopardize the continuation of their present use.

15-202 DIRECT COSTS

In the next to last sentence after the word, "consistently" we

recommend that the following language be inserted: "...within each separate unit engaged in mixed production". This change should take care of large companies with several operating divisions which are engaged in the manufacture of different product lines and possess virtual operating autonomy.

15-202.1 DIRECT MATERIALS

We prefer the language of the present section 202.1. Our Committee considered that the advantages gained by the greater brevity of the revised 202.1 were more than offset by the comprehensive detail and clear-cut provision for overruns, spoilage, etc., set forth in the existing regulation.

15-202.2 DIRECT LABOR

We urge inclusion of language making provision for the use of average labor rates under appropriate circumstances.

15-202.3 OTHER DIRECT COSTS

In the last sentence, line 3, change the word "similar" to "the same". Our Committee felt that the word "similar" was too vague and speculative, and vested too much discretion in the cost inspector to make unauthorized cost deletions.

15-203 INDIRECT COSTS

(a) No comment.

(b) We recommend deletion of the last two sentences of (b). The enumeration of specific changes seems to our Committee to be an unnecessary amplification, carrying with it the danger that it will be used as a check-off list by the cost inspector.

15-203.1 INDIRECT MANUFACTURING AND PRODUCTION EXPENSES

In the first sentence of 203.1 change the words "necessary to" to "incurred in". The present language is unnecessarily broad and subject to conflicting interpretations by the Government and the Contractor.

At the beginning of the third sentence add the words "Examples of" to make it clear that the items are inclusive but not limited thereto.

15-203.2 INDIRECT ENGINEERING EXPENSES

At the end of the first sentence add "...and such other related costs as the contractor consistently charges to overhead". Our Committee felt that the first sentence as written failed to take into account other legitimate costs habitually charged to engineering overhead under reputable accounting methods.

15-203.3 SELLING AND DISTRIBUTION EXPENSES

The proposed revision restates the hoary and fallacious concept that selling to the Government involves no marketing expense on the part of the contractor. Our Committee strongly considers that this fiction has outlived its usefulness; it is time for the government to recognize that a variety of perfectly legitimate selling expenses are incurred by every reputable contractor who sells his products to the Government. This is especially true of the more established suppliers of military equipment who must of necessity maintain close and effective liaison with the purchaser. Although marketing in the ordinary commerical sense is certainly not necessary for doing business with the government, the proposed language fails to recognize any form of non-commercial marketing expenses. We, therefore, recommend that the paragraph as presently written be changed as follows:

First, change the second sentence to read, "There may be an allocation to government work of those expenses in this category including but not limited to, administrative, technical, consulting and other services, which are for the purpose of negotiating, administering and servicing government contracts".

Second, delete the rest of the paragraph.

15-203.4 GENERAL AND ADMINISTRATIVE EXPENSES

We recommend that everything in this paragraph after the second sentence be deleted. There are innumerable other factors which should

receive consideration in determining the equitability of G and A. Different large companies use different methods and smaller companies may make entirely different allocations. Moreover, cost patterns, inventory variations and establishment of theoretical ratios may have little or no relevancy to the practices of companies which do both commercial and military business or which are new to the government contract field.

15-203.5 BASE PERIOD FOR ALLOCATION OF INDIRECT EXPENSES

As presently written this paragraph seems to presuppose that each contractor has only one government contract. What happens if a contractor has half a dozen contracts of different types, extending for different base periods? We believe the entire paragraph should be deleted since the matter appears to be adequately covered in Paragraph 15-203(b).

15-204 APPLICATIONS OF BASIC COST PRINCIPLES AND STANDARDS TO SELECTED ITEMS OF COST.

In the next to last sentence we recommend that you strike everything after the word "Standards". Our Committee felt that to include similar or related items would broaden the treatment to the point of complete uncertainty.

We also recommend that the words "This paragraph and ..." precede the last sentence for the sake of complete clarity.

15-204.1 ADVERTISING

We recommend that a subparagraph (3) be inserted to cover institutional advertising. Such advertising does not offer the product for sale commercially and may not appear exclusively in trade and technical journals. We also recommend that the word "only" be deleted from (a).

15-204.2 BAD DEBTS

No comment.

15-204.3 BIDDING EXPENSE

We recommend that in the second sentence the words "all business" be changed to "the applicable business". In the case of companies doing both commercial and government business it is sometimes customary to exclude certain expenses solely incurred for one type of business from the accounts of the other. This works both to the advantage of the government and the contractor.

15-204.4 CAFETERIAS, DINING ROOMS AND OTHER FOOD SERVICES

It should be recognized that the sale of inexpensively priced lunches to employees in a company dining room or cafeteria has become standard operating practice for all large companies and most small ones; it is a form of fringe benefit which employees expect. We, therefore, see no reason why it should be singled out for special and discriminatory treatment, especially since food services of this kind are by their very nature almost immune from any possible misallocation or abuse. We, therefore, recommend that in the third sentence everything after the word "allowable" be stricken and the sentence ended with a period; we also request that the entire last sentence of the paragraph be deleted.

15-204.5 CIVIL DEFENSE

We recommend that the words "on the contractor's premises pursuant to suggestions or requirements of civil defense authorities..." in the third sentence be deleted. In the atomic age shelters and other civil defense measures are not necessarily located on the contractor's premises.

The last sentence of the paragraph should also be deleted as it fails to make into account supervening circumstances and the overriding

authority of local, civil and federal authorities to require different kinds of civil defense measures and financial contributions.

15-204.6 COMPENSATION FOR PERSONAL SERVICES

a. In the first sentence add after "includes" the following: "...all renumeration paid or set aside such as". Also insert the word "incentive and" before "deferred compensation, etc." The sentence as presently written fails to take into account reserve funds set aside for salaries, wages and bonuses.

b. In the third line it seems probable that the drafter meant corporate "officers", not "officials"; we are also uncertain what is meant by "executives".

We recommend deletion of (iii) as being absolutely speculative and not relatable to any known standard or criterion. Some companies with little or no government business pay their executives far more than do other companies with a preponderant government business, (Viz. the chemical industry vs. the electronics industry): small companies in the non-defense category often pay more than large companies in the defense one, and vice-versa. Has anyone in the Defense Department made a study of executive compensation in different industries? Have they read the recent articles in the Harvard Business Review on the subject?

c. Delete the word "not" and make reasonableness the test, as it is anyway throughout this section.

d. In the first line delete the word "production". Some officers and employees perform services which may not fall exactly within the production category yet which are of inestimable importance to the company.

(1) Insert the words "or practice adopted or" in the third line after "established plan". This will take care of smaller companies

which have a practice of paying bonuses rather than an established plan, and will also permit the establishment of such a plan or practice by a growing company.

(2) Add "...when considered in light of total compensation" to end of sentence. Overall compensation should be the test rather than any one component thereof.

(3) No comment.

(4) We recommend that everything after the words "salary classification" be deleted. The reason for this recommendation is that many small companies have management incentive plans which might be considered unreasonably restricted for purpose of this paragraph. The government has other safeguards here which can be availed of to guard against abuse.

(5) No comment.

(6) Insert "stockholders" after "officer" to make it clear that officer stockholders is the group aimed at.

(7) We recommend deletion of this sentence as being redundant.

e.

(1) No comment.

(2) Delete: "Except as provided in (3) below." Explanation follows:

(i) No comment.

(ii) We suggest deletion of everything in e. after the first sentence. Our Committee feels that any plan approved by the Internal Revenue Service must be acceptable to the military department for accounting and cost allocation purposes or hopeless confusion will result.

(3) We request deletion of this paragraph in its entirety. Our committee considers that the 75% test in 3 (i) is absolutely

unrealistic and has no relevance to the merit or lack of merit of any particular profit-sharing plan; it would be wholly inequitable during any emergency when the ratio of government business to commerical business may suddenly increase since it penalizes the patriotic supplier. Furthermore, there is no criterion for establishing what is meant by government business; does the term mean current sales only, or does it include back-log?

(NOTE: The Defense Department amendment of May 25 arrived after our Committee met to consider the revision. While we cannot say with certainty how the Committee would react to the amendment we believe it would still be objectionable for the same reasons as stated above, since the principle remains unaltered.)

f.

(1) through (4). No comment.

g. We recommend that this subparagraph be rewritten as follows: "For the purpose of determining reasonableness, the employer contribution under profit sharing plans and stock bonus plans shall be subject to the same provisions as provided for in the Internal Revenue Code". The same standards prescribed by the Internal Revenue Services for employer contributions must be accepted by the military services or absolute chaos will result.

h. No comment.

15-204.7 CONTINGENCIES

We think the first sentence could be better expressed as follows: "This type of charge is allowable only if it results from the creation and maintenance of reserves to provide for events whose occurrence can be reasonably foretold with respect to time and intensity". Our Committee felt that the sentence should be rephrased in the positive, but without any reference to assurance of an event happening, which removes it from the category of a contingency.

15-204.8 CONTRIBUTIONS AND DONATIONS

We suggest that a comma be inserted after "charitable" in the

second line.

15-204.9 DEPRECIATION

a. No comment.

b. Our Committee noted that for some time the "declining balance" and other methods of establishing depreciation have been recognized by the provisions of the Internal Revenue Code. To make it clear that where such recognition exists the military services should likewise accord recognition we recommend that the words "...including those methods recognized by the Internal Revenue Code (subject to the limitations set forth in subparagraph e. below)" be inserted after "accounting principles" in line 5, second sentence.

c. We recommend that this paragraph be revised to give positive authorization for depreciation charges as follows: "c. Charges for depreciation on idle or excess facilities will normally be allowed on such facilities as are reasonably necessary for standby purposes". In companies producing both commercial and military type equipment it would be difficult to show that a standby facility is exclusively for one or the other. In actual fact they are for both - and would be so used, depending on the degree of national mobilization.

d. We recommend that the following language be added to the end of the paragraph"...except that depreciation may continue to be charged until such time as the unrecognized depreciation has been absorbed".

e. We recommend that the second sentence of this paragraph be revised as follows: "After the expiration of the emergency period for the facilities concerned, where a determination of "true depreciation" has been made, the remaining balance of the cost of such facility over the amount of "true depreciation" recognized previously in costs will be recognized as allowable, subject to paragraph 15-204.12". This will take care of depreciation requirements over and above accelerated

amortization.

15-204.10 EMPLOYEE MORALE, HEALTH AND WELFARE

No comment.

15-204.11 ENTERTAINMENT EXPENSE

We request that the words "except in reasonable amounts and when related to necessary business meetings" be added at the end of the second sentence.

15-204.12 EXCESS FACILITIES

We recommend that the words "contract performance" be deleted from line 3 of the first sentence. This will make the paragraph conform to the wording of 204.9 c.

15-204.13 FINES AND PENALTIES

No comment.

15-204.14 FRINGE BENEFITS

No comment.

15-204.15 INITIAL PRODUCTION COSTS

We request deletion of the last sentence of the second paragraph. In the constantly advancing state of the military electronics art, what qualification does the cost inspector possess to decide whether the contractor has had reasonable time to make the product efficiently? If the Government is dissatisfied it should terminate the contract -- not disallow costs incurred in good faith during the course of performance.

15-204.16 INSURANCE INDEMNIFICATION

a. No comment.

b. We recommend that b. be rewritten as follows: "Costs of Government required insurance are allowable. Costs of other insurance, except that applicable to Government-owned property, are allowable provided

(1) the insurance has been approved by the military department concerned pursuant to a contractual requirement, or (2) in the absence of such approval requirement, the types of coverage, extent of coverage and rates are reasonable under the circumstances. Costs allowed for use and occupancy insurance will be allowable except coverage relating to profit, interest, federal income taxes, and any other items of expense unallowable under this part".

c., d., and e. No comment.

f. We suggest that mention be made of the interrelation of this subparagraph to related provisions in ASPR VII.

g. We request that "if" be substituted for "only to the extent expressly".

15-204.17 INTEREST AND OTHER FINANCIAL EXPENSES

RETMA has a continuing interest in obtaining recognition from the Defense Department and the General Accounting Office of the allowability of certain kinds of interest, especially when the contractor has relied on his own efforts in financing his performance of Government contracts. A memorandum on this subject is in process of preparation and will be submitted to the Assistance Secretary of Defense (Comptroller) within the next few weeks.

In any event, we consider it essential that this paragraph as finally written be absolutely consistent in form and content with existing Defense Department contract financing policies, especially on progress payments and Defense loans. The interest problem is so interrelated with contract financing that no policy for one should be adopted that is inconsistent with the other.

15-204.18 LABOR RELATIONS

No comment.

15-204.19 LOSSES ON OTHER CONTRACTS

This paragraph is inconsistent with the Court of Claims decision in Bell Aircraft Corp., v. United States, 100 F. Supp. 661 (Ct. Cls. 1051) aff'd per curiam, 344 U.S. 860 (1952), where a Government contractor was allowed to capitalize losses on experimental contracts and allocate them as costs to other Government contracts. We suggest that the paragraph be rewritten to permit allowability of such losses whenever permitted by sound accounting practices.

15-204.20 MAINTENANCE AND REPAIRS

a. No comment.

b. No comment.

15-204.21 MANUFACTURING AND PRODUCTION ENGINEERING

We request that the words "provided such division results in an equitable distribution, Viz.," be inserted immediately before (i) and at the end of the preceding sentence.

15-204.22 MATERIALS AND SUPPLIES

a. No comment.

b. We request that this subparagraph be changed to read as follows: "Cost of materials and supplies shall be suitably adjusted for applicable portions of income and other credits. Such income and other credits include trade discounts, refunds, rebates and allowances, cash discounts taken (to the extent that such discounts are in excess of interest paid) and credits for scrap, salvage and materials returned to vendors."

c. No comment.

d. Insert the words "or regularly manufactured and sold by the contractor through commercial channels" after "stock" in the first line.

e. In the view of our members, flat disallowance of "write-down" of values of inventories is not equitable. 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 original cost. Where the contractor can demonstrate that the methods used to reduce the values of inventories are logical, and have been applied consistently, and that prudence was exercised in acquiring the stocks involved, such inventory valuations should be allowed to the extent allocable to Government Business.

f. We suggest insertion of "non-affiliated" before "customer" in line 7; some company divisions purchase from each other at special prices.

15-204.23 ORGANIZATION EXPENSES

No comment.

15-204.24 OTHER BUSINESS EXPENSES

No comment.

15-204.25 OVERTIME, EXTRA PAY SHIFT AND MULTI-SHIFT PREMIUMS

The paragraph as presently written shows a tendency to consider shift premiums as out of the ordinary and not to be authorized without special permission. In actual fact multi-shift operations, and premium pay for unpopular shifts, is standard operating procedure for many companies; provision is often made for them in union contracts. We recommend that a little (a) precede the paragraph as now written; that all mention of shift payments and shift premiums be deleted therefrom; and that a new subparagraph (b) be added to read as follows: "Shift premiums in accordance with the contractors' practices and procedures are allowable".

In addition, our Committee noted several deficiencies in the provisions for overtime. We feel that all indirect labor (i.e., janitors, plant maintenance staff, administrative and service personnel, etc.) should be permitted necessary overtime without special authorization. Emergency overtime for direct labor should be permitted without written authorization. The contractor should not have to run the risk of cost disallowances whenever he makes arrangements for necessary overtime without a written chit from the contracting officer. Provision should also be made for predetermined overhead rates.

15-204.26 PATENT EXPENSES

We request that the next to last sentence commence with "Charges ...", deleting "all other patent expenses..." The present wording disallows an unspecified category of costs.

15-204.27 PENSION AND RETIREMENT PLANS

a. We recommend that the fourth and fifth sentences be deleted. They presuppose that legitimate pension plans are not conditioned on profits. In many cases they are, especially in smaller companies; sometimes corporate by-laws suspend payments into the pension fund during bad years and authorize the deficiency to be made up in profitable years.

b. Strike everything after "Military Department" in the first sentence. No consideration seems to have been given to the potential chaos created by allowing one branch of the Government to disallow what another has approved. An IRS approved plan should always be acceptable to the military services. We also request that the present second and third sentences be deleted and the following new second sentence be inserted after "Military Departments": "Consideration of the plans by the Military Department will be limited to consideration of cost and allocability thereof and will be the responsibility of the Department to which audit cognizance will be assigned".

c. We request that the first sentence be changed to read, "The cost of pension and retirement plans approved by the Internal Revenue Service are allowable except as otherwise determined to be unallowable under this paragraph". The rest of the subparagraph may stand.

d. No comment.

e. We request that the last sentence of this paragraph e. be deleted. It conflicts with the contractor's arrangements under the

Internal Revenue Code and penalizes government contractors in relation to their commercial competitors.

f. In the second sentence we suggest substitution of the words "may be" for "is usually" before "necessary"; there is no hard and fast rule in such cases. Also, immediately after the end of the second sentence we request the insertion of a new sentence to read as follows: "Where the contractor can demonstrate that reasonable provision has been made for the effect of such reversionary credits in his method of determining pension contributions, no special provision for these credits is required". The beginning of the succeeding sentence should then be changed from "Under these circumstances..." to "Otherwise..."

We further recommend that the last sentence of f. and the succeeding subparagraphs (1) and (2) be deleted in their entirety. They spell out in detail two or three of a great many methods of making such arrangements and will tend to crystallize lower echelon thinking and make them suspicious of equally legitimate but different procedures.

g. Change the last two lines to read as follows: "...pension and retirement plans will be considered on an individual case basis and are allowable subject to the usual tests of reasonableness and allocability."

15-204.28 PLANT PROTECTION EXPENSES

Our Committee was uncertain whether this paragraph applied solely to the physicalprotection of plants and facilities or embraced the whole spectrum of industrial security. There was a general feeling that as presently written only relatively minor expenditures appeared to be covered; the paragraph is silent on such major cost items as security clearances, automatic detection devices, accommodations for

classified documents, etc. Yet there is nowhere else in ASPR XV where the latter items logically fit.

15-204.29 PRECONTRACT COSTS

We request that the last sentence be rewritten as follows: "Such costs will be allowed when authority therefor is specifically set forth in the contract and may be limited to a period of time".

15-204.30 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER

Our Committee felt that the scope and extent of Government regulations, the changing requirements of contract clauses, and shifting Government interpretation of such clauses make it necessary that the contractor avail himself of professional assistance. Whether such assistance is separately engaged or comes from the contractor's staff should be irrelevant. Nor should past cost patterns, impact of Government business, etc., be determing factors in judging allowability. We suggest that subparagraph a. be rewritten as follows:

"a. This item includes the cost of professional services rendered by the members of the particular profession, either as part of the contractor's organization or separately engaged. These costs are allowable when reasonable and should be allocated in accordance with the principles set forth in 15-201."

b. We suggest that b. be deleted in its entirety as unnecessary amplification tending to crystallize lower echelon thinking to the exclusion of other legitimate alternatives.

c. We request that the word "unsuccessful" be inserted before "defense" and "prosecution" in line 4.

15-204.31 PROFITS AND LOSSES, etc.

We concur with the present wording but suggest the addition of the following to the last sentence; "...except to the extent that such gains or losses adjust depreciation on assets acquired for

Government business, or unless specifically provided for in the contract.

15-204.32 RECONVERSION EXPENSES

Our Committee felt that this paragraph should be rewritten to permit certain kinds of reconversion expenses, such as restoration of facilities to pre-Defense work condition, whenever substantial changes in plant and facilities have been effected at Government behest or pursuant to the specialized requirements of defense production.

15-204.33 RECRUITING EXPENSE

No comment.

15-204.34 RENTALS OF PLANT AND EQUIPMENT

We recommend deletion of subparagraph b. and correction of subparagraph a. by insertion of the words "and (ii)" between "...under (i)" and "above..." in the first line.

15-204.35 RESEARCH AND DEVELOPMENT

a. No Comment.

b. (1) We recommend deletion of (iii) on the ground that it is an exorbitant and overreaching demand on the part of the government. We also request deletion of (iv) for the same reasons as set forth earlier under 204.6e (3), to-wit: no logical basis for differentiating between customers over and under 75%; no logical basis for the 75% figure in the first place; and no criterion in the regulation for determining what constitutes Government business, e.g. current sales, sales plus backlog, or past history of Government business.

It seems to us that the last sentence of (1), relating to predetermined overhead rates, should also be deleted; it is merely another cost item and is adequately covered elsewhere.

(2) We request revision of the second sentence of (2) by insertion of the words "and development" between "...reimbursed to a contractor)" and "may, if allocated..." on line 7; we also request substitution of the word "related" for "all" later in the same line, and deletion of "production" in the following line. We recommend deletion of the last sentence of this subparagraph since there is no valid reason why under certain circumstances and in some fields of application part of related research costs should not be allocated to R and D contracts.

We request deletion of all of c. Under certain circumstances capitalized development costs and a pro-rata share of patent costs should be allowable.

15-204.36 ROYALTY PAYMENTS

The words "or proprietory or technical information" should be inserted after "patents" at the end of the first sentence, and after "patent (s)" in lines 1 and 3 of the second sentence. We request that the second sentence end after "allowable" on line 3.

15-204.37 SERVICE AND WARRANTY EXPENSES

We request that consideration be given to including in this Section a clause which would give the contractor the right to include these expenses as an allowable cost where it has been the contractor's practice to include these expenses in the normal course of business.

15-204.38 SEVERANCE PAY

Our Committee felt that the paragraph as presently written could have inequitable results. It should be rewritten to provide for allowability on either an actual or an accrual basis.

15-204.39 SPECIAL TOOLING

We recommend that the entire paragraph be deleted and in lieu thereof a simple statement be inserted to the effect that special tooling is allowable subject to the terms and conditions prescribed for its

acquisition in Section XIII of ASPR.

15-204.40 TAXES

No comment.

15-204.41 TRADE, BUSINESS AND PROFESSIONAL ACTIVITIES

No comment.

15-204.42 TRAINING EXPENSES

We request that sub-paragraph c. of this paragraph be deleted in its entirety; there is no valid reason for differentiating between costs of on-the-job-training and training in educational institutions since the expense of the former may be as great or greater than the latter.

We suggest that a. and b. be combined into one paragraph, the latter being added as a last sentence to the former with the words "which are limited to on the job training" deleted.

We also suggest deletion of "director of " and "and" in line 3 of the first sentence; the term "training staff" should include its head or heads.

15-204.43 TRANSPORTATION EXPENSES

No comment.

15-204.44 TRAVEL EXPENSES

We recommend deletion of d. There is no definition of "premium" transportation in the regulation, and the term is generally unknown in industry. Companies are entitled to have their personnel travel by whatever means they see fit.

The foregoing concludes our comments on the proposed revision of Part 2, ASPR XV. We urge that these comments, together with those of the other industry groups and associations consulted be carefully studied before any final revision of the regulation is attempted. The cost principles applicable to Government contracts touch every aspect

of the contractor's performance; stringent or unrealistic requirements can play havoc with a contractor's internal accounting system and with his ability to competently perform.

Very truly yours,

E. E. McClaran, (per C.M.P.)

E. E. McClaran
Controller,
Eitel-McCullough, Inc.

Chairman, RETMA
Accounting and Cost Principles
Task Committee

Chamber of Commerce of the United States

1615 H STREET, N.W. • WASHINGTON 6, D.C.
NAtional 8-2380

June 17, 1955

Rear Admiral L. H. Thomas, USN
Staff Director
Purchasing and Contracting Policies Division
Department of Defense
The Pentagon
Washington 25, D. C.

Dear Admiral Thomas:

The Chamber of Commerce of the United States appreciates the opportunity to submit its comments and recommendations regarding the proposed revisions to Part II, Section XV, of the Armed Services Procurement Regulations, which prescribes a set of administrative cost principles that are applicable to cost-reimbursement type contracts.

In view of the fact that cost-reimbursement type contracts now account for approximately one-fourth of all defense procurement, we regard this ASPR revision as one of the most important since the Armed Services Procurement Act was enacted eight years ago.

And despite the recent directive that these cost principles no longer may be used as a working guide by contracting officers in the negotiation of prices under fixed-price contracts, it is inevitable that they will have some influence on such negotiations.

Copies of your April 11 letter and enclosure were sent by us to the more than 100 members of our Committees on National Defense and Taxation and our Manufacture Department Committee. In addition, we solicited the recommendations of our Insurance and Domestic Distribution Departments on provisions of particular interest to them. Comments also were received from some of our trade association members. All of these expressions of opinion were evaluated against the background of our policy declarations on Defense Procurement.

Time did not permit the reproduction and distribution of your May 25 letter, in which you extended the deadline for submission of our Section XV comments and requested that such comments cover further revisions to paragraph 15-204.6e. However, our comments will cover these changes, as well as those which accompanied your April 11 letter.

General Comments

Despite certain deficiencies of a rather serious nature, the proposed revisions to Section XV represent, on the whole, a step for-

ward in the administration of government contracts. For example they:

1. Are written in a business rather than legal language and are much more detailed than are the present Cost Principles.

2. Reflect belated acceptance of many modern business practices.

3. Provide for a more realistic allowance of certain cost items.

4. Permit inclusion of many additional elements of cost that are not now allowed.

On the other hand, the proposed provisions:

1. Leave too much latitude for administrative determination. For example, the introduction of phrases such as: "as are reasonably necessary" leaves much to be determined by government auditors who, in the past, frequently have not demonstrated a willingness to accept certain normal and proper business practices and procedures.

2. Perpetuate unwarrented distinctions between the principles governing government contract accounting and those governing tax and general corporate accounting.

3. Continue to disallow certain elements of cost which are an inherent part of doing business, and would disallow several important categories of expenditures which, under present regulations and rulings by the Board of Contract Appeals, are acceptable as items of reimburseable cost.

4. Discriminate against business concerns whose government business is in excess of 25% of its total volume. A cost that is allowable for a contractor with less than 25% government business should be just as allowable for contractors doing a higher percentage of government business.

5. Include a number of blanket stipulations that should be matters for consideration in specific contract negotiations.

Specific Comments and Recommendations

The Chamber's comments and recommendations on specific provisions of the proposed revisions to Section XV are as follows:

15-200 Scope of Part -- This paragraph should be amplified to state that this part of Section XV does not apply to fixed-price type contracts, including price redetermination and incentive types, and that where contracts provide for predetermined overhead rates the principles set forth shall be used only as a basis for negotiating such rates.

Items for special consideration.--There are a number of cost items which the proposed revision of Section XV, ASPR, continues to disallow, not only in contravention of normally accepted commercial accounting principles, but in seeming violation of the proposed revision's own general standard of reasonableness in determining the allowability of contract cost. We refer specifically to advertising, general selling and distribution expenses, and entertainment expenses.

Although we shall have more to say on each of these subjects in our specific recommendations which follow, we should like to register our general view that the allowance of such costs should be made a matter of special negotiation, dependent upon the individual circumstances of each case. In general, these expenses are customary costs of doing business and are expecially related to the continuing growth and vigor of a business enterprise and as such contribute materially to the whole of a company's productive potential. Although not perhaps directly allocable to any government contract work, the government may nevertheless be the beneficiary of substantially lower productive costs made possible by the volume and scale of operations the contractor has attained through this type of expense.

Certainly, there are individual contract situations (e.g., the entertainment of government officials) where it would be inappropriate and, we believe, unwise policy to allow expenses of these types as a reimbursable contract cost. But to disallow categorically all of such expenses (with the minor exception permitted in the case of advertising) is, we believe, quite unjustifiable and clearly not in the government's long-run interest.

Factors Affecting the Allowability of Costs

We do not question the apparent objective of greater clarification implicit in the enumeration of two additional factors affecting the allowability of contract costs. We do, however, take strong exception to the probable results of applying newly created tests for determination of cost allowability which involve "the exercise of good business judgment in the incurrence of cost" and "significant deviations in the established practices of the contractor which substantially increase the contract costs".

In the first place, the proposed revision retains the overriding test of reasonableness, which should be sufficient to protect the government's interest. To add a new and most nebulous criterion, the application of which would necessarily be even more imprecise and nebulous in character, involving retrospective review and reversal of business judgments made under then existing circumstances, will lead only to confusion, inequity, and a temptation to be uncertain in judgment in the first instance.

In the initial award of a defense contract, a contractor's general reputation, management know-how, responsibility and productive efficiency are presumably surveyed with care. It is totally contrary to good contracting policy, in the interest of government as well as the contractor, to superimpose upon this general review authority a criterion involving retroactive review of individual business judgments with respect to the incurrence of costs. This is

particularly true in view of the fact that a post audit is removed, and necessarily so, from the existing circumstances which underlie the business judgment at the time that it is executed.

Likewise, we believe, the second of the factors to which we have called attention is unnecessary in the light of pre-existing tests of general reasonableness and the application of generally accepted accounting principles and practices. We recommend, therefore, that both of these newly established standards for cost determination be eliminated from the proposed revision.

Use of Standard Costs

The proposed regulation appears to be completely silent on the use of standard costs and variances from those costs. Throughout the text of the new draft there is an implication that an actual cost system is to be maintained, at least for all direct elements of cost involved. On the other hand, repeated reference is made to the acceptability of a contractor's standard practice--which may, of course, include the use of standard costs--and we recommend, therefore, that the use of such a cost system be expressly authorized by appropriate language in the new regulation.

Specific Recommendations

The following specific recommendations apply to pertinent subject and paragraph headings, as indicated below:

Direct Costs (Paragraph 15-202)

Revised Subparagraphs 15-202.1 and 15-202.2 are somewhat less specific in respect to allowances for reasonable overruns, spoilage, defective work, use of average labor rates, et cetera, than are the corresponding provisions of ASPR which they are intended to supplant. We recommend, therefore, a continuance of the present provisions of the regulation or an appropriate revision and expansion of language in the newly proposed subparagraphs.

In the case of "other direct costs", Subparagraph 15-202.3, we recommend a revision of the last sentence to read as follows: "When, however, items ordinarily chargeable as indirect costs are charged to a government contract as direct costs, such items must be eliminated from the overhead allocation." (Underscoring supplied.) This suggestion arises from the fact that a single contractor may charge a normally indirect cost to a government contract as a direct cost in one factory but as an indirect cost in another factory, depending both upon circumstances and contract provisions.

Indirect Costs (Paragraph 15-203)

We have a number of specific comments and recommendations with reference to the various types of indirect costs discussed in the proposed revision.

Indirect engineering expenses.--The language of this subparagraph of the proposed revision does not appear to recognize the position of a manufacturer who sells to the government an article essentially identical to his regular civilian output and on which the incurrence of indirect engineering

expense is taking place continually. It is perfectly possible for a manufacturer of this type to have no direct engineering man-hours expended on items sold to the government, but to deny him reimbursement of the allocable portions of certain regular engineering costs which apply to commercial-type items sold to the government is, we believe, wholly indefensible. We urge, therefore, that the regulation take expressly into account this not unusual situation and authorize the allowance as a contract cost of indirect engineering expenses under such circumstances.

We recommend further that the first sentence of this subparagraph be amended by deletion of the word "chiefly" and the addition of the following: "and such other related costs as the contractor consistently charges to engineering overhead". Such amendments would avoid any possibility of interpretation restricting cost allowability to the three general categories of expense specifically identified in the presently proposed language.

Selling and distributions expenses.—This item of contract cost is one to which we have already addressed a general comment, and, in accordance with that general observation, we reiterate our objection to the proposition that "Generally, such expenses are not considered to be allowable...". It is true that the language of the proposed revision appears to represent a partial liberalization of present practice with reference to the allowance of such cost under the government contract. Nevertheless, the allowance of any such cost is made dependent upon a reasonable definition of benefits to contracts in question and clearly prohibits the expenses of "pure selling".

We disagree with the philosophy that selling and distribution expenses are generally unnecessary in obtaining government business, and urge the following specific revisions in the proposed language of Subparagraph 15-202.3: First, elimination in its entirety of the second sentence and the word "active" at the beginning of the third sentence; second, deletion of the words "rather than pure selling" at the conclusion of the third sentence; and third, complete elimination of the last sentence.

General and Administrative Expenses (Subparagraph 15-203.4).—Although the enumeration of factors to be considered in reaching equitable results in the allocation of general and administrative expenses was undoubtedly intended to be a clarification of present provisions, we feel that this attempt at further specification of matters for review in such allocations may only lead to further confusion. We would recommend, therefore, that all of subparagraph 15-203.4 following the second paragraph be deleted. The result would be to bring the allocation of such expenses into line with normal commercial accounting practices and, in addition, avoid any possible overemphasis on the use of factors specifically enumerated. Moreover, it is not entirely clear to us just how the factors of inventory levels and ratios might affect the equitable distribution of general and administrative expenses.

Applications of Basic Cost Principles and Standards to Selected Items of Cost (Paragraph 15-204)

Our specific comments and recommendations with reference to individual items of cost treated in this proposed revision to Section XV, ASPR, appear below.

Advertising (Subparagraph 15-204.1).—This is another of the cost items to which we have made reference in our comments above. The proposed revision to ASPR restricts the allowance of advertising cost to institutional advertising in trade and technical journals and to help-wanted advertising. At the risk of appearing repetitious, we wish to reiterate that institutional advertising, regardless of the media employed, is a real cost of doing business, and the pro rata share of such cost should be allocated to cost-type government contracts along with other general and administrative expenses.

This too narrow restriction on the allowance of advertising cost appears to overlook completely 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.

In general, we emphasize again that advertising, whether institutional or product-line, is an item of expense which should be made the subject of special negotiation in determining its allowability as a government-contract cost. Specifically, general, institutional and educational advertising should be evaluated in individual cases in the light of its direct and indirect benefits to government business. Product advertising is a selling and distribution expense from which the government has long derived demonstrable benefits in the form of productive capacity and should, we believe, be allowable, subject to the safeguard of individual negotiation, as an item of selling and distribution expense.

Bidding Expense (Subparagraph 15-204.3).—The liberalization in allowance of this type of contract cost may be more apparent than real. In almost every instance bidding expense applicable to a particular contract would have been incurred in a prior accounting period with the result that the proposed subparagraph denies the recovery of bidding expense except as to expense of this type relating to future contracts. We recommend, therefore, the consideration of allowing as an item of cost chargeable to a cost reimbursement type contract the contractor's bidding expense directly pertinent to that contract.

Cafeteria, Dining Rooms and Other Food Services (Subparagraph 15-204.4).—We recommend that the last sentence of the proposed subparagraph be deleted in its entirety. Quite aside from the question of who shall

determine the intent of furnishing food services at a loss, there would seem to be a clear inconsistency between this restriction and the general allowance as a contract cost of "employee morale, health and welfare" expenses by Subparagraph 15-204.10. Losses sustained in the operation of food services for the benefit of employees is, of course, no more than a form of fringe benefit and should, we believe, be allocated to all of the contractor's production, including government work, without the necessity of negotiating a special contract provision.

Civil Defense (Subparagraph 15-204.5).--If as a matter of public policy the government desires the widespread support by industry of civil defense programs--and we believe this is clearly the case--we are unable to understand the restriction on allowability of such costs to expenditures made on the contractor's premises and the express prohibition against reimbursement for contributions to local civil defense funds. Many government contractors enter actively into the civil defense programs of their respective communities including not only direct financial contributions but the loan of equipment and personnel. A categorical disallowance of costs so incurred cannot fail to discourage active participation by manufacturing companies in local civil defense programs. At the very least, we suggest that the items now disallowed by the proposed subparagraph be made matters for special negotiation in the light of all attendant circumstances.

Compensation for Personal Services (Subparagraph 15-204.6).--We have a number of basic objections to the language of proposed subparagraph 15-204.6. Our objections relate not only to specific disallowances required by the language of the proposed subparagraph but to the application in this area of arithmetical formulae which are entirely inconsistent with the general test of reasonableness laid down by the regulation for the determination of cost allowability.

We assume that subparagraph a. permits reimbursement for incentive type compensation whether of the immediate or deferred distribution type. However, we believe that the initial sentence should be clarified to explicitly allow reimbursement for such compensation.

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. Moreover, this express prohibition appears to be inconsistent with the allowance by subparagraph 15-204.6.f of stock bonuses as a contract cost.

Turning now to subparagraph d. of this important section of the proposed regulation, we note the inclusion of "production incentives" as an item of allowable cost and the exclusion of "management incentives". Whether or not

the latter type of incentive payment may be read into the general language employed is, of course, a matter of interpretation. We recommend that such payments be expressly allowed subject to the usual tests of reasonableness and normal business practice, for the reasons we have suggested below under our discussion of profit-sharing plans.

We are pleased that contributions to profit-sharing plans are being given express treatment as a contract cost. We do not agree, howevever, with some of the restrictions written into this section of the regulation. By way of general discussion, it appears to us that a variety of considerations not recognized in the proposed subparagraph should go into the determination of the allowability as a contract cost of contributions to profit-sharing plans. The reasonableness of such contributions in the light of total compensation should be a principal consideration. In addition, the purposes of the profit-sharing plan and the question of whether or not contributions of this type are a normal and regular part of the contractor's system of compensation must be given due weight in every case. For these reasons, we cannot agree with the 15 percent-of-total-basic-compensation test for general application.

There is the widest variation in industry as among profit-sharing and stock-bonus plans and their relationship to straight salaries, and the imposition of an arbitrary percentage limitation of this type would, in our opinion, almost certainly produce erratic and inequitable results. The determination of compensation for personal services is a matter for executive judgment, and we repeat 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.

Finally, we note in your letter of May 25 that the previous limitation of 75 percent of nongovernment business on the allowability as a contract cost of contributions to profit-sharing plans has now been modified. This, we believe, is a step in the right direction, particularly as it relates to the numerous companies whose percentage of government business may fluctuate from time to time above or below this fixed limit. Nonetheless, the amended language persists in the use of a strict percentage limitation which necessarily fails to take into account the general test of reasonableness under all the circumstances. We repeat our suggestion that this is an attempt to lay down arbitrary standards in an area of the widest possible variation. We think such a limitation not only unwise but undoubtedly productive of inequitable results.

Contingencies (Subparagraph 15-204.7).--To avoid any possible misinterpretation of the provisions of this subparagraph, we suggest the insertion of the word "reasonably" after the phrase "an event whose occurrence cannot be" appearing in the first sentence. We would suggest also the addition of the following sentence: "Where it can be established that a liability exists, a reasonable estimate will be allowed in determining the costs of the contract."

Depreciation (Subparagraph 15-204.9).--We assume that the ASPR cost interpretation of depreciation appearing in the Department of Defense press release of May 12 has the effect of at least partially altering the import of

this proposed subparagraph. Our comment, therefore, is addressed both to the release and to the proposed language of this subparagraph as we assume it to now be amended.

We note from the May 12 release that depreciation allowances authorized by Section 167 of the Internal Revenue Code of 1954 are acceptable as contract costs subject to their acceptability for tax purposes and the further proviso that the costing of defense contracts is consistent with the costing of the contractor's nondefense work and is so reflected in his books of account. We trust that this express provision will be spelled out in detail in the final publication of this proposed revision to ASPR. In addition to a clear statement of the allowability of depreciation authorized by the new Internal Revenue Code, we believe the regulation in subparagraph b. should be reworded to avoid any possible inference that the words "consistent application" are intended to deny (1) the adoption of the sum-of-the-years'-digits or the declining-balance method, or (2) the permissible switch under the new Internal Revenue Code from a declining-balance to a straight-line method of depreciation at any time during the life of a depreciable asset.

Subparagraph c denies the allowance as a contract cost of depreciation on idle facilities. As a practical matter, a defense contractor producing the same item for civilian and military use is unable to determine the amount of depreciation on idle facilities allocable to military work and thus considered nonallowable. Moreover, depreciation on stand-by facilities is a cost factor invariably present in manufacturing operations except in the most abnormal and short-lived periods of full capacity. As a consequence, the depreciation of idle facilities is an ever present cost of doing business, and the allowance of such costs should be recognized by these regulations.

We suggest finally that under subparagraph e the second sentence be reworded to read as follows: "After the expiration of the emergency period for the facilities concerned where a determination of 'true depreciation' has been made, the balance of the cost of such facility over the amount of 'true depreciation' recognized in costs will be depreciated over its remaining useful life and will be the only amount recognized as allowable cost, subject to paragraph 15-204.12". This suggested change has as its object the assurance of a full recovery of cost in all cases.

Excess Facilities (Subparagraph 15-204.12).--Our comments with reference to the allowance of depreciation on idle facilities apply with equal force to the allowance of the costs of maintaining and housing idle and excess facilities. These are normal costs of doing business and should, we believe, be allowed in normal circumstances.

Initial Production Costs (Subparagraph 15-204.15).--We recommend the elimination of that sentence in this subparagraph which reads, "In cases where these costs continue to an unwarranted extent after the contractor has been allowed reasonable time to learn to make the product efficiently, the excessive costs will be subject to disallowance." This suggestion arises from our feeling that the real point involved is covered sufficiently by the preceding sentence and that the inclusion of this sentence is an open invitation for the substitution of a post audit recommendation in a matter that is properly one for management judgment. Moreover, the government is at all times armed with the power of terminating the contract for the convenience of the government.

Insurance and Indemnification (Subparagraph 15-204.16).--It is our belief that insurance coverage, dictated by business prudence and in effect at the time of undertaking a government contract, is a normal business expense and should be fully allowable for contract cost purposes. The total effect of this subparagraph is to throw the contractor upon the mercy and wisdom of the government in approving an insurance program since, on the one hand, the allowance of insurance premiums as a contract cost is made to depend upon advance approval by the military department involved and, on the other hand, the contractor is denied recovery for any uninsured loss. This would appear to be another case in which the over-all test of reasonableness of coverage and rates is sufficient for the full protection of the government's interest.

The disallowance of the cost of use and occupancy insurance, insofar as it covers profit, interest, et cetera, is, we submit, completely doctrinare inasmuch as there is no practical way of determining generally how much of the cost of such insurance is attributable to coverage of loss for profits and interest.

Materials and Supplies (Subparagraph 15-204.22).--We have two specific comments with reference to this subparagraph.

Any generally recognized method of pricing materials issued from stock is acceptable for contract costing purposes provided the method is consistently applied and the results obtained are equitable. This provision of Subparagraph d is unfortunately watered down by the implication that a special agreement between the contractor and the government is required to allow the use of LIFO inventory costing. LIFO is a generally accepted method of inventory pricing. The results obtained from it are equitable and where it is consistently applied there is, we submit, no reason for a special contractual agreement authorizing its use. We urge that this be made clear in the language of the regulation.

The principal emphasis in Subparagraph f under "Materials and Supplies" is upon the use of a cost basis in the transfer of materials and supplies between plants, divisions or organizations under the same corporate control. This may be proper in some cases. If, however, a multi-plant or multi-division contractor has a well established plan for the pricing of sales or transfers between plants, divisions, et cetera, we believe that the operations of such a system should be recognized for contract cost

purposes subject to the limitation, of course, that transfer prices so charged may not exceed the sales price to the most favored customer or the competitive price of the item from other suppliers. This rather customary method of pricing inter-plant or inter-division transfers is limited by the language of the proposed subparagraph to the sale or transfer of items regularly manufactured and sold through commercial channels by the transferor. We believe this restriction should be eliminated and that the present emphasis upon cost alone as a basis of transfer should be altered by appropriate language revision.

Overtime, Extra Pay Shift and Multi-Shift Premiums (Subparagraph 15-204.25).--Although generally unobjectionable, this portion of the proposed regulation overlooks two possibilities which we believe it should consider. First, it ignores the situation where a manufacturer's production lines contain identical products intended for both civilian and military customers. Under this type of operation it is, we believe, completely impractical to require a separation of overtime premiums on those items intended for delivery under military contracts.

Our second observation has reference to the fact that the proposed language fails to differentiate between overtime and shift premium payments to direct labor and indirect labor. As an example, most manufacturing plants employ guards on a 3-shift, 7-day schedule. Under the terms of the proposed regulation it would be necessary to obtain prior approval for shift premiums paid to such guards even though the cost is simply a distributive charge into burden for all departments. Capital goods companies inform us that military auditors frequently take exception to all indirect overtime and shift premiums. We recommend, therefore, that the proposed subparagraph be reworded in part to read as follows: "Cost of overtime and shift premiums for direct labor is allowable only to the extent expressly provided for in the contract or otherwise authorized by the government. Cost of overtime and shift premiums for indirect labor is allowable without prior approval, if reasonable, and the cost is allowable on a pro rata basis to commercial as well as government work."

Pension and Retirement Plans (Subparagraph 15-204.27).--By the terms of this subparagraph, pension and retirement plans, subject to the approval of the Internal Revenue Service, must have such approval before consideration will be given them by the military department concerned. The regulation provides further, however, that approval by the Internal Revenue Service does not necessarily assure the allowance of contributions to such plans as a contract cost by the military. The conclusion is, of course, that the military department involved will pass upon the allowability of the costs of any pension plan prior to contract finalization. This, we believe, is a completely impractical requirement.

Plant Protection Expenses (Subparagraph 15-204.28).--All plant protection expenses should, in our opinion, be considered fully allowable. We have two objections to the segregation of plant expense stipulated by the language of this subparagraph. First, where a contractor is engaged in the performance of a number of classified government contracts at one location, it would be most difficult, if not impossible, to allocate special plant protection costs to each contract involved. Secondly, and

again where a single contractor holds a number of government contracts, it would be impractical for the contractor to develop an individual overhead rate for each of the government contracts.

Precontract Costs (Subparagraph 15-204.29).--The provisions of this subparagraph should be considered in relation to the provisions of Subparagraph 15-204.32, "Reconversion Expenses". Both types of cost are disallowed by this proposed revision to procurement regulations. It would seem that equity requires the allowance of one or the other as a necessary contract cost. At the very least, we believe that precontract costs and reconversion expenses should be made matters for special consideration under the circumstances of each case rather than being categorically disallowed.

Rentals of Plant and Equipment (Subparagraph 15-204.34).--We question if subparagraph b is required in this case, particularly in the light of the test of reasonableness laid down by subparagraph a. Taken together, the effect of subparagraphs a and b, as now written, is to penalize companies which have sale and leaseback arrangements as contrasted with companies holding conventional leases. We think it would be a rare case to find a conventional lease where the rental rate was equivalent to "normal costs, such as depreciation, taxes, insurance, and maintained expenses" attributable to the facilities leased. We repeat that subparagraph a should be deleted from the regulation.

"Research and Development" (Subparagraph 15-204.35).--In general 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 costs so incurred should be allowed as a government contract cost without requiring as a condition of such allowance an agreement that the contractor divulge to the government the results of independent general research.

Ordinarily the government's contribution to the support of pure research by industry under cost-reimbursement type contracts is relatively limited and yet under the proposed regulations the government seeks the full product of such research with no guarantee that knowledge so divulged may not be made available to others./1 The recent report of the Hoover Commission, recommending a greater rather than lesser expenditure of public funds on research and development, appears to lend credence to the theory that any addition to the general fund of scientific knowledge is an asset to the National Defense program. If there are extreme cases in which the government feels obliged to require a complete divulgence of the results of such research, we recommend that such disclosures be made the matter of special contract negotiations.

1/ Our views on the acquisition of a manufacturer's technical data by the government are set forth at length in our letter of January 3, 1955, copy attached.

Once again we find the 75 per cent non-government business test applies. The objections we have set out above in connection with the application of this test to "compensation for personal services" apply equally in this instance. By way of reiteration, we object generally to the imposition of the fixed percentage limitation as a test for the determination of allowability as a contract cost. At the very least, we believe the test should be modified as it has been in the prior case in conformity with your letter of May 25.

If, as a condition to the allowance of general research expenses as a contract cost, the government insists upon the divulgence of the results of such research, then we believe that the language of the proposed regulation requires clarification. The manner and time of divulging this information is not made clear. Does the language used mean that the contractor assumes an affirmative duty to supply the government with the results of its full research, or does it mean that the contractor simply agrees, if asked, to keep the government informed?

Finally, we are unable to agree with the exclusion from allowability under research and development contracts of costs arising from "related research" conducted with the contractor. It seems to us that there is as much possibility of benefit accruing to a research and development contract as might accrue to a cost-type production contract and, as a consequence, no distinction should be made as to the allowability of costs so incurred.

Taxes (Subparagraph 15-204.40).--Although we have no disagreement in principle, we are constrained to suggest the impracticability, in some cases, of the refunds required under subparagraph c. In the absence of performance under defense contracts at the time of tax refunds, it appears that the practicability of determining the proper amount of such refunds allocable to contracts performed as much as 10 years earlier is highly questionable.

Training Expenses (Subparagraph 15-204.42).--We believe that the disallowance of the costs of training in educational institutions except to the extent specifically provided by contract is unnecessary and, from the government's standpoint, unwise. In many cases it is impossible to foresee at the time of the negotiation of a cost-type contract what training requirements may be involved. In a very real sense the benefits of such training accrue to the government through improved contract performance and net cost reductions. Again, employee educational programs conducted by employers are by now so well established as to make of them a normal cost of doing business. Accordingly, we recommend that subparagraph c be amended to read: "Costs of training in educational institutions will be allowable where the program is available to all employees, the training period is during hours not paid by the contractor, and the cost is distributed on a pro rata basis between commercial and government work". As for training programs which do not meet these specific criteria, they might very properly be left to the discretion of the contracting officer in individual cases.

Travel Expenses (Subparagraph 15-204.44).--We recommend the elimination of subparagraph d which authorizes the allowance of the cost of premium transportation only where such costs are shown to be necessary to performance of the contract. We assume the word "premium" has reference to the choice of air travel rather than rail or to the distinction between differing types of sleeper accommodations. Barring wholly unreasonable expenditures--which are, of course, governed by the general tests applying to all costs incurred under government contracts--this is largely a matter of personnel administration and employee relations, and this restriction should be eliminated from the regulation.

General Conclusions

In concluding we should like to draw your attention again to three basic propositions which are implicit in our approach to the proposed revision of contract cost principles.

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 costs of doing business.

Equally as important, however, as the basic criterion we have suggested is the procedure or 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—in which we feel such expenses as advertising, profit sharing, etc., fall—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 comments and recommendations respecting the proposed revision to the ASPR. May we again express our appreciation for this opportunity to offer our comments on such an important section of procurement regulations. If we can be of any further assistance or if you would desire to discuss these matters directly with representatives of this office, please do not hesitate to call upon us.

Cordially,

Charles Stewart
President

CWS:c
Enclosures

NATIONAL SECURITY INDUSTRIAL ASSOCIATION
Incorporated

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

20 June 1955

Rear Admiral L. H. Thomas, SC, USN
Staff Director
Purchasing and Contracting Policies Division
Office of the Assistant Secretary of Defense
(Supply and Logistics)
The Pentagon
Washington 25, D. C.

Dear Admiral Thomas:

The National Security Industrial Association greatly appreciates the opportunity to review the proposed revision of Part 2 of Section XV of the Armed Services Procurement Regulation, dated March 23, 1955. Because of the vital interest this draft has to the members of NSIA it has been intensively reviewed and our comments are submitted in the expectation that they will receive serious consideration. The enclosed comments have been prepared by the Accounting and Auditing Task Committee and have been reviewed by the NSIA Procurement Advisory Committee, which consists of 156 members, representative of American industry, both large and small, and of every major segment of suppliers to the Military Establishment.

It is the very frank opinion of all members of the reviewing committees that the proposed draft revision is so drastic and contains so many objectionable features, that it should not be released until there has been a full and complete across-the-table discussion between representatives of the Department of Defense and of American business as to the basic principles involved.

It is apparent that wherever the draft adheres to cost principles some encouraging and constructive progress has been made. The proposal has liberalized the treatment accorded contributions and donations and it now specifically covers a number of cost items which do not appear in the current Section XV of ASPR. The inclusion of the latter, however, merely represents a formal recognition of costs which have been recognized as allowable in the past.

The proposal falls far short of following "generally accepted accounting principles and practices," even more so than the current Section XV. An unjustifiable disinclination on the part of the Government to share in the normal costs of doing business, from which the Government derives clear and demonstratable benefits, still pervades this draft. Most of the expenses in the unallowable categories are normal and regular costs of doing business and they, as well as those costs which can be directly allocated to a particular contract, contribute to the productive ability of any business enterprise. All of the enterprise's customers, including the Government, share in benefits which derive from a firm's productive capacity and efficiency and these benefits are no less real because they are indirect.

The failure of the proposed draft to recognize "generally accepted accounting principles" is pointedly indicated in the following respects:

(1) The draft would require the imposition of hindsight judgment of military audit personnel in reviewing the reasonableness of management decisions. The clue to this is set forth in Section 15-201.b(iii). This provision should not be made any part of a document used for cost determination.

(2) Throughout the proposed draft there is interjected a requirement that the auditor evaluate the equities of the situation, in addition to his usual function of measuring the reasonableness of the amount and the proper allocability of the item. Section XV should be limited to indicate types and amounts of cost which are or are not allowable in cost type contracts and it should not be made an audit manual for the various services.

(3) In the treatment of compensation for personal services and research and development expense, the Section arbitrarily discriminates against concontractors with more than 25% government business. If the specific cost items are reasonable in amount and properly allocated to all of the contractor's business, the cost item should be an allowable cost, regardless of the degree of government business. The proposed procedure would discriminate particularly against small business and against the individual employees of any company with more than 25% government business.

(4) In the attempt to "define, delineate and clarify cost determinations of individual items," the draft has entered into a detailed treatment which apparently is an attempt to cover peculiar circumstances of "special cases" this results in arbitrary, unilateral and artificial determinations of allowable costs which is not consistent with sound business practice and is very unfair to government contractors. These unjustified and inequitable restrictions and limitations appear throughout the draft of which the paragraph on compensation is a glaring example. It would be more logical and equitable to cover these special situations at the time of negotiation of original contract terms.

(5) In many cases the determination of allowable costs has been conditioned upon authorization by special contract provision or by written authorization of the contracting officer, which is wholly unsatisfactory and unrealistic. This would involve special negotiations on individual items which would not only be time consuming but also costly in contract negotiations.

The draft also fails to cover certain subjects contained in the present Section XV including the use of standard costs, the use of predetermined overhead rates, moving and rearrangement expenses, relocation expense, subsistence and housing of employees, commissions of bona fide sales representatives, and the cost-sharing of research projects with educational or other non-profit institutions.

In the attached report the members of our Accounting and Auditing Committee have treated each section individually, setting forth first their comment regarding the Section and suggesting where applicable a proposed revision in which deletions are indicated by strike-outs and new material indicated by underlining.

While an effort has been made to state the position of the committee and its reasoning in each section of comment, we firmly believe that it would be highly desirable to schedule a joint industry-military conference for discussion of the basic principles involved and the treatment of individual items. We strongly recommend that this be done and are prepared to send representatives to such a meeting.

Cordially,

Frank L. Fuller

Frank L. Fuller
Committee Executive/for

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

Enclosures: 10 copies

cc: All members:
Procurement Advisory Committee
Accounting & Auditing Committee

NSIA - Accounting and Auditing Committee

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20 June 1955

NATIONAL SECURITY INDUSTRIAL ASSOCIATION
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NSIA SUGGESTED REVISION TO
DOD DRAFT 3/23/55 SECTION XV

10 June 1955

15-200 - SCOPE OF PART

Comment: The paragraph as written carries on the same problem which has been serious in the past and unless corrected may well continue to be serious in the future. This problem is the misapplication of Section XV to other than cost type contracts. This serious problem has been the subject of many discussions with the services ever since Joint Letter #12 dated 5 August 1949 was released together with later varying interpretations from individual services. It is very important to give a clear prohibition in this first paragraph of the revised Section XV against the use of the Section to other than cost type contracts.

In addition, it is not clear what is meant by "commercial type accounting systems" but it is believed that this merely covers the general manufacturing and engineering company as distinct from certain organizations such as schools, universities and the like. If there is a different interpretation by the Section XV sub-committee this likewise should be explained to the contractors.

Suggested Revision:

This part sets forth principles and s tardards 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 organizations having commercial type accounting systems. However, this part does not apply to contracts for facilities, construction and architect-engineer services related to construction, nor does it apply to fixed price type contracts including price redetermination and incentive type contracts. Similarly, this Section does not apply to the termination of contracts which shall be governed by the provisions of ASPR Section VIII.

15-201 - BASIC PRINCIPLES AND STANDARDS

Comments (a) No comment.

(b) The inclusion of item (iii) "exercise of good business judgement in incurrence of cost" is most objectionable since it attempts to convert the set of cost principles into a tool for enforcing the Government's ideas of what constitute good management policies and therefore shouls be deleted. The inclusion of this point would encourage auditors and contracting officers to substitute second guessing in their judgement (many times after-the-fact) for well established policies of a contractor. Obviously, such a provision should never be made a part of a document used for cost determination. Moreover, this position is completely contrary to the principle defined by the Board of Contract Appeals, in the Swartzbaugh Manufacturing Company case which held that "the executive officers of a contracting corporation should be allowed to exercise the judgement on which their stockholders rely and on which, among other factors, the Government has also relied in placing the negotiated contract. If there are other ways of doing the same thing it is not normally the function of the contracting officer to substitute his own judgement by disallowing costs because some other approach to the problem might be preferred."

It is recommended that clause (iv) be deleted on the prounds that the Government has adequate safeguard through the application of the tests of reasonableness and generally accepted accounting principles and practices as covered by clauses (i) and (ii). This provision is therefore redundant.

Item (v) should be amended to broaden the clause that special agreements may be entered into on items of cost and covered by specific provisions in the contract. Consequently, the wording should be amended to give effect to these special provisions. The use of standard costs is not covered and it is also desirable to make some definite statement to permit such costs where consistent with the contractor's accounting practice.

(c) The words "accruing to" should be changed to "received by" to be consistent with past interpretation and to permit a basis which is normally more consistent with the

contractor's accounting practices. In addition the provision made for the proper credits to the Government in the draft is too restrictive and not practical in the case of many credits which do not lend themselves to direct allocation to individual contracts.

d. A suggested addition has been added to this clause to make clear that it is not the intent of this regulation and the proposed revision to require changes in the contractor's accounting practices and procedures which are now properly being applied.

Suggested Revision:

a. Composition of Total Cost. The total cost of a cost-reimbursement type contract is the net sum of (i) the allowable direct costs, (ii) the properly allocable portion of allowable indirect costs and (iii) applicable income and other credits.

b. Factors Affecting Allowability of Costs. The factors to be considered in determining the allowability of costs include (i)reasonableness, (ii) application of generally accepted accounting principles and practices, ~~(iii) exercise of good business judgment in incurrence of cost, (iv) significant deviations in the established practices of the contractor which substantially increase the contract costs, and (v)~~ (iii) any limitations as to types or amounts of cost items set forth in this Part 2 of Section XV or special provisions otherwise included in the contract. The use of standard costs is permissible where consistent with the contractor's normal accounting practice and where proper allowances are made for variances.

c. Credits. The applicable portion of income and other credits, rebates, allowances, and equivalent benefits ~~accruing to~~ received by the contractor and which are related to any allowed cost will be credited to the Government ~~either as a reduction in contract cost or by a cash refund, as appropriate~~ in accordance with methods consistently followed by the contractor.

d. 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). It is not the intent of this part to require the contractor to change its accounting procedures and practices that have been previously accepted for determining costs under Government contracts.

15-202 DIRECT COSTS

Comment: This paragraph has been modified to avoid any implication that the auditor is in a position to dictate to the contractor the accounting system to be used under Government contracts. It is understood that Section XV should not require changes in an accounting system which conforms to generally accepted accounting principles and practices and is consistently applied.

The omission of "or with other work of the contractor" is suggested as it does not add anything to the particular sentence.

In the next to the last sentence the words "within each separate unit engaged in mixed production" have been added to take care of large companies with several operating divisions which are engaged in the manufacture of different product lines and possess virtual operating autonomy.

The addition of "prevent duplicate charges" is intended to define what is understood to be the objective of the particular sentence in which this has been included.

Suggested Revision:

Subject to the provisions of paragraph 15-201, allowable direct costs are those items of cost, or aggregate thereof, which can be identified specifically with any objective, service, program or project under the contract and are chargeable directly thereto. Major items of cost readily identifiable with the contract ~~or with other work of the contractor~~ should be charged directly thereto. This principle may often be applicable to such elements of expense as freight, travel, communications, engineering services, etc., as well as the normal items of materials and productive labor. However, when the contractor is engaged in mixed production, this principle must be applied consistently within each separate unit engaged in mixed production to the costing of both defense and non-defense products or services, in order to produce equitable results and prevent duplicate charges. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect expenses. However, this provision shall not be interpreted to require changes in accounting system which conforms with generally accepted accounting principles and practices and is consistently applied.

15-202.1 DIRECT MATERIALS.

Comment: The word "all" has been added before "items purchased" in the first sentence to make it consistent with the present Section XV as there does not appear to be any reason for its omission. The paragraph as now written does not apparently make allowance for overruns, etc., which, of course, it is necessary to include in material costs.

Suggested Revisions:

The cost of direct materials includes 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 furnishing such product taking into account overruns spoilage and defective work.

15-202.2 DIRECT LABOR

Comment: This paragraph does not make provision for average or standard rates and consequently suggested changes have been made to include these rates as well as to eliminate other wording which is not subject to clear interpretation.

Suggested Revision:

The cost of direct labor includes salaries and wages ~~specifically-identifiable with-and~~ properly chargeable directly to performance of contract ~~or-other-work-of-the contractor.~~ It may also include other associated costs such as payroll taxes and workmen's compensation insurance, 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 will be charged at the actual rates paid by the contractor. However, if it is the contractor's consistent accounting practice to make such charges on the basis of average or standard rates, this practice will be acceptable if it is demonstrated that it will produce reasonable results.

15-202.3 OTHER DIRECT COSTS

Comment: In the last sentence the word "similar" has been changed to "such" since "similar" is too vague and speculative and vests too much discretion in the cost inspector to make unauthorized cost deletions.

Suggested Revision:

Where other items of cost are charged directly to the contract consistent with paragraph 15-202 above, the contractor must demonstrate that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of ~~similar~~ such items applicable to other work of the contractor must be eliminated from indirect costs allocated to the contract.

15-203 INDIRECT COSTS

Comment:

a. No comment.

b. The words "and produce equitable results" should be deleted from the third sentence since this amounts to second guessing as already stated in the objective under paragraph 15-201(b). It is recommended that the next to the last sentence be deleted

since the enumeration of specific changes is an unnecessary amplification carrying with it the danger of being used as a check-off list by the cost inspector.

Suggested Revision:

a. Indirect costs are expenses which are incurred for common or joint objectives are accumulated for accounting purposes by departmental activity or other logical cost grouping and are charged to the contract and other work of the contractor by a process of allocation. Each element thereof is subject to the limitations of this part as to allowability.

b. No specific rules can be stated as to the method of allocation of indirect costs because the actual condition in each instance must be taken into account in determining the most suitable method or methods. The objective should be the selection of a method or methods which will distribute the indirect costs in a fair and equitable manner. The method used in connection with Government contracts must, in order to be acceptable, conform with generally accepted accounting practices, and be applied consistently, ~~and produce equitable results. Any significant change, such as in the nature of the business, extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, or the products being produced, may require reconsideration of the methods previously in use to determine whether they continue to be equitable.~~ Further discussion relative to allocation of the individual categories of indirect costs will be found in the subparagraphs below.

15-203.1 INDIRECT MANUFACTURING AND PRODUCTION EXPENSES

Comments: In the first sentence, the words "necessary to" are unnecessarily broad and subject to conflicting interpretations by the Government and contractor and have therefore been changed to "incurred in". The words "but are not limited to" should be inserted in the third sentence since there are many recognized methods of allocating overhead other than those mentioned which may be more equitable for some companies. The words "(exclusive of overtime premium)" should be deleted since the inclusion of overtime premium in the direct labor base for distributing overhead expenses has been recognized as a generally accepted accounting practice for many years for many companies and therefore a limitation should not be in these regulations prohibiting this practice when it may be more equitable for some contractors.

Modification of the last two sentences is necessary in order that the paragraph not be interpreted as giving the auditor the right to determine what accounting

system the contractor should use. Determination of cost centers is a matter for internal management decision.

Suggested Revision:

Indirect manufacturing and production expenses consist of costs which are incurred in ~~necessary to~~ the productive process as a whole and are not readily subject to treatment as direct costs in accordance with paragraph 15-202. Allocation of indirect manufacturing and production expenses on a time basis, such as direct labor man-hours or machine hours, is a method which generally produces accuracy and equity. Other acceptable bases, in appropriate circumstances, include but are not limited to direct labor dollars, ~~(exclusive of overtime premium),~~ units processed and prime costs of units processed. ~~In some instances,~~ It ~~may be necessary~~ is permissible to departmentalize or establish cost centers in order to distribute equitably the indirect costs. ~~The factors to be considered in determining the extent of departmentalization or establishment of cost centers include variety of products, complexity of processes and relative labor and facility requirements for the various products.~~

15-203.2 INDIRECT ENGINEERING EXPENSES

Comment: Changes have been suggested in order to clarify the interpretation of this paragraph and to make the type of expenses included in engineering activities more flexible so that this paragraph will not be interpreted as a mandatory instruction to the auditor to allow only the items specifically mentioned.

In the second paragraph the words "(exclusive of overtime premium)" should be deleted since the inclusion of overtime premium in the direct labor base for distributing overhead expenses has been recognized as a generally accepted accounting practice for many years for many companies and therefore a limitation should not be in these regulations prohibiting this practice when it may be more equitable for some contractors.

Suggested Revision:

Indirect engineering expenses consist ~~chiefly~~ of engineering supervision, engineering administrative expense, ~~and~~ engineering general supplies, and such other items as the contractor consistently charges to engineering overhead. These expenses arise out of engineering activities ~~which~~ and may include items such as 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 expenses should be allocated to the benefited activities, i.e., contract and other work of the contractor on the basis of direct engineering man-hours expended, direct engineering labor dollars, ~~(exclusive of overtime premium)~~, or other equitable basis. Direct costs of engineering activities should be charged directly to the benefited activities, i.e., contract and other work of the contractor in accordance with paragraph 15-202.

15-203.3 SELLING AND DISTRIBUTION EXPENSES

Comment: This paragraph as presented is unacceptable. While the present Section XV does not specifically allow selling and distribution expenses it recognizes as "allowable indirect costs" in paragraph 15-203 and specifically disallows in paragraph 15-205(q) "selling and distribution activities not related to the contract products." The new provision permits an allocation of only those expenses which consist of "technical, consulting and such other beneficial services (including related supervision and clerical expenses) which are for purposes such as application and adaptation of the contractor's products rather than pure selling." This is an unnecessary limitation on an item of expens which should be fully allowable once it has been shown that the expense is related to the contractor's government work.

The philosophy that selling and distribution expenses are generally unnecessary i securing government business is a viewpoint that is completely erroneous and unjustified. Although some contracting officers do recognize certain direct selling expenses, they endeavor to limit them to the portion which can be directly connected with government orders. However, the Government fails to recognize the indirect benefits it has taken advantage of in being able to place orders for either standard commercial or especially designed products with companies which, through expenditures for advertising, sales promotion and selling activities, have the capacities to produce efficiently and quickly the requirements of Government that otherwise could not be possible without tremendous expenditures and extended delays. Before revision, this paragraph states that selling and distribution expenses are unallowable unless a "reasonable demonstration of benefits

to Government contracts" can be shown. The suggested rephrasing switches the emphasis from generally unallowable to generally allowable. Since bidding expenses are recognized as allowable items of cost in 15-204.3, it is believed that other types of selling and distribution expenses should be treated in a like manner.

Suggested Revision

~~The expenses in this group consist of items which represent the cost of marketing the contractor's products and include sales promotion, advertising, distribution costs and other related items. Generally, such expenses are not considered to be allowable as a charge to Government cost reimbursement type contracts for the reason that marketing in the ordinary commercial sense, is not necessary for doing business with the Government. However, dependent upon a reasonable demonstration of benefits to Government contracts and subject to the other provisions of this part, there may be an allocation to government work of these expenses in this category which consist of technical, consulting and such other beneficial services (including related supervision and clerical expenses) which are for purposes such as application and adaptation of the contractor's products rather than pure selling. Such costs should first be allocated between the contractor's commercial line and its Government contracts. The amount allocated to the latter should then be charged to the individual contracts on any equitable basis. Because of the special problems that arise in this area, it is usually desirable for the contractor to identify in its records by means of subaccounts or otherwise, the items of these expenses considered properly allocable to Government contracts.~~

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.

15-203.4 GENERAL AND ADMINISTRATIVE EXPENSES

Comment: The major portion of this proposed paragraph has been deleted since the sentences deleted do not add anything to the interpretation which is covered by the first two sentences. In addition, the listing of the factors to be considered in reaching equitable results is not clear in meaning and any application thereof could only lead to confusion. In the third sentence item (i) would seem to require auditors to review each cost item in the G & A account and to test it as a percentage of total cost of Government contract performance against the percentage that the same item represents in the total cost of

non-government work. The scrutiny of individual items and the test prescribed is inconsistent with the provisions of paragraph 15-203 calling for the distribution of indirect costs in a fair and equitable manner conforming with generally accepted accounting principles consistently applied, and producing equitable results. The provision in (ii) seems to require the auditor to further check individual items of G & A expenses to determine whether they are distributed in relation to the G & A effort involved in government work, as contrasted with non-government work. In addition, it is difficult, if not impossible, to see how the factors of inventory levels and ratios could possibly affect the equitable distribution of this type of expense.

G & A expenses are those items which by their very nature cannot be identified with any particular contract or business and hence must be allocated arbitrarily. The test prescribed in these sentences, while they might have application to burden items, are not applicable to general and administrative expenses. Such a position would be inconsistent with the provisions of paragraph 15-203(b).

Suggested Revision:

General and administrative expenses consist of costs incurred in the overall management, supervision and conduct of the business. Any recognized method of allocating general and administrative expense is acceptable provided ~~equitable~~ reasonable results are thereby obtained. ~~Some of the factors that should receive consideration in determining whether the results are equitable are (i) the cost pattern of the Government contracts (that is, the percentage of the total cost of the contract, exclusive of general and administrative expenses, represented by each of the several cost components thereof) in relation to the cost pattern for the plant or activity as a whole, and (ii) the ultimate objective of distribution of these expenses in approximate ratio to the general and administrative effort involved in the two categories of work. In addition, consideration should be given to any significant variations of inventories between accounting periods, variations in the ratio of contract inventory levels to all other inventory levels, and any other relevant factors such as these mentioned in paragraph 15-203(b).~~

15-203.5 BASE PERIOD FOR ALLOCATION OF INDIRECT EXPENSES

Comment: This paragraph as presented is ambiguous as well as impractical. It appears to leave the door open to auditors and contracting officers to indicate base periods which

must be used. Where the base period is representative of the period of performance and is sufficiently long to avoid inequities in allocation of costs, the contractor's system should be acceptable.

Suggested Revision:

The base period for allocation of indirect expenses ~~should approximate the period of contract performance or~~ should be representative of ~~that~~ the period of performance and ~~The base period~~ should be sufficiently long to avoid inequities in the allocation of costs.

15-204 APPLICATIONS OF BASIC COST PRINCIPLES AND STANDARDS TO SELECTED ITEMS OF COST.

Comment: It is believed that the suggested revision will clarify the factors to be used in determination of allowability better by actual reference to Section 15-201 rather than by the general statement made in the draft. The principles and standards of 15-201 are also applicable to items not specifically covered.

Suggested Revision:

This paragraph states, in some detail, applications of the basic cost principles and standards set forth in the preceding paragraphs of this part to certain selected items of cost. The statements herein apply irrespective of whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost herein is not intended to imply that it is either allowable or unallowable. With respect to those items not specifically covered, as well as all of the subparagraphs below, determination as to allowability will be made in the light of the basic principles and standards, ~~and, where appropriate, the treatment of similar or related items in this Part.~~ as set forth in Section 15-201. ~~All of the subparagraphs below are subject to the basic principles and standards set out in paragraph 15-201.~~

15-204.1 ADVERTISING

Comment: The draft of this paragraph is not equitable to the contractor in that, except to a very limited extent, it makes no provision for the recovery as cost under Government cost type contracts of all types of advertising expenses to the extent allocable to Government business. Modification has been made to give effect to changes to provide a more equitable treatment.

Such advertising results in the dissemination of technical information to industry and the deletion under item 1 is therefore recommended since this is an unnecessary

qualification which cannot be evaluated.

Item 3 has been added covering "institutional" advertising where the primary purpose is to promote the name of the company rather than individual products, which likewise is important in maintaining the company's facilities, trained personnel and the like. In fact many times it acts almost the same as help-wanted advertising as it establishes in the minds of certain personnel, particularly professional people such as engineers, a pride in their company or a desire to become associated with such a company.

Item 4 has also been added to cover other industrial advertising from which the Government also derives benefits. The Government has consistently failed to recognize except in very limited situations the advantages they derive from facilities which have been built up over a period of time which is the result of many factors, very important of which is advertising. It is well recognized that advertising has been very important in creating volume production, which now means that large industrial plants have been made possible with reservoirs of trained personnel, good facilities, know-how and all of the other requirements for successful production operations. Where advertising programs have been consistent over a period of years, there is no fundamental justification for the Government not to bear a fair share of the current cost of industrial advertising.

Suggested Revision:

Advertising expenses include the costs of advertising media and corollary administrative expenses. Advertising media include magazines, newspapers, radio and television programs, direct mail, trade papers, outdoor advertising, dealer cards and window displays, conventions and exhibits, free goods and samples, and sales literature.

a. The following advertising costs ~~only~~ are allowable.

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

2. Help wanted advertising, as set forth in paragraph 15-204.33.

3. Institutional advertising, which is defined as advertising the primary purpose of which is to promote the name of the company rather than individual products.

4. 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.

15-204.2 BAD DEBTS

Comment: Collection expenses referred to in this section should be limited to those collection expenses related to uncollectible customers' accounts. The phrase "and other claims" is subject to broad interpretation and could be construed to include employees' accounts and similar items which are a normal cost of doing business and hence should be allowable.

Suggested Revision:

Bad debt expenses consist of losses (whether actual or estimated) arising from uncollectible customers' accounts ~~and other claims~~, and include related collection expenses and related legal expenses. These costs are unallowable.

15-204.3 BIDDING EXPENSE

Comment: In the last sentence the words "only" and "equitable" might be interpreted to impose undue restrictions on the allowability of this class of expenses. The costs should be allowable if reasonable and properly allocated.

Suggested Revision:

Bidding expenses are the costs of preparing bid estimates on potential contracts or projects, including the development of engineering and cost data necessary to support the contractor's price proposal or estimated cost of work performance. Bidding expenses of the current accounting period of both successful and unsuccessful bids normally will be treated as indirect expenses and allocated currently to all business of the contractor, in which event no bidding expenses of past accounting periods will be chargeable to the Government contract. However, the contractor's established practice may be to treat bidding expenses by some other recognized method. Regardless of the method used, the results obtained may be accepted ~~only~~ if found to be reasonable. ~~and equitable.~~

15-204.4 CAFETERIAS, DINING ROOMS, AND OTHER FOOD SERVICES

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 near-by.

Suggested Revision:

This class of expenses consists of cost, less revenue, of operating or furnishing facilities for cafeterias, dining rooms, sales stores, canteens, lunch wagons, vending machines or other types of services for contractors employees. ~~at the contractor's facilities.~~ Profits accruing to the contractor from the operation from these services whether operated by the contractor or by a concessionaire, will be treated as a credit to costs of all production within the contractor's plant in which the services are furnished, except for services from which the profits are irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for the benefit of the employees. ~~at the bid location.~~ Reasonable losses from operation from such services are allowable. ~~when it is determined that the contractor is intending to operate such services at no less or profit.~~ The gains or losses from these services must be appropriately allocated to all activities benefited including Government contracts. ~~When such services are intentionally furnished at a less to the contractor, losses on such operation will not be allowed as a cost, unless authorized by special contract provision.~~

15-204.5 CIVIL DEFENSE

Comment: It is recommended that the words "on the contractor's premises", be deleted from the third sentence since bomb shelters and other civil defense measures may not necessarily be located on the contractor's premises.

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 over-all program. This is especially true where the contractor is the predominant industry in the community. Therefore, objection is made to the inclusion

of the final sentence of Section 15-204.5 since civil defense is a community responsibility and should be encouraged rather than discouraged.

Suggested Revision:

Civil defense costs are those incurred in the planning for and the protection of life and property against the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by local and state civil defense authorities. Examples of civil defense costs include cost in excess of normal plant protection expenses and may consist of first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions and other apprcved civil defense measures. Reasonable costs of 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. In the case of capital assets, acquired for civil defense purposes the costs thereof will be depreciated over a reasonable number of years in conformity with generally accepted accounting principles. ~~Except as specifically provided in the contract contributions to local civil defense funds or projects not on the contractor's premises are unallowable.~~

15-204.6 COMPENSATION FOR PERSONAL SERVICES

Comment: The present Section XV provides for the allowance of compensation for personal services, subject only to the test of reasonableness of the total compensation for the services rendered. The proposed Section departs very radically from this concept and requires the Government auditor not only to subject total compensation to the test of reasonableness, but also to inquire into and reject certain specific elements or methods of compensation. In effect, it would substitute the judgment of Government audit personnel for the judgment of the management of industrial concerns in determining the methods used in compensating employees. This approach is completely at variance with generally accepted accounting principles and practices which have always regarded any form of compensation for personal services rendered by employees as an ordinary and necessary cost of doing business. Current compensation also has been recognized consistently by the Internal Revenue Code subject to tests of reasonableness which have been well established under the regulations and court decisions.

The allowability for Government contract cost purposes of the compensation paid to individuals should be tested only by the reasonableness of the total compensation paid in light of the services rendered. The manner in which the compensation is determined or paid is a matter of management judgment which the Government has no right to question and should not attempt to usurp. If, for example, $15,000 is reasonable compensation for a given job, and company A pays this amount in straight salary, while company B pays $10,000 in salary and $5,000 in bonus, incentive or profit-sharing, the total compensation paid by company B should not be subject to question or disallowance merely because of the technique employed. Where the total compensation is reasonable and necessary to attract and retain capable personnel, it should be allowable. If it is not reasonable, it should be questioned and a reasonable amount arrived at by negotiated agreement. The burden of proof of unreasonableness in any individual instance should be on the Government and its representatives should show a realistic basis for setting aside any portion as unreasonable in amount.

The proposed Section completely fails to recognize that over the years a number of different techniques have been developed for arriving at the total compensation of individuals and that these techniques are widely employed by defense contractors. A current survey on compensation methods conducted by the American Management Association shows that of 2,354 companies included in the survey, 59.2% were utilizing bonus, incentive or profit-sharing plans in 1953. Payments under these plans averaged 45% of the salaries of those who received them. Of 1,707 manufacturing companies, 53% had such plans in effect. During the same year retirement programs were in effect in 58% of the 2,354 companies covered by the survey.

These statistics serve to emphasize that bonus and incentive plans, profit-sharing plans and retirement and pension plans, are in wide-spread use, as are insurance programs,

deferred compensation contracts and stock option programs. These programs generally have been adopted with an emphasis on incentive features and the selection of particular plans has been dictated by the needs of the business and by variations in the complexity, volume and other aspects of the business. Adoption of such plans provides stability in basic salaries while offering flexibility and incentives for stimulating efficiency in meeting production schedules, maintaining high standards of quality and keeping operating costs within budgets. All of these results have been of a very real and direct benefit to the Government.

In its treatment of specific elements of total compensation, the proposed Section contains provisions which in their application would, of necessity, be arbitrary, discriminatory and wholly inequitable as between contractors. Certain of these provisions would have the effect of discriminating against small business. The following comments and suggested revisions are offered concerning the individual subparagraphs of 15-204.6.

15-204.6a

Comment: The definition should be expanded to include all the various elements of compensation, specifically including bonuses and pension and retirement programs.

Suggested Revision:

This item includes all remuneration paid or accrued, such as, salaries, wages, bonuses, incentive and deferred compensation, stock options, pension and retirement programs and other fringe benefits for services rendered to the contractor by employees as well as fees paid to directors and committee members. Subject to specific limitations set forth hereunder, such costs are allowable when the total compensation is reasonable in light of the services rendered.

15-204.6b

Comment: The language of the paragraph would indicate that compensation of management officials is always suspect under certain conditions. Regardless of the presence or absence of these conditions, the compensation should be allowable if reasonable. It is also believed that this paragraph should set forth the test of reasonableness.

Suggested Revision:

Generally, the amount of compensation established by the contractor will be considered commensurate with the services rendered. ~~However, compensation of individuals such as corporate officials, directors, executives, department heads, partners and sole proprietors may be subject to special consideration and limitation as to allowability for contract cost purposes where amounts appear excessive. Some situations which may give rise to excessive compensation are where (i) the individual or member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization, or (ii) ownership of the contractor is limited to a small cohesive group, or (iii) the volume of Government contracts when related to the contractor's total business is such as to influence the amount of compensation.~~ Compensation will be considered reasonable where the total compensation, including fringe benefits, is commensurate with the total compensation for similar services paid by other companies in the same line of endeavor. Compensation of the management of closely held corporations, and of partners and sole proprietors will be scrutinized for reasonableness where the individual or member of his immediate family owns or has a commitment to acquire substantially all of the ownership interest in the contractor's business.

15-204.6c

Comment: The issuance of stock options to key employees of corporate management is a practice of many business corporations and it is a rapidly growing trend. Such options serve as an inducement to such employees to stay in continuous service in their businesses and share in the corporate successes achieved. Cost of such options is recognized as a business expense for tax purposes and likewise should be allowed as an expense of doing business under contracts with the Government.

Suggested Revision:

The cost of options to purchase stock of the contractor corporation granted to employees is ~~not~~ allowable as an item of cost.

15-204.6d

Comment: The provisions of this section which deals with currently payable bonuses and other incentives, as contrasted with deferred payment benefits, have incorporated some of the restrictions applied by the Internal Revenue Code to deferred compensation techniques. Such restrictions should not be applied to currently payable bonuses. Moreover, the section is redundant in that it includes certain of the standard tests of allowability already included in Section 15-201. It is believed that this section should cover all

types of currently payable bonuses and other incentives and that such expenses should be wholly allowable when properly allocated and when total compensation does not become unreasonable by virtue of such payments. Accordingly, the section should specifically recognize management incentives, as well as other bonuses and production incentives. (See attached statement on "Allowability of Management Incentive Bonuses for Contract Pricing Purposes" previously filed with the Government.)

Suggested Revision:

~~Subject to the provisions of subparagraph e below~~ bonuses to employees, such as production incentives, management incentives and suggestion or safety awards, represent a part of their total compensation and are allowable when appropriately allocated, if they are:

1. Paid pursuant to an ~~arms-length~~ agreement entered into in good faith between the contractor and the employees before the services are rendered, or pursuant to an established plan consistently followed by the contractor which constitutes, in effect, an implicit agreement on the part of the contractor.

2. Reasonable in amount, when considered as part of total compensation.

3. Paid for current services actually rendered by employees.

4. ~~Available to all employees of the contractor or to all employees within a group or salary classification which is not unreasonably restricted.~~

5. Allowable as an ordinary or necessary business expense for tax purposes.

6. Not restricted to officer or other employee stockholders or are not distributed on the basis of stockholdings.

7. ~~Total employee compensation is reasonable in amount for such services.~~

15-204.6e

Comment: Profit-sharing or incentive compensation plans, stock bonus plans and stock option plans are all an integral part of compensation for services, along with fixed salaries, and are considered necessary business expenses for tax purposes. These plans provide a part of total compensation essential to attract and retain managerial talent under present day tax, and executive market conditions. The market place for managerial talent knows no distinction as to type of business unless, indeed, a premium need be paid

for the talent necessary to handle the complexities of all phases of work on Government contracts.

Allowability for tax purposes is set forth in subparagraph d, as one of the criteria in determining allowable contract costs. Disallowance of carry-over provisions is inconsistent with the intent of subparagraph d.

The last sentence of sub paragraph (2) (ii) should be revised to provide that forfeitures will be taken into consideration in determining the costs currently allocable. The effect of forfeitures under deferred distribution profit-sharing plans will be so infinitesimal in relation to total contract cost and so small in dollar amount as to make it unwise to require any special agreements regarding them. It is believed that it would be much easier to administer a policy which would merely call for their being taken into account in determining currently allocable costs.

The provisions of subparagraph (3) should be deleted. If the plan meets all of the other tests prescribed, the degree to which the contractor is engaged in Government work should not be an element. If the cost is automatically a good cost for contractors with up to 25% Government business, it should be equally good for a contractor doing a higher percentage of Government business. Subparagraph (3) requires the application of an arbitrary, discriminatory and wholly inequitable criteria and would involve burdensome and costly negotiations on each individual contract. It would discriminate particularly against many business concerns whose business is predominantly with the Government and who have been valuable Government suppliers. It is also particularly discriminatory and inequitable when applied against the small business organization, whose business may fluctuate widely above and below the 25% figure. It is believed wholly unnecessary in light of the other requirements of the section and of the requirement of the over-all test of reasonableness and allocability of total compensation.

Suggested Revision:

1. As used herein profit-sharing is construed to be any plan (immediate or deferred-regardless of method of payment or participation) which includes, in whole or in part, a formal sharing of profits or is in any manner measured by dependent upon or contingent upon profit.

2. The cost of profit-sharing plans shall be allowable under the following conditions:

(i) Compensation payable under immediate distribution plans is allowable subject to the criteria set forth in subparagraph d. ~~above and g. below.~~

(ii) Employer contributions under deferred distribution profit-sharing plans, to be allowable costs, must meet all pertinent conditions set forth under subparagraph d. above ~~and g. below~~ and, if subject to Internal Revenue Service consideration, must have their approval. ~~The carry-over provisions of the regulations of Internal Revenue Service with respect to contributions under qualified deferred distribution profit sharing plans shall not be recognized for Government contract cost determination purposes.~~ Forfeitures of non-vested benefits under a profit-sharing plan will be ~~treated in accordance with the principles stated in paragraph 15-204.27f.~~ taken into consideration in determining costs currently allocable.

~~(iii) If the business of the contractor is more than 75% with non-governmental customers, the government's allocable share of the payments under the contractor's plan shall be allowable. However, where the business of the contractor is less than 75% with non-governmental customers, the government will accept for payment only that portion of its allocable share which results in the payment of 25% of the contractor's total payments under its profit sharing plans. The ratio of government to non-governmental business shall be determined on the basis of sales during the contractor's fiscal period to which the profit sharing is related.~~

15-204.6f STOCK BONUS PLANS

Comment: The deletion of the reference to subparagraph g below is recommended to be consistent with the position reflected under subparagraphs d above and g below.

Suggested Revision:

Stock bonuses which are not disallowed by the provisions of subparagraph e above are acceptable as a form of compensation, and the costs thereof are allowable subject to all conditions pertinent under subparagraph d above ~~and g below~~ and meet the following requirements:

1. The valuation placed on the stock for the purpose of calculating such cost must be computed on a sound basis.

2. In the case of unlisted stock having no current market, the contractor must demonstrate the values ascribed thereto are fair and reasonable.

3. Bonuses paid in the form of previously unissued stock of an affiliate will not ordinarily be allowed unless it can be demonstrated that there exists a bona fide

arms length agreement and the values ascribed to such stock are fair and reasonable.

4. Claims for accruals of compensation under a stock bonus arrangement prior to acquisition of stock by employees will not be allowable unless arrangements are made for appropriate credit adjustment of costs in the event such stock is not acquired by employees.

15-204.6g

Comment: Because of the variation in profit-sharing and stock bonus plans and their relationship to straight salaries, as between companies, a percentage limitation of this type would produce capricious and erratic results. The manner in which compensation is determined or paid is a matter of management judgment and the reasonableness of total compensation, in the light of what the market pays and general business practice, should be the criteria for the allowance of costs for personal services.

Suggested Revision:

~~For the purpose of determination of reasonableness, the employer contribution under profit sharing plans and stock bonus plans shall not exceed, in the aggregate for each participating employee, 15% of the total basic compensation paid or accrued to such employees in the year under consideration.~~

15-204.6h

Comment: Contains a typographical error in that the reference should be to 15-204.42, rather than 15-204.43. To conform to the other sections, it should also contain words of allowability.

Suggested Revision:

The determination of allowability of the cost of pension and retirement plans, training expense, overtime, extra pay and multi-shift premiums and other fringe benefits will be in accordance with paragraphs 15-204.27, ~~15-204.43~~ 15-204.42, 15-204.25, and 15-204.14 respectively. Any form of compensation to an employee not specifically mentioned in this part 2, in addition to those set forth in this paragraph, will be given consideration as a part of total compensation, and will be allowable if total compensation is reasonable.

15-204.7 CONTINGENCIES

Comment: This section is a desirable change in that it clearly establishes that the unallowable contingency reserves are those with uncertainty as to the happening of the

event. The entire Part 2 has also been improved through specific provisions covering certain elements of cost which frequently have been considered by auditors to be unallowable contingencies. However, Section 15-204.7 should contain general language making allowable an accrual for any true liability when the only element of uncertainty is the time of payment, or the definite amount of payment. As to the later, reasonable accruals should be permitted. In other words, where a definite liability is accruing, the cost should be recognized and accepted in reasonable amount. A cost should not be considered contingent unless there is really doubt as to the existence of the liability.

Suggested Revision:

This type of charge results from the creation and maintenance of reserves to provide for an event whose occurrence cannot be foretold with certainty as to time, intensity or even an assurance of its happening. These costs are not allowable. However, where a definite liability is accruing during the period of contract performance, a proper accrual for the liability may be made even though the amount of the liability or the time of its payment cannot currently be determined and accordingly the cost must be estimated, in which case a reasonable estimate is allowable. (For self-insurance programs see paragraph 15-204.16).

15-204.8 CONTRIBUTIONS AND DONATIONS

Comment: Contributions which are recognized for income tax purposes should be allowable, subject to the usual tests of reasonableness and allocability. The Department of Defense is to be commended upon its action in recognizing this item which industry has always felt to be a very ordinary and necessary business expense. To avoid misinterpretation a slight revision is suggested in the first sentence, and in view of the tests imposed, it is believed that the latter portion of the last sentence is unnecessary.

Suggested Revision:

Contributions and donations to established nonprofit 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. ~~but the deductibility of the contribution for income tax purposes does not in itself justify its allowability as a contract cost.~~

15-204.9 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) change subparagraph b. to specifically recognize methods authorized by the Internal Revenue Code, (2) delete the reference to contract performance from subparagraph c. on the ground that this provision should not be limited to idle or excess facilities necessary for contract performance, but should include all such facilities reasonably necessary for standby purposes for Government work in general and (3) provide in subparagraph e. that depreciation for contract costing purposes in the post-emergency period should be allowed on the unrecovered cost of the facilities. (For more detailed discussions, see attached statements on "Recognition of New Depreciation Methods Authorized by the 1954 Internal Revenue Code" and "Depreciation on Emergency Facilities Covered by Necessity Certificates for Contract Pricing Purposes" previously filed with the Government.)

Suggested Revision:

a. Depreciation as described herein is a charge to current operations intended to distribute the cost of tangible capital assets, less estimated residual value, if any, over their estimated useful life in a systematic and logical manner. It involves a process of allocation, not of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

b. Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, provided the amount thereof is based upon original acquisition cost. Depreciation will be accounted for by consistent application to the asset(s) concerned of any generally accepted accounting principles, including those recognized by the Internal Revenue Code and should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation charged in any accounting period may vary with volume of production or use of multi-shift operations, provided the method followed is consistent with basic objectives set forth in subparagraph a. above.

c. Charges for depreciation on idle or excess facilities will not be allowed except on such facilities as are reasonably necessary for ~~contract performance~~ standby purposes.

d. Unless otherwise provided in the contract, no use charge will be allowed on assets still in use which have been, in accordance with the contractor's consistent accounting practice, fully depreciated on the contractor's books of account. This does not apply to emergency facilities as covered by subparagraph e. below.

e. Where the contractor has applied for and received a determination of "true depreciation" from an Emergency Facilities Board covering emergency facilities acquired under certificates of necessity, the amounts so determined for "true depreciation" over the emergency period (5 years) will be ~~recognized in lieu of normal depreciation.~~ allowable as a cost. In determining allowable costs, the contractor may elect to use normal depreciation rather than "true depreciation" as determined by the Emergency Facilities Board. However, the method chosen after such determination of "true depreciation" must be followed consistently throughout the life of the emergency facilities. After the expiration of the emergency period for the facilities concerned whichever method is used for contract costing purposes where a determination of "true ~~depreciation" has been made~~, the remaining ~~undepreciated portion of the cost~~ costs of such facility not so recovered will be depreciated over its remaining useful life and will be the only amount recognized as allowable cost, subject to paragraph 15-204.12. ~~The contractor may elect to use normal depreciation rather than the "true depreciation" as determined by the Emergency Facilities Board. However, the method chosen after such determination of "true depreciation" must be followed consistently throughout the life of the emergency facilities.~~

15-204.10 EMPLOYEE MORALE, HEALTH AND WELFARE

Comment: The listing of examples might be interpreted in too restrictive a manner and its revision is suggested in order to include recreation programs and other activities aimed at improving employer-employee relations, or employee performance. The insertion in the last sentence is recommended for clarification.

Suggested Revision:

Included in this category are expenses of health and welfare activities incurred for the improvement of working conditions and the improvement of employer-employee relations and employee performance. Examples of these activities are publications, health or first-aid clinics, recreation, ~~and~~ employee counselling services and others aimed at improving employer-employee relations or employee performance. These costs are allowable when incurred in accordance with the contractor's established practice or custom in the industry or area and are reasonable and equitably allocated to all classes of work performed in the contractor's plant. Income received by a contractor generated from any of these activities will be credited to the costs thereof.

15-204.11 ENTERTAINMENT EXPENSE

Comment: Such expenses 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:

This item includes the cost of amusement, diversion, social activities and incidental costs relating thereto, such as meals, lodging, rentals, transportation and gratuities. These costs are ~~un~~allowable.

15-204.12 EXCESS FACILITIES

Comment: The exception should not be limited to standby facilities for the particular contract and accordingly it is suggested that the words "contract performance" be deleted from the first sentence. Where additional plant capacity is reserved for Government production the cost of such additional capacity should be covered either as a charge against current business, or recovered under a separate Government contract. Accordingly, it is suggested that the last sentence be revised to provide that the cost shall be allowable unless the facilities are covered by a separate contract.

Suggested Revision:

This item includes the cost of maintaining and housing idle and excess facilities, except those reasonably necessary for ~~contract performance~~ standby purposes. These costs are unallowable. The costs of additional plant capacity reserved for ~~defense~~ Government production shall be allowable unless the facilities are made the subject of a separate contract.

15-204.13 FINES AND PENALTIES

No Comment

Included in this item are those costs resulting from violations of, or failure of the contractor to comply with, local, state and Federal laws and regulations. These expenses are not allowable except when incurred as a result of compliance with specific provisions of the contract or instructions in writing from the contracting officer.

15-204.14 FRINGE BENEFITS

No Comment

Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries.

15-204.14 FRINGE BENEFITS Continued

a. The determination as to the allowability of the cost of pension and retirement plans, profit sharing and other bonuses, and servance pay will be in accordance with subparagraphs 15-204.27, 15-204.6 and 15-204.38, respectively.

b. The cost of other fringe benefits such as pay for vacations, hollidays, sick leave, military leave and employee insurance (but see subparagraph 204.16e) is allowable to the extent required by law, employer-employee agreement, or established policy of the contractor that constitutes, in effect, an implicit agreement on the contractor's part.

15-204.15 INITIAL PRODUCTION COSTS

Comment: It is recommended that (1) in the second sentence the word "include" be substituted for the words "consist of" and (2) the last sentence be deleted. "Starting-load costs" or "such costs" do not necessarily "consist of" only or all of the costs mentioned in the second sentence. Therefore the word "include" is considered to be more appropriate.

Auditors and contracting officers of the military departments will have difficulty in determining (a) when starting-load costs have continued to an "unwarranted extent" and (b) when a contractor has been allowed "reasonable time" to learn to make a product efficiently. Therefore, it is believed that the retention of the last sentence can only increase the number of "costs questioned" by the military auditor and the number of cases referred to higher authority by administrative contracting officers and contracting officers, thus resulting in, at the minumum, prolonged justification and argument on the part of contractors and undue delay in settlement of cost-reimbursement matters.

Suggested Revision:

Initial production costs, known also as "starting-load costs", are non-continuing costs that arise in early stages of production because of the contractor's lack of experience with particular materials, manufacturing processes or techniques involved. Such costs may include ~~consist of~~ excessive material costs resulting from abnormal scrap losses, excessive direct labor costs and related overhead resulting from idle time due to testing and change in production methods, cost of training employees, and excessive defective work due to inexperienced labor.

While initial production costs are allowable, the contractor will be expected to work actively to minimize or eliminate them as rapidly as possible. ~~In cases where these costs continue to an unwarranted extent after the contractor has been allowed reasonable time to learn to make the product efficiently, the excessive costs will be subject to disallowance.~~

15-204.16 INSURANCE AND INDEMNIFICATION

Comment: a. The words "and bonds" have been inserted for the reason that cost of bonds should be allowed for reimbursement.

b. In the first sentence, the words "within the limitations as to the extent of coverage and premium rates approved by the Government" should be deleted because the language is implied under subparagraph a. The change in the second sentence should be made since it is unnecessary for the Government to approve programs of "other insurance" and the costs thereof should be allowed to the extent they are reasonable and allocable to Government business. The contractor's judgment as to the amount of coverage and rates should be satisfactory unless specifically disapproved. Deletion of the last sentence is recommended because such insurance has become a recognized element in doing business and the entire cost should be allowed.

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

d. Provisions for losses under a self insurance program should be allowable if such provisions are established on an actuarial or historical basis.

e. No comment.

f. This paragraph has been modified to make it consistent with ASPR 7-203.22.

g. Deletion of this paragraph is recommended since it is not clear what is meant by "Cost of indemnification."

Suggested Revision:

a. Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative, and (2) any other insurance and bonds for which the contractor seeks reimbursement under the contract. The kinds of insurance ordinarily included in the first category are set out in ASPR 10-501.

b. Costs of government required insurance are allowable. ~~within the limitations as to the extent of coverage and premium rates approved by the Government.~~ Costs of other insurance, except that applicable to government-owned property, are allowable ~~provided (1) the insurance has been approved by the military department concerned or (2) in the absence of such approval requirements,~~ to the extent that any part of a contractor's insurance program has not been disapproved by the military departments, provided that the types of coverage, extent of coverage, and rates are reasonable under the circumstances. ~~Costs allowed for use and occupancy insurance, however, will in principle be limited so as to exclude coverage of profit, interest, federal income taxes, and any other items of expense unallowable under this part.~~

c. The costs of insurance or any reserve covering the risk of loss of or damage to government-owned property are ~~not~~ allowable except to the extent that the Government ~~may have required the contractor to carry such insurance,~~ has specifically relieved the contractor or his subcontractors of the risks by contractual agreement.

d. Provisions for losses under ~~The costs of~~ a self-insurance program established on an actuarial or historical basis are allowable ~~provided the program has been approved by the military department concerned~~ subject to the tests of reasonableness and allocability under paragraph 15-201. Actual losses sustained under such a self-insurance program are therefore not allowable.

e. The costs of insurance on the lives of officers, partners, or proprietors, are not allowable except where such insurance is part of an employee plan which is not unduly restricted.

f. Losses not covered by insurance resulting from failure to insure ~~(through self-insurance or otherwise) against a contingent loss or damage, where a reasonably prudent business organization would have insured against such loss or damage are not~~ allowable, except in those instances where the contractor failed to comply with the direction of the contracting officer to carry insurance.

g. ~~Cost of indemnification will be allowable only to the extent expressly provided for in the contract.~~

15-204.17 INTEREST AND OTHER FINANCIAL EXPENSES

Comments: NSIA views upon this subject were presented to the Honorable Charles E. Wilson in a letter dated 3 September 1954. The present treatment of interest and other financial

expense is inequitable and such costs should be allowed. (See attached statement entitled "Allowability of Interest on Borrowed Capital in Military Contract Pricing.")

Suggested Revision:

This item includes interest paid or accrued (regardless of the nature of the obligation which gives rise to the interest cost), bond discount and expenses, and the cost of financing and refinancing operations as well as legal and professional fees paid in connection with the preparation of a prospectus, cost of preparation and issuance of stock rights and expenses related thereto. (See also 15-204.24). These costs are allowable. ~~unallowable, except for interest assessed by state or local taxing authorities under the conditions set forth in subparagraph 15-204.40.~~

15-204.18 LABOR RELATIONS

No comment.

This item covers expenses incurred in maintaining satisfactory relations between the contractor and his employees. It includes the cost of shop stewards, labor management committees, employee publications and other related activities. Costs incurred for these purposes are allowable.

15-204.19 LOSSES ON OTHER CONTRACTS

Comments: This paragraph should be revised to permit the allowability of losses or costs incurred under participating research and development contracts where it is intended. As written, the paragraph is inconsistent with the Court of Claims decision in Bell Aircraft Corp., v. U.S., 100 F. Supp. 661 (Ct. Cls. 1951) aff'd. per curiam, 344 U.S. 860 (1952), where a Government contractor was allowed to capitalize losses on experimental contracts and allocate them as costs to other Government contracts.

Suggested Revision:

This item covers any excess of costs over income under any and all other contracts, whether such other contracts are of a supply, research and development or other nature. Except for participating research and development contracts, costs of this nature are not allowable as a cost of performance of the Government contract.

15-204.20 MAINTENANCE AND REPAIRS

Comments: It is recommended that:

1. In the second line, the word "property" be defined to include Government-owned facilities.

2. In the fourth line, the word "its" be changed to "an".

3. Subparagraph b. 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 b. 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:

a. This item includes those costs necessary for the upkeep of property (including Government-owned facilities) which neither adds to the permanent value of the property nor appreciably prolongs its intended life but keeps it in an ~~its~~ efficient operating condition. These costs are allowable. Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation will be allowable only on a depreciation basis. Cost of maintenance and repairs of excess facilities and of idle facilities (other than reasonable standby facilities) are not allowable.

~~b.--Deferred-maintenance-is-defined-as-maintenance-and-repairs-which-for some-reason-such-as-abnormal-operating-conditions-or-lack-of-funds,-is-delayed-to-a future-period.--The-cost-of-maintenance-and-repairs-which-has-been-deferred-from-a-period-prior-to-the-contract-is-not-allowable-unless-specifically-provided-for-in-the contract.--Likewise,-the-estimated-cost-of-maintenance-and-repairs-normally-required-but-not-accomplished-during-the-period-of-the-contract-will-not-be-allowed-as-a-cost unless-specifically-provided-for-in-the-contract.~~

15-204.21 MANUFACTURING AND PRODUCTION ENGINEERING

Comments: It is recommended that tool modification be included in the list of current manufacturing processes. Manufacturing and production engineering includes tool modification as well as tool design and tool improvement.

The last sentence of the paragraph should be modified to be consistent with the referenced paragraphs 15-202 and 15-203. The contractor's consistent practice of distributing such costs should be acceptable. The present language of the paragraph will cause questions to be raised by military auditors and contracting officers merely because a contractor's practice may not be in accordance with the instruction "should ordinarily be" or "should be".

Suggested revision:

Manufacturing and production engineering includes the cost of engineering activities in connection with (1) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design, modification, and improvement and (2) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production. These costs are allowable. For purposes of distribution, such costs should ordinarily be distributed as provided in paragraphs 15-202 and 15-203. ~~divided-into-two-categories: (1)-these-which directly-benefit-a-contract,-a-project,-or-a-product-line-and-(ii)-these-expenses-which are-not-subject-to-direct-costing.--Items-in-category-(1)-should-be-charged-directly-to the-contract-or-project-or-allocated-to-the-products-in-the-product-line.--Costs-in category-(ii)-should-be-allocated-to-all-benefitted-work.~~

15-204.22 MATERIALS AND SUPPLIES

Comments:

a. The major change here is the deletion of the word "net". Industry should have the freedom of choice between applying discounts, adjustments, etc. either direct or through overhead.

b. The reasons for the changes in this paragraph are apparent. Here again Industry should have the prerogative of treating such credits either direct or through

overhead.

c. No comment.

d. The word "generally" has been deleted as it is felt to be too restrictive as used in this sentence. Any recognized method of pricing should be acceptable. The word "equitable" has been replaced by "reasonable". This substitution is made on the basis that the word "equitable" can be too controversial by injecting into the exercise of judgment by the Audit Service or Contracting Officer elements not encountered if the word "reasonable" is used.

The provision in the second sentence regarding the use of replacement cost should be permissable without contract provision. In addition the requirements of identifying such items at the time the contract is entered into would be entirely too burdensome to the contractor and in fact would not be feasible from a practical standpoint.

e. Flat disallowance of "write-down" of values of inventories is not equitable. 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 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.

f. 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 made from sources outside of the contractor's business as a legitimate item of contract cost and which, of course, includes 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. It is felt that this is basically wrong and the redraft of the ASPR comments and proposals is intended to correct this.

g. A paragraph has been added to cover pricing on articles normally manufactured by a contractor where it involves the contractor's prime location. Paragraph f covers these transactions where "inter-unit" shipments or transfers are involved but does not cover the contractor's prime division where he may supply articles normally manufactured and supplied on his prime contract. The arguments for the acceptance of paragraph f hold equally as well for this paragraph.

Suggested revision:

a. This item includes the ~~net~~ costs of such items as raw materials, parts, sub-assemblies, components, and manufacturing supplies, whether purchased outside or manufactured by the contractor, and may include such collateral items as inbound transportation and in-transit insurance. These costs are allowable subject, however, to the provisions of subparagraphs b through f below.

b. Cost of materials and supplies shall be suitably adjusted either directly or indirectly as a reduction of costs for applicable portions of income and other credits received by the contractor. Such income and other credits may include trade discounts, refunds, rebates and allowances, cash discounts taken by the contractor, ~~and~~ credits for scrap and salvage, and materials returned to vendors. ~~However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond his control, such lost discounts will be allowed.~~

c. When materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to the contract.

d. If materials are issued from stock, any ~~generally~~ recognized method of pricing such materials will be acceptable, provided the method is consistently applied and the results obtained are ~~equitable~~ reasonable. Where materials in stock at the commencement date of the contract have a provable replacement cost significantly higher than book cost, the contractor may, ~~and the Government may, by contract provision, agree upon the~~ use ~~of~~ a method of pricing based upon the fair value of the materials as of the date of the contract, but not in excess of replacement cost on such date. ~~Such agreement should include identification of the types or kinds of materials involved and should be made at the time the contract is entered into and provided for therein.~~

e. Reasonable charges arising from difference between periodic physical inventory quantities and related material control records will be included in arriving at the cost of materials, provided that such charges ~~(i) do not include "write-downs" of values, and (ii)~~ relate to the period of performance of the contract. All credits arising from differences between periodic physical inventory quantities and related material control records shall be taken into account.

f. ~~Ordinarily~~ If a contractor has an established method for pricing sales or transfers of materials ~~and~~, supplies and services between plants, divisions, or organizations, under a common control, ~~shall be stated on the basis of cost to the transferor. 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 provided that the price charged to the contract~~ any such materials or supplies manufactured and sold by any such transferor 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 transferor's ~~sale~~ price customarily charged to its most favored non-affiliated user customer for the same item or service in like quantity or (ii) the prices ~~of~~ 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.

g. 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.

15-204.23 ORGANIZATION EXPENSES

No Comment.

This item consists of expenditures in connection with organization or re-organization of a business. Examples of such costs are incorporation fee, attorneys fee, fees to promoters and organizers and costs of raising capital. These costs are unallowable. (See paragraph 15-204.17).

15-204.24 OTHER BUSINESS EXPENSES

Comments: The use of the word "annual" in the first sentence should be deleted since contractors are required, under certain circumstances, to issue periodic reports to stockholders in accordance with requirements of the Securities Exchange Commission and other regulatory bodies.

In the last sentence of this paragraph that portion directly following the word "allowable" has been deleted since this portion of the sentence would give the Contracting Officer an opportunity to match opinion with the contractor as to his business practices

which is considered to be outside the realm of his responsibility. Further, it is felt that 15-201 covering the factors of reasonableness and application of generally accepted accounting principles and practices adequately covers the Contracting Officer.

Suggested Revision:

Included in this item are such recurring expenses as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of ~~annual~~ reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies and incidental costs of directors' and committee meetings. The above and similar costs are allowable when ~~incurred in reasonable amounts in accordance with the contractor's established practices and are~~ allocated on an equitable basis to all classes of work.

15-204.25 OVERTIME, EXTRA-PAY SHIFT AND MULTI-SHIFT PREMIUMS

Comments: Contractors should not be required to separately identify overtime premium if it is not in accordance with the contractor's accounting system. The requirement is restrictive and unnecessarily burdensome.

The major change made in this paragraph deals with overtime and shift premiums identified to direct and indirect labor and emergency overtime. The paragraph as written would treat shift payments and shift premiums as out of the ordinary and not to be authorized without special permission. The practice of granting premium pay for unpopular shifts in a multi-shift operation is standard operating procedure; in fact, it is normally made a provision in union contracts. The paragraph should therefore be rewritten as suggested to set up a paragraph (a) covering overtime pay and a paragraph (b) covering shift premiums with the understanding that shift premiums are allowable if in accordance with the contractor's practices and procedures.

In so far as emergency overtime is concerned, allowance of this type of premium without specific authorization is contained in ASPR 12-102(c) which states "The policy stated above shall not be construed to limit the use of or payment for emergency overtime work as may be required ..... ". Such a provision should also be included in 15-204.25 as reflected in the suggested revision.

Suggested Revision:

This item consists of the premium portion of overtime and shift payments to employees. Such premiums may be classified as either direct or indirect labor costs. ~~but the amount of overtime premium should be separately identified.~~ When direct labor cost is the base for distribution of overhead, overtime premiums shall not be included therein. (a) Cost of overtime ~~and shift premiums~~ paid to the direct labor force are allowable ~~only~~ to the extent expressly provided for in the contract or otherwise authorized by the Government. ~~See ASPR 12.102 for further information concerning the policy regarding such authorization.~~ However, this shall not be construed to limit the use of or payment for emergency overtime work as may be required. The cost of overtime paid to the indirect labor force for emergency overtime work or to handle periodic peak administrative loads is allowable. ~~The amount of overtime and shift premium cost charged on government contracts shall be equitable in relation to the amount of such costs charged on non-government work being concurrently performed in the contractor's plant and the factors which necessitate the incurrence of the cost.~~ (b) Shift premiums in accordance with the contractor's practices and procedures are allowable.

15-204.26 PATENT EXPENSES

Comments: The proposed language of this paragraph would disallow the cost of preparing patent applications unless such applications were filed on behalf of the Government or the written authorization of the contracting officer was obtained. 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. Such activities are of direct benefit to the Government even though the Government may not obtain any rights under the patents because, by obtaining a patent, a contractor avoids the necessity of eventually being required to pay a royalty to some other person who may obtain a patent on the same invention. Moreover, the costs of maintaining a patent department in any manufacturing company is a necessary cost to its overall operations and should be considered as a necessary cost of doing business. The primary change which has been made in the paragraph therefore covers an addition which would allow all costs leading to the issuance of patents as well as infringement, investigation and litigation. There has also been included preparation of licenses to the Government as well as disclosures.

Suggested Revision:

Included in this item are such expenses as amortization of the cost of purchased patents and all costs leading to the issuance of patents, as well as the cost of infringement investigation and litigation. Amortization of the cost of purchased patents applicable to contract products or processes is allowable. ~~The cost of preparing disclosures~~ All costs leading to the issuance of patents, the cost of infringement, investigation and litigation, cost of preparing disclosures and licenses to the Government as required by the contract, and of preparing assignment and other papers in connection with the filing of a patent application for the Government, and any expenses incident to patents incurred upon the written authorization of the contracting officer, are allowable. ~~All other patent expenses and~~ Charges for the use of patents where the Government has a license or the right to free use thereof, are unallowable. ~~The cost of research and development work leading to patents is treated in subparagraph 15-204.35.~~

15-204.27 PENSION AND RETIREMENT PLANS

Comments: (a) Paragraph 'a' of this clause establishes a definition for pension and retirement plans. We have suggested deletion of the fourth and fifth sentences from the definition because of their restrictive nature. Pension and retirement plans may be established which are dependent upon profits and such plans if approved by the Internal Revenue Service should be acceptable to the Military. In other instances such plans may fall under the scope of the special case situations covered by paragraph 'g'. The fifth sentence is ambiguous and raises a number of points capable of misinterpretation. There is some indication that if pension plans employ funds, arising from any cause whatsoever in the operation of the plan, in a manner other than to reduce the employers contribution, the plan will be considered as falling outside the definition. In addition, the sentence mingles the technique of determining pension benefits with the question of how certain reversionary credits should be handled. Paragraph 'f' adequately deals with reversionary credits and the possibility that some pension plans may provide for increased benefits under certain circumstances should not outlaw them.

(b) Part 6 of Section XV has heretofore treated pension and retirement plans as giving rise to recognized costs of doing business. In establishing principles in part 2 for determining the allowability of such required costs, it is necessary to take into account that pension plans are employed by firms of all sizes. The pension and

retirement plans of all commercial enterprises (other than tax-exempt and non-profit institutions) come under the cognizance of the Internal Revenue Service for approval purposes. The Government business done by these firms as compared to commercial business varies from small to relatively large proportions. Generally, the proportion of Government business done on a cost reimbursement basis is relatively small as compared with the total business of the contractor. Because of all of the above factors it is important that a standard applied by only one Government Agency be used in evaluating the plans employed by the various segments of industry. Where such Government approval has been obtained, additional approvals by agencies of the Military Departments are unnecessary.

For purposes of determining allowability and allocability, approval of the cognizant auditing agency should be binding upon the other Departments; it is unnecessarily expensive for both the Government and the contractor to be required repeatedly to submit the contractor's system for review to a number of Agencies.

(c) Criteria established to determine the allowability of costs should consider the costs allowable under such approved plans subject to the usual tests of reasonableness and allocability. Where the contractor has an established pension plan in which all employees working on Government and other business are indistinguishable as to conditions of employment, eligibility of benefits, pension contributions should be allowed in full to the extent allocable to Government business.

(d) No comment.

(e) Reallocation of costs between years on the basis of Internal Revenue technical limits which 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. Application of the Internal Revenue Code limitation in any year without permitting the carry-over to subsequent years is inequitable. The contractor has in fact, incurred the cost and its deferral to another year for tax purposes recognizes this. To attempt to segregate a small portion of the contractor's contribution

allocable to a single contract in a particular year, when the majority of contractors have a number of Government contracts on which performance is spread over a number of years, is a meaningless refinement which in the long run will benefit neither the Government, the Military Department nor the taxpayer.

(f) Methods used by some contractors to determine pension contributions take into account unusual as well as normal fluctuations in employment and are susceptible to review to so demonstrate. Methods used by other contractors to determine contributions may be found to be inadequate to provide for such fluctuations and may thereby make it necessary for the Government to require special provisions for revisionary credits. In such instances no particular methods should be prescribed but each case should be handled by whatever method is mutually agreed to be appropriate in the light of all the circumstances.

(g) The costs of lump sum purchases of annuities or of lump sum payments to approved pension and retirement plans should be allowable without specific contract provision. The Government is adequately protected by the tests of reasonableness and allocability referred to in paragraph 15-201(b).

Suggested Revision:

a. A pension plan as used herein is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to his 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 service 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 will be considered a pension plan, if, under the plan, either the benefits payable to the employee or the required contributions by the contractor can be determined actuarially.

b. Pension and retirement plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the Military Department. Consideration of the plans by the Military Department will be limited to consideration of cost and allocability thereof and will be the responsibility of the Department to which audit cognizance is assigned and determinations by the cognizant audit agency will be accepted by the other Departments. ~~However, approval of the plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such plan by the Military Department. Consideration of the plans will be the responsibility of the Department to which audit cognisance is assigned and the subsequent action taken by that Department will generally be accepted by the other Departments. In cases where the Internal Revenue Service withdraws approval of a plan, amounts allocated to contract costs will be withdrawn accordingly.~~ Where pension and retirement plans of non-profit or other tax-exempt organizations are not required to be reviewed and approved by the Internal Revenue Service, it will be the responsibility of the Department to which audit cognizance is assigned to give consideration to the acceptability of such plans.

c. The cost of pension and retirement plans approved by the Internal Revenue Service ~~which are properly deductible from taxable income~~ are allowable except as otherwise determined unallowable under this paragraph. The cost of retirement plans, which are based on profit sharing, shall be subject to paragraph 15-204.6e. Costs of acceptable pension and retirement plans established by non-profit or other tax-exempt organizations are also allowable except as otherwise determined under this paragraph.

d. Pension and retirement costs constitute a part of the total compensation by a contractor to the individuals covered by the plan, and accordingly, are subject to the provisions of this section with respect to reasonableness of the total compensation paid to the individual for the services rendered. (See 15-204.6)

e. The amount of the contribution subject to allocation as a contract cost will be limited to the maximum amount required to fund an approved plan, or the amount actually contributed, ~~during~~ for the taxable year, whichever is the lesser. ~~The carry-over provisions of the Internal Revenue Code with respect to contributions under pension and retirement plans shall not be recognized for the purpose of determining allowable pension and retirement costs under Government contracts.~~

f. Credits which arise under pension plans from various sources, such as dividends and cancellation of employee benefits which have not vested at the time of termination of their employment, must be taken into account in an equitable manner in the determination of the allowable pension and retirement contribution. Special provision for these credits ~~is usually~~ may be necessary when the contractor's organization has substantially expanded for the performance of military contracts and there is a reasonable expectation that the employment of a large number of the additional employees will be terminated upon curtailment of military work. 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, ~~Under these circumstances~~, 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. ~~There are two general methods which may be used, individually or in combination, in making such arrangements.~~

~~(1)--A-lump-sum-or-percentage-discount-of-current-pension-costs-negotiated and-agreed-upon-in-advance.--Determination-of-such-allowance-generally-is-not-an actuarial-problem-involving-a-calculation-based-upon-known-factors,-but-rather-is-an attempt-to-reach-a-negotiated-agreement-as-to-various-uncertain-or-variable-factors in-a-complex-situation.~~

~~(2)--A-retrospective-determination-at-some-time-in-the-future-when-a-more accurate-estimate-can-be-made-by-virtue-of-experience-which-may-have-developed.--Until such-determination,-current-costs,-which-should-be-not-of-current-credits may-be allowed-provided-an-appropriate-contractual-agreement-can-be-reached-which-reserves the-Government's-right-to-future-credits.~~

g. The costs of lump sum purchases of annuities or of lump sum cash payments or periodic cash payments made to provide pension or retirement benefits for retiring or retired employees other than incurred under approved pension and retirement plans will be considered on an individual case basis and are allowable ~~only-to-the-extent-specifically-provided-for-in-the-contract.~~ subject to the usual tests of reasonableness and allocability.

15-204.28 PLANT PROTECTION EXPENSES

Comments: All plant protection expense should be considered as allowable cost. The objection to segregation of plant protection into two classifications is two-fold. First, in the case of a contractor working on a number of classified Government contracts in a given location, it would be difficult if not impossible to apply such special plant protection costs directly to each contract. One guard may provide equal protection to all work. Second, it is not practical for the contractor to develop individual overhead rates for each Government contract if he holds numerous contracts.

This paragraph as written also fails to recognize the existence of a third class of plant protection expenses, namely, those expenses which arise peculiarly from doing business with the Government, but which are not of a type which arise because of the specific "direction" and "approval" of the Contracting Officer. Expenses referred to include the costs of clearing personnel to handle classified work, the acquisition of special cabinets and safes for storage purposes, etc. as required by the Security Agreements and Military Security Requirements Clause of contracts. These costs are common to Government business as a whole and are apart from special security measures which may be ordered by a contracting officer under a specific contract. In view of the foregoing, the article should be rewritten as follows:

Suggested Revision:

This item includes the cost of all plant protection measures such as wages of guards, equipment of guards (uniforms, fire arms, etc.), and depreciation on plant protection capital assets, storage of classified matter, clearance of employees, etc. and includes all costs required by the nature of contractor's business, requirements of Military Security Requirements Clause ASPR 7-104.12 and DD441 Security Agreement and the cost of special plant protection measures specifically ordered or approved by the Contracting Officer. These costs are allowable and allocable in accordance with the basic principles and standards of 15-201. ~~For the purpose of contract costing, these expenses are divided into 2 categories, namely, normal plant protection expenses and special plant protection expense. Normal plant protection costs are allowable and are allocable to all work in the plant. Special plant protection costs, which term refers to an extension of the contractor's normal plant protection program are also allowable and allocable to specific Government contracts requiring special protection upon the specific direction and approval of the contracting officer.~~

15-204.29 PRE-CONTRACT COSTS

Comments: The second sentence of the paragraph as written tends to contradict the first in that it limits the type and amount of cost that may be allowable without regard to whether such costs are otherwise reasonable and necessary and would therefore have been allowed if incurred after the execution of the contract. Accordingly, it is suggested that the paragraph be rewritten as follows:

Suggested Revision:

Pre-contract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs will ~~not~~ be allowed ~~unless~~ when authority therefor is specifically set forth in the contract and may be limited to a period of time. ~~as well as to the type and amount of such costs.~~

15-204.30 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER

Comments: (a) This paragraph as written singles out the costs of professional services rendered by members separately engaged, 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.

(b) 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 regula-

tions, 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.

(c) The cost of successful defense of anti-trust suits and the successful prosecution of claims against the Government should also be allowable. We suggest the clause be rewritten as follows:

Suggested Revision:

a. This item includes the cost of professional services rendered by the members of the particular profession whether as members of the contractor's organization or separately engaged. These costs generally are allowable when reasonable and allocable in accordance with the basic principles and standards of 15-201. ~~in-relation-to-the services-rendered-and-are-not-contingent-upon-recovery-of-the-costs-from-the-Government.~~

b. ~~Factors-to-be-considered-(among-others)-in-determining-the-allowability of-costs-in-a-particular-case-are:--(i)-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-organization;-and-(iv)-whether-or-not-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-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.

c. The costs of legal, accounting and consulting services and related expenses incurred in connection with organization or reorganization, prosecution of patent infringement litigation (except as provided for in 15-204.26), unsuccessful defense of anti-trust suits, and the unsuccessful prosecution of claims against the Government are unallowable.

15-204.31 PROFITS AND LOSSES ON DISPOSITION OF PLANT AND EQUIPMENT OR OTHER CAPITAL ASSETS

Comments: Flat exclusion of profits and losses on disposition of Plant and Equipment is objectionable. If assets are acquired for a contract and have no other use, a profit or loss on disposition indicates that the depreciation assumptions were not completely realized and the profit or loss on disposition adjusts for the difference. It is suggested that the clause be modified as follows:

Suggested Revision:

Included herein are gains or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments. Profits or losses on sale or exchange of ~~capital assets, including~~ investments, will be excluded in computing contract costs. Profits or losses on the sale or exchange of plant, equipment, or other depreciable assets will be included in computing contract costs.

15-204.32 RECONVERSION EXPENSES

Comments: Where a contractor has made special plant changes in order to introduce a Government contract into his production, the cost of that contract is not complete until it covers 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 Defense 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 expenses are those incurred in 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.~~

15-204.33 RECRUITING EXPENSE

No comment.

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

15-204.34 RENTALS OF PLANT AND EQUIPMENT ~~(including sale and leaseback of facilities)~~

Comments: In the preamble to the paragraph, the words "to investment organizations (such as insurance companies) or to private investors" should be deleted since the language is too restrictive and susceptible to misinterpretation.

It is recommended that clause (b) be deleted from this paragraph since clause (a) appears to provide adequate safeguards. Clause (b) 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 (a), which indicates that rates must be reasonable in light of the type, condition and value of the facilities leased, appears to give the Government complete protection. If clause (b) 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 (a) 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 (a) provides for a check of option arrangements and other provisions of rental agreements for the purpose of determining reasonableness.

Suggested Revision:

The following revisions are necessary because of deleting clause (b):

This item includes expenses for (i) use of land, buildings, and equipment or other personal property, and (ii) rental expenses under sale and lease-back agreements incurred by contractors through sale of plant facilities and concurrently leasing back the same facilities.

a. Rentals of plant and equipment under (i) and (ii) above are allowable if the rates are reasonable in light of the type, condition and value of the facilities leased, options available and other provisions of the rental agreement.

b. ~~Rentals specified in sale and lease back agreements under (ii) above are allowable only to the extent that such rentals do not exceed normal costs (such as depreciation, taxes, insurance and maintenance expenses) which would have been incurred had the contractor retained legal title to the facilities.~~

15-204.35 RESEARCH AND DEVELOPMENT

Comments: It is believed that the Government has started out with a constructive effort to recognize the great mutual benefits to be derived from encouraging research by industry. However, the new draft then proceeds to so fence in the cost allowance by restrictions as to destroy much of the originally indicated intent. Specifically, it is believed the following changes should be made to eliminate these restrictions:

1. Clause (1)(iii) should be deleted which requires the contractor to divulge results of independent general research. This 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.

2. Clause (1)(iv) should be eliminated which establishes a completely arbitrary and discriminatory distinction between contractors with 75% or more of their business with non-Government customers and those with less than 75%. If the cost of a research program meets the tests of reasonableness and other criteria, the degree to which the contractor is engaged in Government work should not be a determining factor. If a particular item is a good cost for contractors with up to 25% Government business, it is equally good for a contractor with a higher ratio of Government business. This limitation is particularly inequitable when applied to businesses whose Government work is subject to fluctuations above and below 25%. The criterion fails to give any consideration whatsoever to amount or importance of research involved.

3. The paragraph following clause (1)(iv) which states that the conditions apply also in the negotiation of predetermined overhead rates should be deleted. This statement is not pertinent to a regulation covering cost principles nor is it necessary.

4. In connection with research which relates to a product or product line covered by a specific research and development contract, 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. The changes shown under suggested revisions of clause (2) are made to give effect to this principle.

5. Revision of paragraph c 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:

Research and development expenses (sometimes referred to as general engineering expenses) for the purpose of contract costing are divided into two major categories, namely:

a. General research, also referred to as basic research, fundamental research, pure research and blue-sky research.

b. Related research or development, also referred to as applied research, product research and product line research.

(1) General research is that type of research which is directed towards increase of knowledge in science. It is research where the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. The costs of a contractor's independent general research (that which is not sponsored by a contract or grant or is not otherwise reimbursed to a contractor) shall be an allowable cost in all cost type contracts under the following conditions:

(i) The amount of such costs is reasonable.

(ii) The costs are equitably allocated to all work of the contractor other than its independent general and related research.

~~(iii) The contractor agrees to divulge to the Government the results of such independent general research.~~

~~(iv) The business of the contractor at the time of entering the contract is predominantly (75% or more) with non-Governmental customers. If less than 75% at the time of entering the contract, allowance may be authorized by special contract provision.~~

~~The above conditions will also apply in the negotiation of predetermined overhead rates.~~

(2) Related research is that type of research which is directed toward practical application of science, and "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 15-204.21.) The costs of a contractor's independent related research and development (that which is not sponsored by a contract or grant or is not otherwise reimbursed to a contractor) is allowable ~~may~~, if equitably allocated ~~on the basis of all production, be allowed~~ as a cost under any cost type ~~production~~ contract if the research is related to the contract product or product line. ~~No portion of such research will be allowable under cost type research and development contracts.~~ Where related research and development is directed toward the development of products primarily for military use, the cost thereof may be allocated entirely to Government business.

c. Research and development costs, regardless of the nature, which were incurred in accounting periods prior to the award of a particular military contract, (including amounts capitalized and the cost of patents obtained) will not be allocated to that contract unless approved by the contracting officer or allowable as precontract costs (Paragraph 15-204.29).

15-204.36 ROYALTY PAYMENTS

Comments: Royalties and fees paid for the use of patents or technical information 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 Revision:

This item covers amounts paid or payable for the right to use patents or technical information. ~~Where the use of such patents is necessary for the proper performance of the contract and where the Government does not already have a license or other right to use such patents, the royalties are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the contracting officer.~~ Royalties or fees paid or payable by a contractor for the right to use such patents or technical information are allowable to the extent allocable to government contracts.

15-204.37 SERVICE AND WARRANTY EXPENSES

No comment.

This item includes the costs of servicing the product installation, training personnel in the use, operation and maintenance of the product, correcting product defects, replacing defective parts, and other related operations or practices. Actual costs to be reimbursed to the contractor will be in accordance with the clause of the contract entitled "Inspection of Supplies and Correction of Defects", (See paragraph ASPR 7-203.5), or as otherwise provided in the contract.

15-204.38 SEVERANCE PAY

Comments: The criteria to determine the allowability of the cost of severance pay as set forth in the second paragraph of this section appears to be clear and adequate. However, the subsequent attempt to separate severance payments into two classes - normal turnover severance pay and mass severance pay - can only lead to unnecessary confusion and inconsistent interpretation. The proposed revision would eliminate the source of confusion without taking away the prime requisites for the determination of allowability referred to above and the further tests of reasonableness and allocability. Besides being unnecessary,

the government's proposed treatment of "mass severance pay" would in most cases be cumbersome, difficult and impractical to apply.

Suggested Revision

Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated.

The cost of severance pay is allowable only to the extent that, in each case, it is required by (i) law, (ii) employer-employee agreements, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) the circumstances of the particular employment.

For contract costing purposes severance pay is ~~divided into two categories as follows:~~

~~a. Normal Turnover Severance Pay. The cost of severance payments is~~ allowable and must be allocated to all classes of work being performed in the contractor's plant at the time of payment. However, 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.~~

~~b. Mass Severance Pay. The cost of abnormal or mass severance pay 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 entire period of employment with the contractor and equitably apportioning such cost to all business of the contractor performed during that period.~~

A reservation in the final release of claims (See ASPR 7-203.4) may be made in the case of completed cost-reimbursement type contracts when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

15-204.39 SPECIAL TOOLING

No comment.

The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or to the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. The cost of special tooling when acquired for and its usefulness is limited to government contracts, is allowable and will be charged directly to the government contracts. When such special tooling is acquired it shall be subject to the provisions of the contract clause set forth in ASPR 13-503 entitled "Government Property."

15-204.40 TAXES

Comments: In subparagraph a (iii), the excluded taxes should be limited to those for which the Government has actually provided exemption. In many cases the cost of securing exemption exceeds the amount to be saved and neither the Government nor the contractor would require the exemption to be claimed.

The suggested change in the last sentence of subparagraph b is to specifically provide for the coverage of any other costs incurred in complying with the instructions or directions of contracting officers. In addition the words "prior to payment of such taxes" in the first sentence have been deleted since they are inconsistent with item (iii) in subparagraph a and item (iii) in subparagraph b. Moreover, it would be impossible to carry out the action indicated in b prior to payment of taxes since, in many cases, the illegality or erroneous character of taxes are not established until long after such taxes are paid.

Subparagraph c should require direct credits only where the taxes were originally charged directly to government contracts. Refunds of taxes treated by the contractor as overhead should be credited to overhead.

Suggested Revision

Taxes are charges levied by a government unit. They do not include fines and and penalties except as otherwise provided herein.

a. In general, taxes (including state and local income taxes) which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except (i) for Federal income and excess profits taxes; (ii) taxes in connection with financing, refinancing or refunding operations (see paragraph 15-204.17); (iii) taxes from which ~~exemptions are available to the contractor directly or available to the contractor~~ the contractor is exempt based on an exemption ~~afforded~~ furnished by the Government; and (iv) special assessments on land which represent capital improvements.

b. Taxes otherwise allowable under a above, but which may be illegally or erroneously assessed may be allowed as a cost of work performed, provided that the contractor, ~~prior to payment of such taxes~~ (i) promptly requests instructions from the contracting officer concerning such taxes; (ii) agrees to comply with such instructions; and (iii) if so directed by the contracting officer also agrees to take all necessary

action in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer, shall be allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs as will the cost of any other action taken under b (ii) and b (iii) above.

c. Any refund of taxes, penalties or interest thereon which were directly reimbursed under the contract shall be credited to ~~contract~~ the costs of that contract. ~~in the proportion in which contract costs absorbed the costs of taxes, interest or penalties.~~ If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

15-204.41 TRADE, BUSINESS, AND PROFESSIONAL ACTIVITIES

Comments: Subparagraph c as proposed by the government is unduly restrictive in that it refers only to technical information or information that is aimed at the stimulation of production. Industry feels that meetings, conferences and exhibitions for the purpose of improving overall coordination of the business or various segments thereof, or the dissemination of information about the business to the trade, the public, prospective employees, etc., is just as important to the successful performance of government contracts as are technical and production meetings. The section has been broadened accordingly.

Suggested Revision:

a. Memberships. This item includes costs of membership in trade, business, and professional organizations and such costs are allowable.

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

c. Meetings, ~~and~~ Conferences and Exhibitions. Expenses representing the purchase of meals, transportation, rental of facilities for meetings, conferences, exhibitions and costs incidental thereto, when the primary purpose of the incurrance of such expenses is the dissemination of ~~technical~~ information ~~or the stimulation of production, are allowable~~ intended to improve the overall effectiveness of the contractor are allowable.

15-204.42 TRAINING EXPENSES

Comments: Objection is made to the proposal which limits the definition of allowable

expenses to those incurred in a program controlled by the contractor or to training in educational institutions. The language of subparagraph a is unduly restrictive and should be broadened to recognize any training expense which is properly allocable to government contracts. Subparagraphs b and c are unacceptable since training expense in educational institutions is a matter of business judgement and should not be isolated for special and specific treatment in the contractual document. Therefore, the cost of training in outside educational institutions should be allowable when undertaken under an established program of the contractor.

Suggested Revision:

a. This item includes the costs of preparing and maintaining a program of instruction designed to increase the overall effectiveness of employees. Included are the costs of ~~the director of~~ training, ~~and staff~~ training materials and text books when the training program is controlled by the contractor, and employee compensation, subsistence, travel, tuition, fees, training materials, ~~and~~ text books, etc., when the training is ~~in educational institutions~~ conducted by other than the contractor.

b. Such costs ~~which are limited to on the job training~~ are allowable when properly allocated.

~~c. Costs of training in educational institutions are now allowable, except to the extent specifically provided in the contract.~~

15-204.43 TRANSPORTATION EXPENSES

Comment: The only change suggested here is self-explanatory and if for the purpose of clarification.

Suggested Revision:

Transportation expenses include the cost of freight, express, cartage and postage relating either to goods purchased, in process, or delivered.

When such costs can readily be identified with the items involved they may be direct costed or added to the cost of such ~~material~~ items. (See paragraph 15-204.22). Where identification with the materials received cannot readily be made, inbound transportation expense may be charged to the appropriate indirect expense accounts, provided the contractor follows a consistent procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as direct charges.

15-204.44 TRAVEL EXPENSES

Comments: The Government's proposed statement of cost principles as regards travel expense

is not flexible enough to meet conditions under which contractors operate today and are unnecessarily restrictive in the light of the basic principles and standards set forth in Section 15-201.

Changes are suggested to:

a. No comment.

b. Provide for the treatment of travel expense by the contractor as either a direct or indirect cost, whichever is in accordance with his normal business practice.

c. Provide for the use of the per diem reimbursement method and/or the actual reimbursement method if consistent with contractor's normal practice, i.e., in the case of certain groups of employees, one method might be used and, in the case of another group, the alternate method might be used. This should be permitted if consistency exists as between the treatment of expenses of similar groups.

d. Provide for the allowance of premium transportation costs when incurred in accordance with contractor's established practice.

e. Eliminate any reference to entertainment expense because such expense is covered separately in paragraph 15-204.11.

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

Suggested Revision:

This includes costs of transportation, lodging, subsistence and incidental expenses incurred by contractor personnel in a travel status while on official company business.

a. Travel expenses incurred in the normal course of overall administration of the business and applicable to the entire business are allowable when properly allocated.

b. Travel expenses directly attributable to contract performance ~~may~~ will be charged to the contract directly or indirectly in accordance with the ~~principle of~~

~~direct-costing~~ contractor's normal business practice.

c. Subsistence and lodging including tips or similar incidental expenses may be reimbursed either on an actual or per diem basis. ~~The-basis-selected-should-be-consistently-followed.~~ The method or methods used should be consistent with the established practice of the contractor.

d. Costs of premium transportation ~~may-be-allowed-when-it-is-shown-to-be-necessary-to-performance-of-the-contract~~ are allowable when incurred by contractor personnel in accordance with contractor's normal business practice.

e. ~~Entertainment-expenses-are-not-allowable.~~

f. 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.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION
Incorporated

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

NSIA Bulletin . . . Procurement Information

No. 80-54 14 September 1954

To: All Members of the National Security Industrial Association

Allowability of Interest on Borrowed Capital in Military Contract Pricing

COPY

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

My dear Mr. Secretary:

The use of "generally accepted accounting principles" as a basis for solving problems which develop in the accounting or auditing fields under Government contracts is a commendable goal which has been supported for a long time by this Association. Considerable progress has been made in the acceptance of these principles by Department of Defense representatives as well as by Industry representatives.

In one very important area, however, no progress has been made. This area is the acceptance by Government representatives of interest as an allowable cost under Government contracts. In view of the fact that this position is inconsistent with "generally accepted accounting principles" and is a problem which has become more acute since Section XV of the Armed Services Procurement Regulation was released some five years ago, we request your cooperation in reviewing the problem with your policy group covering this subject in the Department of Defense. For your consideration, we enclose a paper on this subject which outlines the National Security Industrial Association's point of view. The Executive Committee of the Association has approved this enclosure and has specifically authorized the President of NSIA to bring it to your attention.

After your review we hope that a meeting can be held between your policy group and representatives of our Association which, as you know, represents a very broad cross-segment of Industry. We would appreciate the opportunity of discussing this problem in detail at the convenience of your representatives.

Yours sincerely,

/s/

HOMER H. EWING, President
National Security Industrial Association

HHE/emg
Encl.

This Bulletin is designed to set forth activities of Association committees dealing with military procurement procedures. Comments, criticisms and suggestions expressed herein represent the views of committee members only. It remains for each member to make its own policy decisions and to deal with the Military Establishment as it sees fit.

Allowability of Interest on Borrowed Capital

In Military Contract Pricing

I. Introduction

Within the last few years, the Armed Services have taken a fairly consistent position in the direction of setting forth "interest on borrowings(however represented), bond discount and expenses, and financing charges" as unallowable costs in military contracts, regardless of frequent complaints of contractors.

Historically, this position has been consistently followed in cost reimbursement type contracts from inception as reflected by T. D. 5000 set forth in the "Green Book" entitled "Explanation of Principles for Determination of Costs Under Government Contracts" and later in Section XV - "Cost Principles" - of the Armed Services Procurement Regulation.

After the issuance of Section XV, the audit agencies of the Military Departments by Joint Letter No. 12 dated August 5, 1949, directed audit personnel to follow Section XV in conducting overhead rate determinations, audits and accounting reviews under both cost type and fixed-price contracts. Accordingly, auditors have in practice been reporting interest as an unallowable item of cost under cost type contracts and as a "cost questioned" under fixed-price type contracts.

The use of these Cost Principles for fixed-price type contracts has been primarily responsible for the disallowance of interest in such cases. Obviously, this is clearly a misapplication of Section XV.

For reasons set forth in further detail below, the denial of interest expense as an operating cost for pricing purposes, in either CPFF, fixed-price, or other type contracts, is unjustified.

II. Government Position re Disallowance of Interest

Historically, arguments most frequently advanced by the Military Departments for denying the allowance of interest fall into the following three categories:

1) Interest expense is regarded as merely a return on equity capital and therefore should be treated in the same way as a dividend.

2) This cost is taken into consideration in setting profits on military contracts.

3) Contractors should be adequately capitalized to finance their operations and to allow interest would result in discriminating in favor of contractors who borrow money as against those who do not.

III. Interest Not a Return on Equity Capital

It is common industry practice in our existing economy to use either short or long term borrowing to finance current business operations. The need for this practice becomes even more apparent when a contractor embarks upon the performance of military contracts. Therefore, to regard such an operating expense as nothing more than a return on equity capital and therefore unallowable is completely unwarranted.

Companies supplying the Armed Services are basically manufacturing contractors and as such are capitalized accordingly in order that construction of widely fluctuating quantities of products that are supplied from time to time may be produced in the most economical manner

and at the lowest cost to the customer. This requires, among other things, that the capital structure provide for considerable flexibility in the scope of Industry's operations in order to: (1) maintain a nucleus of skills and facilities during prolonged periods of low volume production; (2) provide the financial strength and liquidity that will establish credit stability required to support high volume emergency production programs; and (3) at the same time avoid the serious risks as well as the costly burden of carrying excess capitalization during prolonged periods of low volume production.

Compared with consumer production, where production volume can be carefully planned over a period of years based upon estimates of consumer demands, volume of production for the Armed Services is controlled directly by the Armed Forces based upon military requirements of the moment. The manufacturer of military supplies must operate in a state of constant readjustment; that is, be prepared at a moment's notice to expand production capabilities in a period of months that would take a consumer goods industry many years to do, or to contract even more abruptly than the period of expansion.

Moreover, capital borrowings in the performance of Government contracts are frequently made necessary because of common delays in obtaining payment such as the slow processing of invoices, delays encountered in obtaining definitive contractual instruments authorizing payment, Government revisions of delivery schedules which delay or stretch out deliveries over a longer period, thereby prolonging investments in inventories, and other Government action.

Under these conditions, even the best capitalized company could not continue to finance from its own resources such an expansion and contraction of its manufacturing organization.

This responsibility has been recognized by Congress through the passage of enabling legislation authorizing a V-Loan program, certain provisions in the Armed Services Procurement Act and in sections of the Defense Production Act.

The argument is sometimes advanced that progress payments granted to military contractors take care of needs. This technique has never been adequate enough even to meet normal and necessary financing requirements. Under the recently revised policy of the Department of Defense with respect to progress payments, the necessity of military contractors to resort to other means of financing has become even more acute.

IV. Interest Not an Element of Profit

The disallowance of interest as a bargaining tool in relation to profit is unfair and illogical. Under the recognized laws of business economics, as well as under "generally accepted accounting principles" established by the accounting profession and used throughout American business and finance, all expenditures of carrying on business operations (other than distributions of capital) which are not properly capitalizable in the balance sheet are regarded as ordinary and necessary costs merely for the purpose of adjusting the profit allowance is a distortion of the fundamental principle of accounting and economics that "income less costs equals profit".

Interest expense is only one of a large number of factors that must be considered in arriving at standards of profit allowance and the development of such standards is an entirely separate problem which should not be confused with the statement of accepted accounting principles governing cost.

The argument is sometimes advanced that the handling of interest as a cost has always been controversial even within the accounting profession. This controversy has never been over the question of whether interest incurred was a cost of operation; that fact has always been accepted. The controversial questions are:

1) Should the costs of operating separate lines or locations be charged with a fictitic "interest" with an offsetting credit to income in order to reflect the comparative u of capital employed at each separate cost center for purposes of developing comparab operating costs? This problem does not involve the cost of interest actually paid borrowed capital.

2) The other question is when should interest incurred be charged into inventories and carried there for balance sheet purposes, and when should it be absorbed as a curren operating expense in determining income? The answer obviously varies with the type of business involved. In any event, the fact that interest is a cost of operations has never been questioned.

The argument that the profit allowance includes a provision for a return on borrowed capital is fallacious in view of the fact that the Armed Services tend to adhere to fixed negotiated profit rates regardless of whose capital is employed. Moreover, the average rate of earning on Government business, by Industry in general, is well below the average rate of earnings o non-Government business.

The failure to regard interest as an element of cost is also inconsistent with the Governmen position with respect to rental costs of facilities. In the task of developing efficient pr duction methods, for which American Industry has established a good reputation, important decisions must be made at various times whether to purchase a facility or to rent it. This decision should be free of artificial and distorting influences. However, the disallowance of interest cost even though rental costs (which include someone's interest cost) are allowe results in a distortion of decision to the detriment of efficient operations. This distort- ion would exist where any ordinary cost is disallowed per se.

V. Interest Not a Discriminatory Expense

The third aspect of the Government's view on this subject is completely unrealistic. It suggests that wherever one business employs a type of cost expenditure not expended by all other business, such cost should not be allowed. The fallacy of this suggestion is self- evident. For example, one contractor may employ the use of a highly specialized machine with efficient results, while his competitors perform the process with hand labor. Since interest is only one of many types of cost, there is no reason to believe that the final prices of the non-borrowing contractor would be lower than those of the contractor who borrows. Therefore, for real fairness, all costs recognized as such under generally accepted accounting principle should be equally allowable to all contractors, to the extent such costs are incurred.

VI. Inconsistent Position of Government

The Government, as a whole, is inconsistent in the treatment of interest. It is allowed as an item of cost for tax purposes, for renegotiation of Military contracts, and for termina- tions of Government contracts in accordance with Section VIII of the Armed Services Procure- ment Regulation applicable to fixed-price contracts. To disallow interest as a cost for pricing purposes in Military contracts is, therefore, completely illogical.

VII. Summary

In summary, recognition of interest on borrowings and other financing charges as accepted items of cost under generally accepted accounting principles and the regulations of Internal Revenue Service is urged.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION
Incorporated

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

NSIA Bulletin . . . Procurement Information

No. 95-55

9 May 1955

TO: All Members of the National Security Industrial Association

Subject: Recognition of New Depreciation Methods Authorized by the 1954 Internal Revenue Code.

Inclosed is a letter addressed to the Honorable W. J. McNeil, Assistant Secretary of Defense (Comptroller) with an attached industry statement regarding "Recognition of New Depreciation Methods Authorized by 1954 Internal Revenue Code."

Copies of this letter have also been sent to the following:

Honorable F. H. Higgins, Assistant Secretary of the Army (L&RD)
Honorable Raymond H. Fogler, Assistant Secretary of the Navy (Material)
Honorable Roger Lewis, Assistant Secretary of the Air Force (Material)
Honorable Wm. B. Franke, Comptroller, Department of the Army
Lt. General C. B. Stone III, Comptroller, Department of the Air Force
Major General K. E. Webber, Auditor General, Department of theAir Force
Rear Admiral C. G. Warfield, Assistant Comptroller Audit, Department of the Navy
Brigadier General C. H. Royce, Chief Army Audit Agency
Mr. Warren Webster, Jr., Director of Procurement & Production Policies, Office of the Assistant Secretary of Defense (Supply & Logistics)
Mr. Howard W. Bordner, Deputy Comptroller for Accounting Policy, Office of the Assistant Secretary of Defense (Comptroller).

Frank L. Fuller

Frank L. Fuller
Procurement Advisory Committee Executive

1 Inclosure
cc ltr to Hon W. J. McNeil w/
industry statement

Note: Membership of the Accounting and Auditing Committee was included in Procurement Information Bulletin No. 91-55

FLF/gf

This Bulletin is designed to set forth activities of Association committees dealing with military procurement procedures. Comments, criticisms and suggestions expressed herein represent the views of committee members only. It remains for each member to make its own policy decisions and to deal with the Military Establishment as it sees fit.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

May 9, 1955

C O P Y

Honorable W. J. McNeil
Assistant Secretary of Defense (Comptroller)
The Pentagon
Washington 25, D. C.

Dear Mr. Secretary:

Since the enactment of the 1954 Internal Revenue Code contractors have been faced with the srious problem of setting up their accounting records and filing their income tax returns on the basis of new alternative depreciation methods authorized by the Code without knowing to what extent the new depreciation methods will be accepted for Government contract pricing purposes. Numerous conferences have been held with representatives of the Department of Defense and the Military Services on this subject at which some indication has been given that such new depreciation methods would be recognized. The contractors, however, have no assurance of this and some contractors are currently running into difficulties in having such new depreciation methods recognized for contract pricing purposes.

The Department of Defense is therefore strongly urged to issue promptly a policy statement permitting recognition for contract pricing purposes of the alternative depreciation methods authorized by the 1954 Internal Revenue Code. For your consideration, there is inclosed a paper on the subject which outlines the position of the National Security Industrial Association prepared by our Accounting and Auditing Task Committee. After your review, it would be appreciated if a meeting could be arranged between your policy group and representatives of our Association for the purpose of discussing this problem in detail at the convenience of your representatives.

The attached statement was worked up in advance of the release to industry for comment of the proposed revision of cost principles - Section XV of ASPR. It is believed to be of sufficient importance to warrant your prompt consideration since the points of issue are either at variance with this proposed revision of ASPR or are not adequately covered.

An identical letter has also been addressed to the Honorable Thomas P. Pike, Assistant Secretary of Defense (Supply & Logistics).

Cordially,

S/

J. K. Richards
Executive Director

Inclosure

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

RECOGNITION OF NEW DEPRECIATION METHODS

AUTHORIZED BY THE 1954 INTERNAL REVENUE CODE

Introduction

The Department of Defense is strongly urged to issue promptly a policy statement permitting recognition for contract pricing purposes of alternative depreciation methods authorized by the 1954 Internal Revenue Code.

In view of the fact that the Code permits the use of the methods retroactively to January 1, 1954, all contractors are faced with a very serious problem of setting up their accounting records and filing their income tax returns on the basis of these methods without knowing to what extent the new depreciation methods will be accepted for contract pricing purposes. Contractors currently closing out completed price-redetermination type contracts and negotiating final overhead rates are confronted with the problem that the Government auditors and negotiators have no instructions which permit them to arrive at a final agreement. Accordingly, contractors must either reserve the item, or negotiate a settlement which might not be equitable or satisfactory.

The new depreciation methods under the 1954 Code were adopted for very sound business and economic reasons and have been recognized by both the Congress and the accounting profession as being based on sound accounting principles. The declining-balance method and the sum-of-the-years digits method were included in the Code in order to bring allowances for depreciation into accord with reality, to give recognition to the obsolescence factor and to remove barriers to modernization which existed under methods previously authorized. The House Ways and Means Committee and the Senate Committee on Finance both found that "based on a realistic estimate of useful life the proposed system conforms to sound accounting principles."

House Ways and Means Committee Report - Report No. 1337

House Report No. 1337 issued by the Ways and Means Committee on March 9, 1954, after observing that determination of the useful life of a particular asset and the method of allocating depreciation allowances to the years of use are both matters of judgment, stated (Underscoring supplied):

> "In many cases present allowances for depreciation are not in accord with economic reality, particularly when it is considered that adequate depreciation must take account of the factor of obsolescence . . . There is evidence that the present system of depreciation acts as a barrier to investment, particularly with respect to risky commitments in fixed assets. Comparatively slow rates of write-off tend to discourage replacement of obsolete equipment and the installation of modern, up-to-date machinery. Under long-run peacetime conditions, in the absence of the inflationary pressures existing in the forced-draft economy of the postwar period, present tax depreciation methods might depress business capital expenditures below the level needed to keep the economy operating at high levels of output and employment. . . .

> In the formation of its liberalized depreciation policy your committee relies heavily upon the use of an improved declining-balance method. This method concentrates deductions in the early years of service and results in a timing of allowances more in accord with the actual pattern of loss of economic usefulness. With the rate limited to twice the corresponding straight-line rate and based on a realistic estimate of useful life, the proposed system conforms to sound accounting principles. . . .
>
> Mindful of the need for constructive action within the limits of sound budgetary policy, your committee has adopted provisions which will give the economy added stimulus and resilience without departing from realistic standards of depreciation accounting."

Senate Finance Committee Report - Report No. 1622

Report No. 1622 issued by the Senate Committee on Finance on June 18, 1954, also recognized the economic advantages of the new methods, as well as the fact that they conformed to sound accounting principles. The Committee set forth its views in the following language (Underscoring supplied):

> "The stimulus to investment through liberalized depreciation is most important with respect to the creation of new assets. Moreover, the reality of faster depreciation in the early years is generally greater in the case of new than used property. The liberalized declining-balance method included in the bill concentrates deductions in the early years of service and results in a timing of allowances more in accord with the actual pattern of loss of economic usefulness. With the rate limited to twice the corresponding straight-line rate and based on a realistic estimate of useful life, the proposed system conforms to sound accounting principles."

Opinion of the American Institute of Accountants

The American Institute of Accountants has officially recognized the new methods as "meeting the requirement of being systematic and rational" and have stated that "they may well provide the most satisfactory allocation of costs." The Committee on Auditing Procedure of the American Institute has dealt directly with the question in their Accounting Research Bulletin No. 44. The first two paragraphs of Bulletin No. 44 are particularly significant and are quoted below:

> "1. The declining-balance method of estimating periodic depreciation has a long history of use in England and in other countries including, to a limited extent, the United States. Interest in this method has been increased by its specific recognition for income-tax purposes in the Internal Revenue Code of 1954.
>
> 2. The declining-balance method is one of those which meets the requirements of being "systematic and rational" (Accounting

15-204.15 INITIAL PRODUCTION COSTS

Comment: It is recommended that (1) in the second sentence the word "include" be substituted for the words "consist of" and (2) the last sentence be deleted. "Starting-load costs" or "such costs" do not necessarily "consist of" only or all of the costs mentioned in the second sentence. Therefore the word "include" is considered to be more appropriate.

Auditors and contracting officers of the military departments will have difficulty in determining (a) when starting-load costs have continued to an "unwarranted extent" and (b) when a contractor has been allowed "reasonable time" to learn to make a product efficiently. Therefore, it is believed that the retention of the last sentence can only increase the number of "costs questioned" by the military auditor and the number of cases referred to higher authority by administrative contracting officers and contracting officers, thus resulting in, at the minumum, prolonged justification and argument on the part of contractors and undue delay in settlement of cost-reimbursement matters.

Suggested Revision:

Initial production costs, known also as "starting-load costs", are non-continuing costs that arise in early stages of production because of the contractor's lack of experience with particular materials, manufacturing processes or techniques involved. Such costs may include ~~consist of~~ excessive material costs resulting from abnormal scrap losses, excessive direct labor costs and related overhead resulting from idle time due to testing and change in production methods, cost of training employees, and excessive defective work due to inexperienced labor.

While initial production costs are allowable, the contractor will be expected to work actively to minimize or eliminate them as rapidly as possible. ~~In cases where these costs continue to an unwarranted extent after the contractor has been allowed reasonable time to learn to make the product efficiently, the excessive costs will be subject to disallowance.~~

15-204.16 INSURANCE AND INDEMNIFICATION

Comment: a. The words "and bonds" have been inserted for the reason that cost of bonds should be allowed for reimbursement.

b. In the first sentence, the words "within the limitations as to the extent of coverage and premium rates approved by the Government" should be deleted because the language is implied under subparagraph a. The change in the second sentence should be made since it is unnecessary for the Government to approve programs of "other insurance" and the costs thereof should be allowed to the extent they are reasonable and allocable to Government business. The contractor's judgment as to the amount of coverage and rates should be satisfactory unless specifically disapproved. Deletion of the last sentence is recommended because such insurance has become a recognized element in doing business and the entire cost should be allowed.

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

d. Provisions for losses under a self insurance program should be allowable if such provisions are established on an actuarial or historical basis.

e. No comment.

f. This paragraph has been modified to make it consistent with ASPR 7-203.22.

g. Deletion of this paragraph is recommended since it is not clear what is meant by "Cost of indemnification."

Suggested Revision:

a. Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative, and (2) any other insurance and bonds for which the contractor seeks reimbursement under the contract. The kinds of insurance ordinarily included in the first category are set out in ASPR 10-501.

b. Costs of government required insurance are allowable. ~~within the limitations as to the extent of coverage and premium rates approved by the Government.~~ Costs of other insurance, except that applicable to government-owned property, are allowable ~~provided (1) the insurance has been approved by the military department concerned or (2) in the absence of such approval requirements,~~ to the extent that any part of a contractor's insurance program has not been disapproved by the military departments, provided that the types of coverage, extent of coverage, and rates are reasonable under the circumstances. ~~Costs allowed for use and occupancy insurance, however, will in principle be limited so as to exclude coverage of profit, interest, federal income taxes, and any other items of expense unallowable under this part.~~

c. The costs of insurance or any reserve covering the risk of loss of or damage to government-owned property are ~~not~~ allowable except to the extent that the Government ~~may have required the contractor to carry such insurance,~~ has specifically relieved the contractor or his subcontractors of the risks by contractual agreement.

d. Provisions for losses under ~~The costs of~~ a self-insurance program established on an actuarial or historical basis are allowable ~~provided the program has been approved by the military department concerned~~ subject to the tests of reasonableness and allocability under paragraph 15-201. Actual losses sustained under such a self-insurance program are therefore not allowable.

e. The costs of insurance on the lives of officers, partners, or proprietors, are not allowable except where such insurance is part of an employee plan which is not unduly restricted.

f. Losses not covered by insurance resulting from failure to insure ~~(through self-insurance or otherwise) against a contingent loss or damage, where a reasonably prudent business organization would have insured against such loss or damage are not~~ allowable, except in those instances where the contractor failed to comply with the direction of the contracting officer to carry insurance.

g. ~~Cost of indemnification will be allowable only to the extent expressly provided for in the contract.~~

15-204.17 INTEREST AND OTHER FINANCIAL EXPENSES

Comments: NSIA views upon this subject were presented to the Honorable Charles E. Wilson in a letter dated 3 September 1954. The present treatment of interest and other financial

expense is inequitable and such costs should be allowed. (See attached statement entitled "Allowability of Interest on Borrowed Capital in Military Contract Pricing.")

Suggested Revision:

This item includes interest paid or accrued (regardless of the nature of the obligation which gives rise to the interest cost), bond discount and expenses, and the cost of financing and refinancing operations as well as legal and professional fees paid in connection with the preparation of a prospectus, cost of preparation and issuance of stock rights and expenses related thereto. (See also 15-204.24). These costs are allowable. ~~unallowable, except for interest assessed by state or local taxing authorities under the conditions set forth in subparagraph 15-204.40.~~

15-204.18 LABOR RELATIONS

No comment.

This item covers expenses incurred in maintaining satisfactory relations between the contractor and his employees. It includes the cost of shop stewards, labor management committees, employee publications and other related activities. Costs incurred for these purposes are allowable.

15-204.19 LOSSES ON OTHER CONTRACTS

Comments: This paragraph should be revised to permit the allowability of losses or costs incurred under participating research and development contracts where it is intended. As written, the paragraph is inconsistent with the Court of Claims decision in Bell Aircraft Corp., v. U.S., 100 F. Supp. 661 (Ct. Cls. 1951) aff'd. per curiam, 344 U.S. 860 (1952), where a Government contractor was allowed to capitalize losses on experimental contracts and allocate them as costs to other Government contracts.

Suggested Revision:

This item covers any excess of costs over income under any and all other contracts, whether such other contracts are of a supply, research and development or other nature. Except for participating research and development contracts, costs of this nature are not allowable as a cost of performance of the Government contract.

15-204.20 MAINTENANCE AND REPAIRS

Comments: It is recommended that:

1. In the second line, the word "property" be defined to include Government-owned facilities.

2. In the fourth line, the word "its" be changed to "an".

3. Subparagraph b. 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 b. 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:

a. This item includes those costs necessary for the upkeep of property (including Government-owned facilities) which neither adds to the permanent value of the property nor appreciably prolongs its intended life but keeps it in an ~~its~~ efficient operating condition. These costs are allowable. Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation will be allowable only on a depreciation basis. Cost of maintenance and repairs of excess facilities and of idle facilities (other than reasonable standby facilities) are not allowable.

~~b.--Deferred-maintenance-is-defined-as-maintenance-and-repairs-which-for some-reason-such-as-abnormal-operating-conditions-or-lack-of-funds,-is-delayed-to-a future-period.--The-cost-of-maintenance-and-repairs-which-has-been-deferred-from-a-period-prior-to-the-contract-is-not-allowable-unless-specifically-provided-for-in-the contract.--Likewise,-the-estimated-cost-of-maintenance-and-repairs-normally-required-but-not-accomplished-during-the-period-of-the-contract-will-not-be-allowed-as-a-cost unless-specifically-provided-for-in-the-contract.~~

15-204.21 MANUFACTURING AND PRODUCTION ENGINEERING

Comments: It is recommended that tool modification be included in the list of current manufacturing processes. Manufacturing and production engineering includes tool modification as well as tool design and tool improvement.

The last sentence of the paragraph should be modified to be consistent with the referenced paragraphs 15-202 and 15-203. The contractor's consistent practice of distributing such costs should be acceptable. The present language of the paragraph will cause questions to be raised by military auditors and contracting officers merely because a contractor's practice may not be in accordance with the instruction "should ordinarily be" or "should be".

Suggested revision:

Manufacturing and production engineering includes the cost of engineering activities in connection with (1) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design, modification, and improvement and (2) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production. These costs are allowable. For purposes of distribution, such costs should ordinarily be distributed as provided in paragraphs 15-202 and 15-203. ~~divided-into-two-categories: (1)-these-which directly-benefit-a-contract,-a-project,-or-a-product-line-and-(ii)-those-expenses-which are-not-subject-to-direct-costing.--Items-in-category-(1)-should-be-charged-directly-to the-contract-or-project-or-allocated-to-the-products-in-the-product-line.--Costs-in category-(ii)-should-be-allocated-to-all-benefitted-work.~~

15-204.22 MATERIALS AND SUPPLIES

Comments:

a. The major change here is the deletion of the word "net". Industry should have the freedom of choice between applying discounts, adjustments, etc. either direct or through overhead.

b. The reasons for the changes in this paragraph are apparent. Here again Industry should have the prerogative of treating such credits either direct or through

overhead.

c. No comment.

d. The word "generally" has been deleted as it is felt to be too restrictive as used in this sentence. Any recognized method of pricing should be acceptable. The word "equitable" has been replaced by "reasonable". This substitution is made on the basis that the word "equitable" can be too controversial by injecting into the exercise of judgment by the Audit Service or Contracting Officer elements not encountered if the word "reasonable" is used.

The provision in the second sentence regarding the use of replacement cost should be permissable without contract provision. In addition the requirements of identifying such items at the time the contract is entered into would be entirely too burdensome to the contractor and in fact would not be feasible from a practical standpoint.

e. Flat disallowance of "write-down" of values of inventories is not equitable. 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 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.

f. 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 made from sources outside of the contractor's business as a legitimate item of contract cost and which, of course, includes 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. It is felt that this is basically wrong and the redraft of the ASPR comments and proposals is intended to correct this.

g. A paragraph has been added to cover pricing on articles normally manufactured by a contractor where it involves the contractor's prime location. Paragraph f covers these transactions where "inter-unit" shipments or transfers are involved but does not cover the contractor's prime division where he may supply articles normally manufactured and supplied on his prime contract. The arguments for the acceptance of paragraph f hold equally as well for this paragraph.

Suggested revision:

a. This item includes the ~~net~~ costs of such items as raw materials, parts, sub-assemblies, components, and manufacturing supplies, whether purchased outside or manufactured by the contractor, and may include such collateral items as inbound transportation and in-transit insurance. These costs are allowable subject, however, to the provisions of subparagraphs b through f below.

b. Cost of materials and supplies shall be suitably adjusted either directly or indirectly as a reduction of costs for applicable portions of income and other credits received by the contractor. Such income and other credits may include trade discounts, refunds, rebates and allowances, cash discounts taken by the contractor, ~~and~~ credits for scrap and salvage, and materials returned to vendors. ~~However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond his control, such lost discounts will be allowed.~~

c. When materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to the contract.

d. If materials are issued from stock, any ~~generally~~ recognized method of pricing such materials will be acceptable, provided the method is consistently applied and the results obtained are ~~equitable~~ reasonable. Where materials in stock at the commencement date of the contract have a provable replacement cost significantly higher than book cost, the contractor may, ~~and the Government may, by contract provision, agree upon the use of~~ a method of pricing based upon the fair value of the materials as of the date of the contract, but not in excess of replacement cost on such date. ~~Such agreement should include identification of the types or kinds of materials involved and should be made at the time the contract is entered into and provided for therein.~~

e. Reasonable charges arising from difference between periodic physical inventory quantities and related material control records will be included in arriving at the cost of materials, provided that such charges ~~(i) do not include "write downs" of values, and (ii)~~ relate to the period of performance of the contract. All credits arising from differences between periodic physical inventory quantities and related material control records shall be taken into account.

f. ~~Ordinarily~~ If a contractor has an established method for pricing sales or transfers of materials ~~and~~, supplies and services between plants, divisions, or organizations, under a common control, ~~shall be stated on the basis of cost to the transferor. 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 provided that the price charged to the contract~~ any such materials or supplies manufactured and sold by any such transferor 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 transferor's ~~sale~~ price customarily charged to its most favored non-affiliated user customer for the same item or service in like quantity or (ii) the prices of 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.

g. 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.

15-204.23 ORGANIZATION EXPENSES

No Comment.

This item consists of expenditures in connection with organization or re-organization of a business. Examples of such costs are incorporation fee, attorneys fee, fees to promoters and organizers and costs of raising capital. These costs are unallowable. (See paragraph 15-204.17).

15-204.24 OTHER BUSINESS EXPENSES

Comments: The use of the word "annual" in the first sentence should be deleted since contractors are required, under certain circumstances, to issue periodic reports to stockholders in accordance with requirements of the Securities Exchange Commission and other regulatory bodies.

In the last sentence of this paragraph that portion directly following the word "allowable" has been deleted since this portion of the sentence would give the Contracting Officer an opportunity to match opinion with the contractor as to his business practices

which is considered to be outside the realm of his responsibility. Further, it is felt that 15-201 covering the factors of reasonableness and application of generally accepted accounting principles and practices adequately covers the Contracting Officer.

Suggested Revision:

Included in this item are such recurring expenses as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy solicitations, preparation and publication of ~~annual~~ reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies and incidental costs of directors' and committee meetings. The above and similar costs are allowable when ~~incurred in reasonable amounts in accordance with the contractor's established practices and are~~ allocated on an equitable basis to all classes of work.

15-204.25 OVERTIME, EXTRA-PAY SHIFT AND MULTI-SHIFT PREMIUMS

Comments: Contractors should not be required to separately identify overtime premium if it is not in accordance with the contractor's accounting system. The requirement is restrictive and unnecessarily burdensome.

The major change made in this paragraph deals with overtime and shift premiums identified to direct and indirect labor and emergency overtime. The paragraph as written would treat shift payments and shift premiums as out of the ordinary and not to be authorized without special permission. The practice of granting premium pay for unpopular shifts in a multi-shift operation is standard operating procedure; in fact, it is normally made a provision in union contracts. The paragraph should therefore be rewritten as suggested to set up a paragraph (a) covering overtime pay and a paragraph (b) covering shift premiums with the understanding that shift premiums are allowable if in accordance with the contractor's practices and procedures.

In so far as emergency overtime is concerned, allowance of this type of premium without specific authorization is contained in ASPR 12-102(c) which states "The policy stated above shall not be construed to limit the use of or payment for emergency overtime work as may be required ..... ". Such a provision should also be included in 15-204.25 as reflected in the suggested revision.

Suggested Revision:

This item consists of the premium portion of overtime and shift payments to employees. Such premiums may be classified as either direct or indirect labor costs. ~~but the amount of overtime premium should be separately identified.~~ When direct labor cost is the base for distribution of overhead, overtime premiums shall not be included therein. (a) Cost of overtime ~~and shift premiums~~ paid to the direct labor force are allowable ~~only~~ to the extent expressly provided for in the contract or otherwise authorized by the Government. ~~See ASPR 12.102 for further information concerning the policy regarding such authorization.~~ However, this shall not be construed to limit the use of or payment for emergency overtime work as may be required. The cost of overtime paid to the indirect labor force for emergency overtime work or to handle periodic peak administrative loads is allowable. ~~The amount of overtime and shift premium cost charged on government contracts shall be equitable in relation to the amount of such costs charged on non-government work being concurrently performed in the contractor's plant and the factors which necessitate the incurrence of the cost.~~ (b) Shift premiums in accordance with the contractor's practices and procedures are allowable.

15-204.26 PATENT EXPENSES

Comments: The proposed language of this paragraph would disallow the cost of preparing patent applications unless such applications were filed on behalf of the Government or the written authorization of the contracting officer was obtained. 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. Such activities are of direct benefit to the Government even though the Government may not obtain any rights under the patents because, by obtaining a patent, a contractor avoids the necessity of eventually being required to pay a royalty to some other person who may obtain a patent on the same invention. Moreover, the costs of maintaining a patent department in any manufacturing company is a necessary cost to its overall operations and should be considered as a necessary cost of doing business. The primary change which has been made in the paragraph therefore covers an addition which would allow all costs leading to the issuance of patents as well as infringement, investigation and litigation. There has also been included preparation of licenses to the Government as well as disclosures.

Suggested Revision:

Included in this item are such expenses as amortization of the cost of purchased patents and all costs leading to the issuance of patents, as well as the cost of infringement investigation and litigation. Amortization of the cost of purchased patents applicable to contract products or processes is allowable. ~~The cost of preparing disclosures~~ All costs leading to the issuance of patents, the cost of infringement, investigation and litigation, cost of preparing disclosures and licenses to the Government as required by the contract, and of preparing assignment and other papers in connection with the filing of a patent application for the Government, and any expenses incident to patents incurred upon the written authorization of the contracting officer, are allowable. ~~All other patent expenses and~~ Charges for the use of patents where the Government has a license or the right to free use thereof, are unallowable. ~~The cost of research and development work leading to patents is treated in subparagraph 15-204.35.~~

15-204.27 PENSION AND RETIREMENT PLANS

Comments: (a) Paragraph 'a' of this clause establishes a definition for pension and retirement plans. We have suggested deletion of the fourth and fifth sentences from the definition because of their restrictive nature. Pension and retirement plans may be established which are dependent upon profits and such plans if approved by the Internal Revenue Service should be acceptable to the Military. In other instances such plans may fall under the scope of the special case situations covered by paragraph 'g'. The fifth sentence is ambiguous and raises a number of points capable of misinterpretation. There is some indication that if pension plans employ funds, arising from any cause whatsoever in the operation of the plan, in a manner other than to reduce the employers contribution, the plan will be considered as falling outside the definition. In addition, the sentence mingles the technique of determining pension benefits with the question of how certain reversionary credits should be handled. Paragraph 'f' adequately deals with reversionary credits and the possibility that some pension plans may provide for increased benefits under certain circumstances should not outlaw them.

(b) Part 6 of Section XV has heretofore treated pension and retirement plans as giving rise to recognized costs of doing business. In establishing principles in part 2 for determining the allowability of such required costs, it is necessary to take into account that pension plans are employed by firms of all sizes. The pension and

retirement plans of all commercial enterprises (other than tax-exempt and non-profit institutions) come under the cognizance of the Internal Revenue Service for approval purposes. The Government business done by these firms as compared to commercial business varies from small to relatively large proportions. Generally, the proportion of Government business done on a cost reimbursement basis is relatively small as compared with the total business of the contractor. Because of all of the above factors it is important that a standard applied by only one Government Agency be used in evaluating the plans employed by the various segments of industry. Where such Government approval has been obtained, additional approvals by agencies of the Military Departments are unnecessary.

For purposes of determining allowability and allocability, approval of the cognizant auditing agency should be binding upon the other Departments; it is unnecessarily expensive for both the Government and the contractor to be required repeatedly to submit the contractor's system for review to a number of Agencies.

(c) Criteria established to determine the allowability of costs should consider the costs allowable under such approved plans subject to the usual tests of reasonableness and allocability. Where the contractor has an established pension plan in which all employees working on Government and other business are indistinguishable as to conditions of employment, eligibility of benefits, pension contributions should be allowed in full to the extent allocable to Government business.

(d) No comment.

(e) Reallocation of costs between years on the basis of Internal Revenue technical limits which 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. Application of the Internal Revenue Code limitation in any year without permitting the carry-over to subsequent years is inequitable. The contractor has in fact, incurred the cost and its deferral to another year for tax purposes recognizes this. To attempt to segregate a small portion of the contractor's contribution

allocable to a single contract in a particular year, when the majority of contractors have a number of Government contracts on which performance is spread over a number of years, is a meaningless refinement which in the long run will benefit neither the Government, the Military Department nor the taxpayer.

(f) Methods used by some contractors to determine pension contributions take into account unusual as well as normal fluctuations in employment and are susceptible to review to so demonstrate. Methods used by other contractors to determine contributions may be found to be inadequate to provide for such fluctuations and may thereby make it necessary for the Government to require special provisions for revisionary credits. In such instances no particular methods should be prescribed but each case should be handled by whatever method is mutually agreed to be appropriate in the light of all the circumstances.

(g) The costs of lump sum purchases of annuities or of lump sum payments to approved pension and retirement plans should be allowable without specific contract provision. The Government is adequately protected by the tests of reasonableness and allocability referred to in paragraph 15-201(b).

Suggested Revision:

a. A pension plan as used herein is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to his 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 service 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 will be considered a pension plan, if, under the plan, either the benefits payable to the employee or the required contributions by the contractor can be determined actuarially.

b. Pension and retirement plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the Military Department. Consideration of the plans by the Military Department will be limited to consideration of cost and allocability thereof and will be the responsibility of the Department to which audit cognizance is assigned and determinations by the cognizant audit agency will be accepted by the other Departments. ~~However, approval of the plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such plan by the Military Department. Consideration of the plans will be the responsibility of the Department to which audit cognisance is assigned and the subsequent action taken by that Department will generally be accepted by the other Departments. In cases where the Internal Revenue Service withdraws approval of a plan, amounts allocated to contract costs will be withdrawn accordingly.~~ Where pension and retirement plans of non-profit or other tax-exempt organizations are not required to be reviewed and approved by the Internal Revenue Service, it will be the responsibility of the Department to which audit cognizance is assigned to give consideration to the acceptability of such plans.

c. The cost of pension and retirement plans approved by the Internal Revenue Service ~~which are properly deductible from taxable income~~ are allowable except as otherwise determined unallowable under this paragraph. The cost of retirement plans, which are based on profit sharing, shall be subject to paragraph 15-204.6e. Costs of acceptable pension and retirement plans established by non-profit or other tax-exempt organizations are also allowable except as otherwise determined under this paragraph.

d. Pension and retirement costs constitute a part of the total compensation by a contractor to the individuals covered by the plan, and accordingly, are subject to the provisions of this section with respect to reasonableness of the total compensation paid to the individual for the services rendered. (See 15-204.6)

e. The amount of the contribution subject to allocation as a contract cost will be limited to the maximum amount required to fund an approved plan, or the amount actually contributed, ~~during~~ for the taxable year, whichever is the lesser. ~~The carry-over provisions of the Internal Revenue Code with respect to contributions under pension and retirement plans shall not be recognized for the purpose of determining allowable pension and retirement costs under Government contracts.~~

f. Credits which arise under pension plans from various sources, such as dividends and cancellation of employee benefits which have not vested at the time of termination of their employment, must be taken into account in an equitable manner in the determination of the allowable pension and retirement contribution. Special provision for these credits ~~is usually~~ may be necessary when the contractor's organization has substantially expanded for the performance of military contracts and there is a reasonable expectation that the employment of a large number of the additional employees will be terminated upon curtailment of military work. 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, ~~Under these circumstances~~, 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. ~~There are two general methods which may be used, individually or in combination, in making such arrangements.~~

~~(1)--A lump-sum or percentage discount of current pension costs negotiated and agreed upon in advance.--Determination of such allowance generally is not an actuarial problem involving a calculation based upon known factors, but rather is an attempt to reach a negotiated agreement as to various uncertain or variable factors in a complex situation.~~

~~(2)--A retrospective determination at some time in the future when a more accurate estimate can be made by virtue of experience which may have developed.--Until such determination, current costs, which should be not of current credits may be allowed provided an appropriate contractual agreement can be reached which reserves the Government's right to future credits.~~

g. The costs of lump sum purchases of annuities or of lump sum cash payments or periodic cash payments made to provide pension or retirement benefits for retiring or retired employees other than incurred under approved pension and retirement plans will be considered on an individual case basis and are allowable ~~only to the extent specifically provided for in the contract.~~ subject to the usual tests of reasonableness and allocability.

15-204.28 PLANT PROTECTION EXPENSES

Comments: All plant protection expense should be considered as allowable cost. The objection to segregation of plant protection into two classifications is two-fold. First, in the case of a contractor working on a number of classified Government contracts in a given location, it would be difficult if not impossible to apply such special plant protection costs directly to each contract. One guard may provide equal protection to all work. Second, it is not practical for the contractor to develop individual overhead rates for each Government contract if he holds numerous contracts.

This paragraph as written also fails to recognize the existence of a third class of plant protection expenses, namely, those expenses which arise peculiarly from doing business with the Government, but which are not of a type which arise because of the specific "direction" and "approval" of the Contracting Officer. Expenses referred to include the costs of clearing personnel to handle classified work, the acquisition of special cabinets and safes for storage purposes, etc. as required by the Security Agreements and Military Security Requirements Clause of contracts. These costs are common to Government business as a whole and are apart from special security measures which may be ordered by a contracting officer under a specific contract. In view of the foregoing, the article should be rewritten as follows:

Suggested Revision:

This item includes the cost of all plant protection measures such as wages of guards, equipment of guards (uniforms, fire arms, etc.), and depreciation on plant protection capital assets, storage of classified matter, clearance of employees, etc. and includes all costs required by the nature of contractor's business, requirements of Military Security Requirements Clause ASPR 7-104.12 and DD441 Security Agreement and the cost of special plant protection measures specifically ordered or approved by the Contracting Officer. These costs are allowable and allocable in accordance with the basic principles and standards of 15-201. ~~For the purpose of contract costing, these expenses are divided into 2 categories, namely, normal plant protection expenses and special plant protection expense. --Normal plant protection costs are allowable and are allocable to all work in the plant. --Special plant protection costs, which term refers to an extension of the contractor's normal plant protection program are also allowable and allocable to specific Government contracts requiring special protection upon the specific direction and approval of the contracting officer.~~

15-204.29 PRE-CONTRACT COSTS

Comments: The second sentence of the paragraph as written tends to contradict the first in that it limits the type and amount of cost that may be allowable without regard to whether such costs are otherwise reasonable and necessary and would therefore have been allowed if incurred after the execution of the contract. Accordingly, it is suggested that the paragraph be rewritten as follows:

Suggested Revision:

Pre-contract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs will ~~not~~ be allowed ~~unless~~ when authority therefor is specifically set forth in the contract and may be limited to a period of time. ~~as well as to the type and amount of such costs.~~

15-204.30 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER

Comments: (a) This paragraph as written singles out the costs of professional services rendered by members separately engaged, 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.

(b) 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 regula-

tions, 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.

(c) The cost of successful defense of anti-trust suits and the successful prosecution of claims against the Government should also be allowable. We suggest the clause be rewritten as follows:

Suggested Revision:

a. This item includes the cost of professional services rendered by the members of the particular profession whether as members of the contractor's organization or separately engaged. These costs generally are allowable when reasonable and allocable in accordance with the basic principles and standards of 15-201. ~~in relation to the services rendered and are not contingent upon recovery of the costs from the Government.~~

b. ~~Factors to be considered (among others) in determining the allowability of costs in a particular case are: (i) 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 organization; and (iv) whether or not the proportion of Government work to the contractor's total business is such as to influence the contractor in favor of incurring the costs, particularly where the services rendered are not 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.

c. The costs of legal, accounting and consulting services and related expenses incurred in connection with organization or reorganization, prosecution of patent infringement litigation (except as provided for in 15-204.26), unsuccessful defense of anti-trust suits, and the unsuccessful prosecution of claims against the Government are unallowable.

15-204.31 PROFITS AND LOSSES ON DISPOSITION OF PLANT AND EQUIPMENT OR OTHER CAPITAL ASSETS

Comments: Flat exclusion of profits and losses on disposition of Plant and Equipment is objectionable. If assets are acquired for a contract and have no other use, a profit or loss on disposition indicates that the depreciation assumptions were not completely realized and the profit or loss on disposition adjusts for the difference. It is suggested that the clause be modified as follows:

Suggested Revision:

Included herein are gains or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments. Profits or losses on sale or exchange of ~~capital assets, including~~ investments, will be excluded in computing contract costs. Profits or losses on the sale or exchange of plant, equipment, or other depreciable assets will be included in computing contract costs.

15-204.32 RECONVERSION EXPENSES

Comments: Where a contractor has made special plant changes in order to introduce a Government contract into his production, the cost of that contract is not complete until it covers 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 Defense 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 expenses are those incurred in 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.~~

15-204.33 RECRUITING EXPENSE

No comment.

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

15-204.34 RENTALS OF PLANT AND EQUIPMENT ~~(including sale and leaseback of facilities)~~

Comments: In the preamble to the paragraph, the words "to investment organizations (such as insurance companies) or to private investors" should be deleted since the language is too restrictive and susceptible to misinterpretation.

It is recommended that clause (b) be deleted from this paragraph since clause (a) appears to provide adequate safeguards. Clause (b) 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 (a), which indicates that rates must be reasonable in light of the type, condition and value of the facilities leased, appears to give the Government complete protection. If clause (b) 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 (a) 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 (a) provides for a check of option arrangements and other provisions of rental agreements for the purpose of determining reasonableness.

Suggested Revision:

The following revisions are necessary because of deleting clause (b):

This item includes expenses for (i) use of land, buildings, and equipment or other personal property, and (ii) rental expenses under sale and lease-back agreements incurred by contractors through sale of plant facilities and concurrently leasing back the same facilities.

a. Rentals of plant and equipment under (i) and (ii) above are allowable if the rates are reasonable in light of the type, condition and value of the facilities leased, options available and other provisions of the rental agreement.

b. ~~Rentals specified in sale and lease back agreements under (ii) above are allowable only to the extent that such rentals do not exceed normal costs (such as depreciation, taxes, insurance and maintenance expenses) which would have been incurred had the contractor retained legal title to the facilities.~~

15-204.35 RESEARCH AND DEVELOPMENT

Comments: It is believed that the Government has started out with a constructive effort to recognize the great mutual benefits to be derived from encouraging research by industry. However, the new draft then proceeds to so fence in the cost allowance by restrictions as to destroy much of the originally indicated intent. Specifically, it is believed the following changes should be made to eliminate these restrictions:

1. Clause (1)(iii) should be deleted which requires the contractor to divulge results of independent general research. This 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.

2. Clause (1)(iv) should be eliminated which establishes a completely arbitrary and discriminatory distinction between contractors with 75% or more of their business with non-Government customers and those with less than 75%. If the cost of a research program meets the tests of reasonableness and other criteria, the degree to which the contractor is engaged in Government work should not be a determining factor. If a particular item is a good cost for contractors with up to 25% Government business, it is equally good for a contractor with a higher ratio of Government business. This limitation is particularly inequitable when applied to businesses whose Government work is subject to fluctuations above and below 25%. The criterion fails to give any consideration whatsoever to amount or importance of research involved.

3. The paragraph following clause (1)(iv) which states that the conditions apply also in the negotiation of predetermined overhead rates should be deleted. This statement is not pertinent to a regulation covering cost principles nor is it necessary.

4. In connection with research which relates to a product or product line covered by a specific research and development contract, 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. The changes shown under suggested revisions of clause (2) are made to give effect to this principle.

5. Revision of paragraph c 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:

Research and development expenses (sometimes referred to as general engineering expenses) for the purpose of contract costing are divided into two major categories, namely:

a. General research, also referred to as basic research, fundamental research, pure research and blue-sky research.

b. Related research or development, also referred to as applied research, product research and product line research.

(1) General research is that type of research which is directed towards increase of knowledge in science. It is research where the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. The costs of a contractor's independent general research (that which is not sponsored by a contract or grant or is not otherwise reimbursed to a contractor) shall be an allowable cost in all cost type contracts under the following conditions:

(i) The amount of such costs is reasonable.

(ii) The costs are equitably allocated to all work of the contractor other than its independent general and related research.

~~(iii) The contractor agrees to divulge to the Government the results of such independent general research.~~

~~(iv) The business of the contractor at the time of entering the contract is predominantly (75% or more) with non-Governmental customers. If less than 75% at the time of entering the contract, allowance may be authorized by special contract provision.~~

~~The above conditions will also apply in the negotiation of predetermined overhead rates.~~

(2) Related research is that type of research which is directed toward practical application of science, and "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 15-204.21.) The costs of a contractor's independent related research and development (that which is not sponsored by a contract or grant or is not otherwise reimbursed to a contractor) is allowable ~~may~~, if equitably allocated ~~on the basis of all production, be allowed~~ as a cost under any cost type ~~production~~ contract if the research is related to the contract product or product line. ~~No portion of such research will be allowable under cost type research and development contracts.~~ Where related research and development is directed toward the development of products primarily for military use, the cost thereof may be allocated entirely to Government business.

c. Research and development costs, regardless of the nature, which were incurred in accounting periods prior to the award of a particular military contract, (including amounts capitalized and the cost of patents obtained) will not be allocated to that contract unless approved by the contracting officer or allowable as precontract costs (Paragraph 15-204.29).

15-204.36 ROYALTY PAYMENTS

Comments: Royalties and fees paid for the use of patents or technical information 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 Revision:

This item covers amounts paid or payable for the right to use patents or technical information. ~~Where the use of such patents is necessary for the proper performance of the contract and where the Government does not already have a license or other right to use such patents, the royalties are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the contracting officer.~~ Royalties or fees paid or payable by a contractor for the right to use such patents or technical information are allowable to the extent allocable to government contracts.

15-204.37 SERVICE AND WARRANTY EXPENSES

No comment.

This item includes the costs of servicing the product installation, training personnel in the use, operation and maintenance of the product, correcting product defects, replacing defective parts, and other related operations or practices. Actual costs to be reimbursed to the contractor will be in accordance with the clause of the contract entitled "Inspection of Supplies and Correction of Defects", (See paragraph ASPR 7-203.5), or as otherwise provided in the contract.

15-204.38 SEVERANCE PAY

Comments: The criteria to determine the allowability of the cost of severance pay as set forth in the second paragraph of this section appears to be clear and adequate. However, the subsequent attempt to separate severance payments into two classes - normal turnover severance pay and mass severance pay - can only lead to unnecessary confusion and inconsistent interpretation. The proposed revision would eliminate the source of confusion without taking away the prime requisites for the determination of allowability referred to above and the further tests of reasonableness and allocability. Besides being unnecessary,

the government's proposed treatment of "mass severance pay" would in most cases be cumbersome, difficult and impractical to apply.

Suggested Revision

Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated.

The cost of severance pay is allowable only to the extent that, in each case, it is required by (i) law, (ii) employer-employee agreements, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) the circumstances of the particular employment.

For contract costing purposes severance pay is ~~divided into two categories as follows:~~

~~a.--Normal Turnover Severance Pay.--The cost of severance payments is~~ allowable and must be allocated to all classes of work being performed in the contractor's plant at the time of payment. However, 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.~~

~~b.--Mass Severance Pay.--The cost of abnormal or mass severance pay 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 entire period of employment with the contractor and equitably apportioning such cost to all business of the contractor performed during that period.~~

A reservation in the final release of claims (See ASPR 7-203.4) may be made in the case of completed cost-reimbursement type contracts when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

15-204.39 SPECIAL TOOLING

No comment.

The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or to the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. The cost of special tooling when acquired for and its usefulness is limited to government contracts, is allowable and will be charged directly to the government contracts. When such special tooling is acquired it shall be subject to the provisions of the contract clause set forth in ASPR 13-503 entitled "Government Property."

15-204.40 TAXES

Comments: In subparagraph a (iii), the excluded taxes should be limited to those for which the Government has actually provided exemption. In many cases the cost of securing exemption exceeds the amount to be saved and neither the Government nor the contractor would require the exemption to be claimed.

The suggested change in the last sentence of subparagraph b is to specifically provide for the coverage of any other costs incurred in complying with the instructions or directions of contracting officers. In addition the words "prior to payment of such taxes" in the first sentence have been deleted since they are inconsistent with item (iii) in subparagraph a and item (iii) in subparagraph b. Moreover, it would be impossible to carry out the action indicated in b prior to payment of taxes since, in many cases, the illegality or erroneous character of taxes are not established until long after such taxes are paid.

Subparagraph c should require direct credits only where the taxes were originally charged directly to government contracts. Refunds of taxes treated by the contractor as overhead should be credited to overhead.

Suggested Revision

Taxes are charges levied by a government unit. They do not include fines and and penalties except as otherwise provided herein.

a. In general, taxes (including state and local income taxes) which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except (i) for Federal income and excess profits taxes; (ii) taxes in connection with financing, refinancing or refunding operations (see paragraph 15-204.17); (iii) taxes from which ~~exemptions are available to the contractor directly or available to the contractor~~ the contractor is exempt based on an exemption ~~afforded~~ furnished by the Government; and (iv) special assessments on land which represent capital improvements.

b. Taxes otherwise allowable under a above, but which may be illegally or erroneously assessed may be allowed as a cost of work performed, provided that the contractor, ~~prior to payment of such taxes~~ (i) promptly requests instructions from the contracting officer concerning such taxes; (ii) agrees to comply with such instructions; and (iii) if so directed by the contracting officer also agrees to take all necessary

action in cooperation with and for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer, shall be allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs as will the cost of any other action taken under b (ii) and b (iii) above.

c. Any refund of taxes, penalties or interest thereon which were directly reimbursed under the contract shall be credited to ~~contract~~ the costs of that contract. ~~in the proportion in which contract costs absorbed the costs of taxes, interest or penalties.~~ If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

15-204.41 TRADE, BUSINESS, AND PROFESSIONAL ACTIVITIES

Comments: Subparagraph c as proposed by the government is unduly restrictive in that it refers only to technical information or information that is aimed at the stimulation of production. Industry feels that meetings, conferences and exhibitions for the purpose of improving overall coordination of the business or various segments thereof, or the dissemination of information about the business to the trade, the public, prospective employees, etc., is just as important to the successful performance of government contracts as are technical and production meetings. The section has been broadened accordingly.

Suggested Revision:

a. Memberships. This item includes costs of membership in trade, business, and professional organizations and such costs are allowable.

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

c. Meetings, ~~and~~ Conferences and Exhibitions. Expenses representing the purchase of meals, transportation, rental of facilities for meetings, conferences, exhibitions and costs incidental thereto, when the primary purpose of the incurrance of such expenses is the dissemination of ~~technical~~ information ~~or the stimulation of production, are allowable~~ intended to improve the overall effectiveness of the contractor are allowable.

15-204.42 TRAINING EXPENSES

Comments: Objection is made to the proposal which limits the definition of allowable

expenses to those incurred in a program controlled by the contractor or to training in educational institutions. The language of subparagraph a is unduly restrictive and should be broadened to recognize any training expense which is properly allocable to government contracts. Subparagraphs b and c are unacceptable since training expense in educational institutions is a matter of business judgement and should not be isolated for special and specific treatment in the contractual document. Therefore, the cost of training in outside educational institutions should be allowable when undertaken under an established program of the contractor.

Suggested Revision:

a. This item includes the costs of preparing and maintaining a program of instruction designed to increase the overall effectiveness of employees. Included are the costs of ~~the director of~~ training, ~~and staff~~ training materials and text books when the training program is controlled by the contractor, and employee compensation, subsistence, travel, tuition, fees, training materials, ~~and~~ text books, etc., when the training is ~~in educational institutions~~ conducted by other than the contractor.

b. Such costs ~~which are limited to on the job training~~ are allowable when properly allocated.

~~c. Costs of training in educational institutions are now allowable, except to the extent specifically provided in the contract.~~

15-204.43 TRANSPORTATION EXPENSES

Comment: The only change suggested here is self-explanatory and if for the purpose of clarification.

Suggested Revision:

Transportation expenses include the cost of freight, express, cartage and postage relating either to goods purchased, in process, or delivered.

When such costs can readily be identified with the items involved they may be direct costed or added to the cost of such ~~material~~ items. (See paragraph 15-204.22). Where identification with the materials received cannot readily be made, inbound transportation expense may be charged to the appropriate indirect expense accounts, provided the contractor follows a consistent procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as direct charges.

15-204.44 TRAVEL EXPENSES

Comments: The Government's proposed statement of cost principles as regards travel expense

is not flexible enough to meet conditions under which contractors operate today and are unnecessarily restrictive in the light of the basic principles and standards set forth in Section 15-201.

Changes are suggested to:

a. No comment.

b. Provide for the treatment of travel expense by the contractor as either a direct or indirect cost, whichever is in accordance with his normal business practice.

c. Provide for the use of the per diem reimbursement method and/or the actual reimbursement method if consistent with contractor's normal practice, i.e., in the case of certain groups of employees, one method might be used and, in the case of another group, the alternate method might be used. This should be permitted if consistency exists as between the treatment of expenses of similar groups.

d. Provide for the allowance of premium transportation costs when incurred in accordance with contractor's established practice.

e. Eliminate any reference to entertainment expense because such expense is covered separately in paragraph 15-204.11.

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

Suggested Revision:

This includes costs of transportation, lodging, subsistence and incidental expenses incurred by contractor personnel in a travel status while on official company business.

a. Travel expenses incurred in the normal course of overall administration of the business and applicable to the entire business are allowable when properly allocated.

b. Travel expenses directly attributable to contract performance ~~may~~ will be charged to the contract directly or indirectly in accordance with the ~~principle of~~

~~direct-costing~~ contractor's normal business practice.

c. Subsistence and lodging including tips or similar incidental expenses may be reimbursed either on an actual or per diem basis. ~~The-basis-selected-should-be-consistently-followed.~~ The method or methods used should be consistent with the established practice of the contractor.

d. Costs of premium transportation ~~may-be-allowed-when-it-is-shown-to-be-necessary-to-performance-of-the-contract~~ are allowable when incurred by contractor personnel in accordance with contractor's normal business practice.

e. ~~Entertainment-expenses-are-not-allowable.~~

f. 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.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION
Incorporated

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

NSIA Bulletin . . . Procurement Information

No. 80-54 14 September 1954

To: All Members of the National Security Industrial Association

Allowability of Interest on Borrowed Capital in Military Contract Pricing

COPY

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

My dear Mr. Secretary:

The use of "generally accepted accounting principles" as a basis for solving problems which develop in the accounting or auditing fields under Government contracts is a commendable goal which has been supported for a long time by this Association. Considerable progress has been made in the acceptance of these principles by Department of Defense representatives as well as by Industry representatives.

In one very important area, however, no progress has been made. This area is the acceptance by Government representatives of interest as an allowable cost under Government contracts. In view of the fact that this position is inconsistent with "generally accepted accounting principles" and is a problem which has become more acute since Section XV of the Armed Services Procurement Regulation was released some five years ago, we request your cooperation in reviewing the problem with your policy group covering this subject in the Department of Defense. For your consideration, we enclose a paper on this subject which outlines the National Security Industrial Association's point of view. The Executive Committee of the Association has approved this enclosure and has specifically authorized the President of NSIA to bring it to your attention.

After your review we hope that a meeting can be held between your policy group and representatives of our Association which, as you know, represents a very broad cross-segment of Industry. We would appreciate the opportunity of discussing this problem in detail at the convenience of your representatives.

Yours sincerely,

/s/

HOMER H. EWING, President
National Security Industrial Association

HHE/emg
Encl.

This Bulletin is designed to set forth activities of Association committees dealing with military procurement procedures. Comments, criticisms and suggestions expressed herein represent the views of committee members only. It remains for each member to make its own policy decisions and to deal with the Military Establishment as it sees fit.

Allowability of Interest on Borrowed Capital

In Military Contract Pricing

I. Introduction

Within the last few years, the Armed Services have taken a fairly consistent position in the direction of setting forth "interest on borrowings(however represented), bond discount and expenses, and financing charges" as unallowable costs in military contracts, regardless of frequent complaints of contractors.

Historically, this position has been consistently followed in cost reimbursement type contracts from inception as reflected by T. D. 5000 set forth in the "Green Book" entitled "Explanation of Principles for Determination of Costs Under Government Contracts" and later in Section XV - "Cost Principles" - of the Armed Services Procurement Regulation.

After the issuance of Section XV, the audit agencies of the Military Departments by Joint Letter No. 12 dated August 5, 1949, directed audit personnel to follow Section XV in conducting overhead rate determinations, audits and accounting reviews under both cost type and fixed-price contracts. Accordingly, auditors have in practice been reporting interest as an unallowable item of cost under cost type contracts and as a "cost questioned" under fixed-price type contracts.

The use of these Cost Principles for fixed-price type contracts has been primarily responsible for the disallowance of interest in such cases. Obviously, this is clearly a misapplication of Section XV.

For reasons set forth in further detail below, the denial of interest expense as an operating cost for pricing purposes, in either CPFF, fixed-price, or other type contracts, is unjustified.

II. Government Position re Disallowance of Interest

Historically, arguments most frequently advanced by the Military Departments for denying the allowance of interest fall into the following three categories:

1) Interest expense is regarded as merely a return on equity capital and therefore should be treated in the same way as a dividend.

2) This cost is taken into consideration in setting profits on military contracts.

3) Contractors should be adequately capitalized to finance their operations and to allow interest would result in discriminating in favor of contractors who borrow money as against those who do not.

III. Interest Not a Return on Equity Capital

It is common industry practice in our existing economy to use either short or long term borrowing to finance current business operations. The need for this practice becomes even more apparent when a contractor embarks upon the performance of military contracts. Therefore, to regard such an operating expense as nothing more than a return on equity capital and therefore unallowable is completely unwarranted.

Companies supplying the Armed Services are basically manufacturing contractors and as such are capitalized accordingly in order that construction of widely fluctuating quantities of products that are supplied from time to time may be produced in the most economical manner

and at the lowest cost to the customer. This requires, among other things, that the capital structure provide for considerable flexibility in the scope of Industry's operations in order to: (1) maintain a nucleus of skills and facilities during prolonged periods of low volume production; (2) provide the financial strength and liquidity that will establish credit stability required to support high volume emergency production programs; and (3) at the same time avoid the serious risks as well as the costly burden of carrying excess capitalization during prolonged periods of low volume production.

Compared with consumer production, where production volume can be carefully planned over a period of years based upon estimates of consumer demands, volume of production for the Armed Services is controlled directly by the Armed Forces based upon military requirements of the moment. The manufacturer of military supplies must operate in a state of constant readjustment; that is, be prepared at a moment's notice to expand production capabilities in a period of months that would take a consumer goods industry many years to do, or to contract even more abruptly than the period of expansion.

Moreover, capital borrowings in the performance of Government contracts are frequently made necessary because of common delays in obtaining payment such as the slow processing of invoices, delays encountered in obtaining definitive contractual instruments authorizing payment, Government revisions of delivery schedules which delay or stretch out deliveries over a longer period, thereby prolonging investments in inventories, and other Government action.

Under these conditions, even the best capitalized company could not continue to finance from its own resources such an expansion and contraction of its manufacturing organization.

This responsibility has been recognized by Congress through the passage of enabling legislation authorizing a V-Loan program, certain provisions in the Armed Services Procurement Act and in sections of the Defense Production Act.

The argument is sometimes advanced that progress payments granted to military contractors take care of needs. This technique has never been adequate enough even to meet normal and necessary financing requirements. Under the recently revised policy of the Department of Defense with respect to progress payments, the necessity of military contractors to resort to other means of financing has become even more acute.

IV. Interest Not an Element of Profit

The disallowance of interest as a bargaining tool in relation to profit is unfair and illogical. Under the recognized laws of business economics, as well as under "generally accepted accounting principles" established by the accounting profession and used throughout American business and finance, all expenditures of carrying on business operations (other than distributions of capital) which are not properly capitalizable in the balance sheet are regarded as ordinary and necessary costs merely for the purpose of adjusting the profit allowance is a distortion of the fundamental principle of accounting and economics that "income less costs equals profit".

Interest expense is only one of a large number of factors that must be considered in arriving at standards of profit allowance and the development of such standards is an entirely separate problem which should not be confused with the statement of accepted accounting principles governing cost.

The argument is sometimes advanced that the handling of interest as a cost has always been controversial even within the accounting profession. This controversy has never been over the question of whether interest incurred was a cost of operation; that fact has always been accepted. The controversial questions are:

1) Should the costs of operating separate lines or locations be charged with a fictitic "interest" with an offsetting credit to income in order to reflect the comparative u of capital employed at each separate cost center for purposes of developing comparab operating costs? This problem does not involve the cost of interest actually paid borrowed capital.

2) The other question is when should interest incurred be charged into inventories and carried there for balance sheet purposes, and when should it be absorbed as a curren operating expense in determining income? The answer obviously varies with the type of business involved. In any event, the fact that interest is a cost of operations has never been questioned.

The argument that the profit allowance includes a provision for a return on borrowed capital is fallacious in view of the fact that the Armed Services tend to adhere to fixed negotiated profit rates regardless of whose capital is employed. Moreover, the average rate of earning on Government business, by Industry in general, is well below the average rate of earnings o non-Government business.

The failure to regard interest as an element of cost is also inconsistent with the Governmen position with respect to rental costs of facilities. In the task of developing efficient pr duction methods, for which American Industry has established a good reputation, important decisions must be made at various times whether to purchase a facility or to rent it. This decision should be free of artificial and distorting influences. However, the disallowance of interest cost even though rental costs (which include someone's interest cost) are allowe results in a distortion of decision to the detriment of efficient operations. This distort- ion would exist where any ordinary cost is disallowed per se.

V. Interest Not a Discriminatory Expense

The third aspect of the Government's view on this subject is completely unrealistic. It suggests that wherever one business employs a type of cost expenditure not expended by all other business, such cost should not be allowed. The fallacy of this suggestion is self- evident. For example, one contractor may employ the use of a highly specialized machine with efficient results, while his competitors perform the process with hand labor. Since interest is only one of many types of cost, there is no reason to believe that the final prices of the non-borrowing contractor would be lower than those of the contractor who borrows. Therefore, for real fairness, all costs recognized as such under generally accepted accounting principle should be equally allowable to all contractors, to the extent such costs are incurred.

VI. Inconsistent Position of Government

The Government, as a whole, is inconsistent in the treatment of interest. It is allowed as an item of cost for tax purposes, for renegotiation of Military contracts, and for termina- tions of Government contracts in accordance with Section VIII of the Armed Services Procure- ment Regulation applicable to fixed-price contracts. To disallow interest as a cost for pricing purposes in Military contracts is, therefore, completely illogical.

VII. Summary

In summary, recognition of interest on borrowings and other financing charges as accepted items of cost under generally accepted accounting principles and the regulations of Internal Revenue Service is urged.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION
Incorporated

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

NSIA Bulletin . . . Procurement Information

No. 95-55

9 May 1955

TO: All Members of the National Security Industrial Association

Subject: Recognition of New Depreciation Methods Authorized by the 1954 Internal Revenue Code.

Inclosed is a letter addressed to the Honorable W. J. McNeil, Assistant Secretary of Defense (Comptroller) with an attached industry statement regarding "Recognition of New Depreciation Methods Authorized by 1954 Internal Revenue Code."

Copies of this letter have also been sent to the following:

Honorable F. H. Higgins, Assistant Secretary of the Army (L&RD)
Honorable Raymond H. Fogler, Assistant Secretary of the Navy (Material)
Honorable Roger Lewis, Assistant Secretary of the Air Force (Material)
Honorable Wm. B. Franke, Comptroller, Department of the Army
Lt. General C. B. Stone III, Comptroller, Department of the Air Force
Major General K. E. Webber, Auditor General, Department of theAir Force
Rear Admiral C. G. Warfield, Assistant Comptroller Audit, Department of the Navy
Brigadier General C. H. Royce, Chief Army Audit Agency
Mr. Warren Webster, Jr., Director of Procurement & Production Policies, Office of the Assistant Secretary of Defense (Supply & Logistics)
Mr. Howard W. Bordner, Deputy Comptroller for Accounting Policy, Office of the Assistant Secretary of Defense (Comptroller).

Frank L. Fuller

Frank L. Fuller
Procurement Advisory Committee Executive

1 Inclosure
cc ltr to Hon W. J. McNeil w/
industry statement

Note: Membership of the Accounting and Auditing Committee was included in Procurement Information Bulletin No. 91-55

FLF/gf

This Bulletin is designed to set forth activities of Association committees dealing with military procurement procedures. Comments, criticisms and suggestions expressed herein represent the views of committee members only. It remains for each member to make its own policy decisions and to deal with the Military Establishment as it sees fit.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

May 9, 1955

C O P Y

Honorable W. J. McNeil
Assistant Secretary of Defense (Comptroller)
The Pentagon
Washington 25, D. C.

Dear Mr. Secretary:

Since the enactment of the 1954 Internal Revenue Code contractors have been faced with the srious problem of setting up their accounting records and filing their income tax returns on the basis of new alternative depreciation methods authorized by the Code without knowing to what extent the new depreciation methods will be accepted for Government contract pricing purposes. Numerous conferences have been held with representatives of the Department of Defense and the Military Services on this subject at which some indication has been given that such new depreciation methods would be recognized. The contractors, however, have no assurance of this and some contractors are currently running into difficulties in having such new depreciation methods recognized for contract pricing purposes.

The Department of Defense is therefore strongly urged to issue promptly a policy statement permitting recognition for contract pricing purposes of the alternative depreciation methods authorized by the 1954 Internal Revenue Code. For your consideration, there is inclosed a paper on the subject which outlines the position of the National Security Industrial Association prepared by our Accounting and Auditing Task Committee. After your review, it would be appreciated if a meeting could be arranged between your policy group and representatives of our Association for the purpose of discussing this problem in detail at the convenience of your representatives.

The attached statement was worked up in advance of the release to industry for comment of the proposed revision of cost principles - Section XV of ASPR. It is believed to be of sufficient importance to warrant your prompt consideration since the points of issue are either at variance with this proposed revision of ASPR or are not adequately covered.

An identical letter has also been addressed to the Honorable Thomas P. Pike, Assistant Secretary of Defense (Supply & Logistics).

Cordially,

S/

J. K. Richards
Executive Director

Inclosure

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

RECOGNITION OF NEW DEPRECIATION METHODS

AUTHORIZED BY THE 1954 INTERNAL REVENUE CODE

Introduction

The Department of Defense is strongly urged to issue promptly a policy statement permitting recognition for contract pricing purposes of alternative depreciation methods authorized by the 1954 Internal Revenue Code.

In view of the fact that the Code permits the use of the methods retroactively to January 1, 1954, all contractors are faced with a very serious problem of setting up their accounting records and filing their income tax returns on the basis of these methods without knowing to what extent the new depreciation methods will be accepted for contract pricing purposes. Contractors currently closing out completed price-redetermination type contracts and negotiating final overhead rates are confronted with the problem that the Government auditors and negotiators have no instructions which permit them to arrive at a final agreement. Accordingly, contractors must either reserve the item, or negotiate a settlement which might not be equitable or satisfactory.

The new depreciation methods under the 1954 Code were adopted for very sound business and economic reasons and have been recognized by both the Congress and the accounting profession as being based on sound accounting principles. The declining-balance method and the sum-of-the-years digits method were included in the Code in order to bring allowances for depreciation into accord with reality, to give recognition to the obsolescence factor and to remove barriers to modernization which existed under methods previously authorized. The House Ways and Means Committee and the Senate Committee on Finance both found that "based on a realistic estimate of useful life the proposed system conforms to sound accounting principles."

House Ways and Means Committee Report - Report No. 1337

House Report No. 1337 issued by the Ways and Means Committee on March 9, 1954, after observing that determination of the useful life of a particular asset and the method of allocating depreciation allowances to the years of use are both matters of judgment, stated (Underscoring supplied):

> "In many cases present allowances for depreciation are not in accord with economic reality, particularly when it is considered that adequate depreciation must take account of the factor of obsolescence . . . There is evidence that the present system of depreciation acts as a barrier to investment, particularly with respect to risky commitments in fixed assets. Comparatively slow rates of write-off tend to discourage replacement of obsolete equipment and the installation of modern, up-to-date machinery. Under long-run peacetime conditions, in the absence of the inflationary pressures existing in the forced-draft economy of the postwar period, present tax depreciation methods might depress business capital expenditures below the level needed to keep the economy operating at high levels of output and employment. . . .

> In the formation of its liberalized depreciation policy your committee relies heavily upon the use of an improved declining-balance method. This method concentrates deductions in the early years of service and results in a timing of allowances more in accord with the actual pattern of loss of economic usefulness. With the rate limited to twice the corresponding straight-line rate and based on a realistic estimate of useful life, the proposed system conforms to sound accounting principles. . . .
>
> Mindful of the need for constructive action within the limits of sound budgetary policy, your committee has adopted provisions which will give the economy added stimulus and resilience without departing from realistic standards of depreciation accounting."

Senate Finance Committee Report - Report No. 1622

Report No. 1622 issued by the Senate Committee on Finance on June 18, 1954, also recognized the economic advantages of the new methods, as well as the fact that they conformed to sound accounting principles. The Committee set forth its views in the following language (Underscoring supplied):

> "The stimulus to investment through liberalized depreciation is most important with respect to the creation of new assets. Moreover, the reality of faster depreciation in the early years is generally greater in the case of new than used property. The liberalized declining-balance method included in the bill concentrates deductions in the early years of service and results in a timing of allowances more in accord with the actual pattern of loss of economic usefulness. With the rate limited to twice the corresponding straight-line rate and based on a realistic estimate of useful life, the proposed system conforms to sound accounting principles."

Opinion of the American Institute of Accountants

The American Institute of Accountants has officially recognized the new methods as "meeting the requirement of being systematic and rational" and have stated that "they may well provide the most satisfactory allocation of costs." The Committee on Auditing Procedure of the American Institute has dealt directly with the question in their Accounting Research Bulletin No. 44. The first two paragraphs of Bulletin No. 44 are particularly significant and are quoted below:

> "1. The declining-balance method of estimating periodic depreciation has a long history of use in England and in other countries including, to a limited extent, the United States. Interest in this method has been increased by its specific recognition for income-tax purposes in the Internal Revenue Code of 1954.
>
> 2. The declining-balance method is one of those which meets the requirements of being "systematic and rational" (Accounting

Terminology Bulletin No. 1, paragraph 56). In those cases where the expected productivity or revenue-earning power of the asset is relatively greater during the earlier years of its life, or where maintenance charges tend to increase during the later years, the declining-balance method may well provide the most satisfactory allocation of cost. The conslusions of this Bulletin also apply to the other methods, including the "sum-of-the-years-digits" method, which produce substantially similar results."

Accordingly, it should be noted that the American Institute has found the new methods to be acceptable for public statement purposes.

Summary

(1) The Congress in adopting the new methods has determined that they result in timing of allowances more nearly in accord with the actual pattern of loss of economic usefulness, and that such new methods conform to sound accounting principles.

(2) The accounting profession has recognized the new methods as meeting its requirements of being "systematic and rational", and has approved their use for public statement purposes as providing an acceptable allocation of cost.

(3) The new methods are limited to new property acquired after January 1, 1954, having an estimated useful life of three or more years, and do not allow more than two-thirds depreciation in the first half of the useful life of the item.

(4) The failure to recognize these new methods would require some contractors to maintain two sets of records and would complicate the accounting and administrative burden to both contractor and the Government.

Recommendation

The Department of Defense is therefore urged to issue promptly a policy statement permitting recognition for contract pricing purposes of alternative depreciation methods authorized by the 1954 Internal Revenue Code.

March 24, 1955

NSIA 21 April '55

NATIONAL SECURITY INDUSTRIAL ASSOCIATION
Incorporated

NATIONAL HEADQUARTERS: *1107 19th Street, N.W. · Washington 6, D.C.* / *REpublic 7-7474*

NSIA Bulletin . . . Procurement Information

No. 92-55 22 April 1955

To: All Members of the National Security Industrial Association

Subject: Depreciation on Emergency Facilities Covered by Certificates of Necessity.

Inclosed is a letter addressed to the Honorable W. J. McNeil, Assistant Secretary of Defense (Comptroller) with an attached industry statement regarding depreciation on emergency facilities covered by necessity certificates for contract pricing purposes.

Copies of this letter have also been sent to the following:

Honorable F. H. Higgins, Assistant Secretary of the Army (L&RD)
Honorable Raymond H. Fogler, Assistant Secretary of the Navy (Material)
Honorable Roger Lewis, Assistant Secretary of the Air Force (Material)
Honorable Wm. B. Franke, Comptroller, Department of the Army
Lt. General C. B. Stone III, Comptroller, Department of the Air Force
Major General K. E. Webber, Auditor General, Department of the Air Force
Rear Admiral C. G. Warfield, Assistant Comptroller Audit, Department of the Navy
Brigadier General C. H. Royce, Chief Army Audit Agency
Mr. Warren Webster, Jr., Director of Procurement & Production Policies, Office of the Assistant Secretary of Defense (Supply & Logistics)
Mr. Howard W. Bordner, Deputy Comptroller for Accounting Policy, Office of the Assistant Secretary of Defense (Comptroller)

Frank L. Fuller

Frank L. Fuller
Procurement Advisory Committee Executive

1 Inclosure
cc ltr to Hon. W.J. McNeil w/
industry statement

Note: Membership of the Accounting and Auditing Committee was included in Procurement Information Bulletin No. 91-55.

FLF/ff

This Bulletin is designed to set forth activities of Association committees dealing with military procurement procedures. Comments, criticisms and suggestions expressed herein represent the views of committee members only. It remains for each member to make its own policy decisions and to deal with the Military Establishment as it sees fit.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

C O P Y

April 22, 1955

Honorable W. J. McNeil
Assistant Secretary of Defense (Comptroller)
The Pentagon
Washington 25, D. C.

Dear Mr. Secretary:

The subject of depreciation on emergency facilities covered by Necessity Certificates for contract pricing purposes continues to be a problem to the industry members of the National Security Industrial Association and others. Although it appears that the original intent of the Department of Defense was to recognize full cost recovery of such emergency facilities through depreciation allowances as a cost in contract pricing over the life of such emergency facilities, a number of limitations have been placed upon this full cost recovery in the emergency and post-emergency periods and therefore the current policy is inequitable. Details of problems encountered are presented in the attached statement.

To correct these inequities, it is recommended that, if a contractor elects not to use a determination of "true depreciation," a policy statement be issued indicating that the contractor would be allowed to allocate depreciation on emergency facilities on a normal basis during the emergency period and the post-emergency period. With respect to a contractor electing to use a determination of "true depreciation," it is recommended that the Department of Defense Directive 4105.34, Section 3, paragraph H, be modified to clearly indicate that a contractor will recover in the post-emergency period as an element of cost his original cost of the facility less true depreciation actually recovered as a cost during the emergency period.

For your consideration, a paper is inclosed on this subject which outlines the position of the National Security Industrial Association, prepared by our Accounting and Auditing Task Committee. After your review, it would be appreciated if a meeting could be arranged between your policy group and representatives of our Association for the purpose of discussing this problem in detail at the convenience of your representatives.

The attached statement was prepared prior to the release for industry comment of the proposed revision of Cost Principles, Section XV of ASPR. It is believed that this principle is of sufficient importance to warrant your prompt consideration since the points of issue are either at variance with the proposed revision of ASPR or are not adequately covered therein.

An identical letter has also been addressed to the Honorable Thomas P. Pike, Assistant Secretary of Defense (Supply & Logistics).

Cordially,

S/

J. K. Richards
Executive Director

Inclosure

NATIONAL SECURITY INDUSTRIAL ASSOCIATION
Incorporated

NATIONAL HEADQUARTERS: *1107 19th Street, N.W. · Washington 6, D.C. / REpublic 7-7474*

NSIA Bulletin... Procurement Information

No. 91-55 April 21, 1955

To: All Members of the National Security Industrial Association

Subject: Allowability of Management Incentive Bonuses for Contract Pricing Purposes.

Attached is a copy of a letter addressed to the Honorable Thomas P. Pike, Assistant Secretary of Defense (Supply & Logistics), which includes an industry statement regarding the allowability of management incentive bonuses for contract pricing purposes.

Copies of this letter and inclosure have been sent to the Honorable F. H. Higgins, Assistant Secretary of the Army (L&RD), Honorable Raymond H. Fogler, Assistant Secretary of the Navy, (Material) and Honorable Roger Lewis, Assistant Secretary of the Air Force (Material).

Frank L. Fuller

Frank L. Fuller
Procurement Advisory Committee Executive

1 Inclosure
cc ltr to Hon. T. P. Pike w/
industry statement

(see over)

FLF/gf

This Bulletin is designed to set forth activities of Association committees dealing with military procurement procedures. Comments, criticisms and suggestions expressed herein represent the views of committee members only. It remains for each member to make its own policy decisions and to deal with the Military Establishment as it sees fit.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

List of the Members of the NSIA - Accounting and Auditing Committee:

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Henry W. Sweeney & Co.
52 Wall Street
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R. H. Yanney
The Hoover Company
East Maple Street
North Canton, Ohio

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

C O P Y

April 21, 1955

Honorable Thomas P. Pike
Assistant Secretary of Defense (Supply & Logistics)
The Pentagon
Washington 25, D. C.

Dear Mr. Secretary:

Recently, an important development took place which was precipitated by the recent action of the U. S. Air Force in instructing all procurement personnel to exclude consideration of management incentive compensation in all new contract negotiations. Further action is also contemplated with respect to existing contracts.

It is our understanding that as the result of this recent action, the entire problem of allowable compensation is under consideration in connection with the redrafting of the cost principles under Section XV of ASPR.

The use of generally accepted accounting principles as the basis for solving problems, which develop in the accounting or auditing fields under Government contracts, has been supported by this Association for a long time. In this recent course of action, however, it appears that the acceptance of these principles has been completely abandoned and that this position is even in direct conflict with the cost principles under Section XV of the Armed Services Procurement Regulation, paragraph 15-204(c) and paragraph 15-201, which provide for the applications of tests of reasonableness and allocability in the determination of allowable compensation.

This instruction to disallow management incentive compensation represents an unjustified disinclination on the part of the Government to share in the normal costs of doing business from which the Government derives clear and demonstrable benefits. It is therefore recommended that, in the absence of a determination of unreasonableness in relation to the value of services performed, total compensation should be regarded as an allowable cost for Government contract pricing purposes.

For your consideration, there is inclosed herewith a paper on this subject which outlines the position of the National Security Industrial Association as prepared by our Accounting and Auditing Task Committee. After your review, we would appreciate your arranging a meeting between your policy group and representatives of our Association for the purpose of discussing this problem in detail at the convenience of your representatives.

The attached statement was prepared prior to the release for industry comment of the proposed revision of Cost Principles, Section XV of ASPR. It is believed that this principle is of sufficient importance to warrant your prompt consideration since the points of issue are either at variance with the proposed revision of ASPR or are not adequately covered therein. In this connection, it has been noted that an article on page 2 of the April 13th issue of the Wall Street Journal reported that the final decision on incentive plans has not yet been made.

Specific comments on the draft of Section XV will be submitted at a later date.

Cordially,

S/

J. K. Richards
Executive Director

Inclosure

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

ALLOWABILITY OF MANAGEMENT INCENTIVE BONUSES FOR CONTRACT PRICING PURPOSES

Introduction

A recent important development has taken place concerning the disallowance of management incentive compensation as a Government contract cost for contract pricing purposes which is unfair and inequitable and demands immediate corrective action. This situation applies not only to cost-plus-fixed-fee type contracts but also to initial pricing and price redetermination under fixed price type contracts.

This problem has been precipitated by the recent action of the U. S. Air Force in instructing all procurement personnel to exclude consideration of management incentive compensation in all new contract negotiations. Further instructions are also contemplated with respect to existing contracts. No Air Force directive on this subject has been made public but it is understood that it is under consideration in connection with the redrafting of the Cost Principles - ASPR Section XV.

Although it appears that the Air Force is attempting to recognize distinctions between management incentive compensation plans limited to top executives and those extended to all or most of a company's employees, in practice such compensation paid to all employees above certain levels of management responsibility is being disallowed. This position amounts to a general condemnation of all types of incentive compensation plans for the personnel affected regardless of the merits of individual plans and completely abandons the tests of reasonableness and allocability previously followed in the application of generally accepted accounting principles and practices.

Conflict With Cost Principles

This position is in direct conflict with the cost principles under Section XV of the Armed Services Procurement Regulation, paragraph 15-204(c) which provides the following:

> "Subject to the requirements of paragraph 15-201 with respect to the general basis for determining allowability of costs, and irrespective of whether the particular costs are treated by the contractor as direct or indirect, the following items of costs are considered allowable within the limitations indicated:
>
> - - - - - - - - - - - - - -
>
> "(c) Compensation of corporate officers, executives and department heads. (The term 'compensation' includes all amounts paid or set aside, such as pension and retirement benefits in accordance with the interpretation set forth in paragraph 15-601, salaries, royalties, license fees, bonuses, and deferred compensation benefits. 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.)"

Paragraph 15-201 also provides that

> "The tests used in determining the allowability of cost also include (i) reasonableness, (ii) application of generally accepted accounting principles and practices and (iii) any limitations as to types or amounts of cost items set forth

in this part 2 of Section XV or otherwise included in the contract. Failure to mention any items of cost in this part is not intended to imply that it is either allowable or not allowable."

Variance From Generally Accepted Accounting Principles

The position of the U. S. Air Force is also completely at variance with generally accepted accounting principles and practices which have always regarded any form of compensation for personal services rendered by employees, including incentive bonuses, as an ordinary and necessary cost of doing business. This principle has also been consistently applied in the requirements of the Internal Revenue Code, subject to the tests of reasonableness which have been well established under regulations and court decisions.

The argument frequently presented by the Services for not allowing bonuses is that they are based upon or contingent upon profits or constitute a distribution of profit. Actually, from the standpoint of a cost of doing business, this method of compensation is no different in principle from any other type of incentive payment or provision for a fringe benefit. Moreover, it should be recognized that the adoption of a management incentive bonus plan establishes a moral if not a legal obligation between the contractor and his employer and hence establishes a cost which must be incurred before profits are determined. As a practical matter, the obligation for payment having been established, the basis of profits is usually one of limiting the total amount of such compensation that can be paid.

It is immaterial whether such cost is determined before profits or after profits, providing the cost is reasonable in amount and is in accord with the accepted concept of a cost of doing business. The principal factor to be considered

is one of whether it is an ordinary and necessary business expense which other contractors may provide for by a different method.

If situations exist where certain executives are recipients of unreasonable bonuses, existing cost principles are adequate for dealing with such situations. A determination of the reasonableness of an executive's total compensation should be made on the basis of the value of such services to the contractor rather than on the manner in which the compensation is paid.

It should be recognized that there has been a strong trend on the part of industry in recent years to adopt manifold compensation plans emphasizing incentive features and providing for supplemental payments in addition to basic salaries. The adoption of such plans has been dictated frequently by variations in volume, complexity and efficiency of the contractor. If it were not for such forms of compensation it would be necessary to readjust salaries from time to time, either upwards or downwards to reflect broad changes in quality of performance and results obtained.

Invariably such compensation programs have stimulated efficiency in meeting production schedules, have maintained high standards of quality and have kept costs within budgets, all of which have been of direct benefit to the Government.

Conclusion

In conclusion, we believe that the current action of disallowing management incentive compensation represents an unjustified disinclination on the part of the Government to share in the normal costs of doing business from which the Government derives clear and demonstrable benefits. This cost is a normal and regular charge of doing business and it contributes to the productive ability of any business enterprise just as certainly as those costs which can be directly allocated to a

particular contract. To the extent that the Government shares in the benefits which derive from a firm's productive capacity and efficiency, these benefits are no less real because they are indirect.

It is believed that this recent action now introduces the judgment of Government personnel in the place of the judgment of the directors of industrial concerns in the matter of determining the method of compensation for key employees. It fails to recognize the compensation levels necessary to pay for services performed as well as to protect and hold competent management personnel under prevailing market conditions.

In the absence of a determination of unreasonableness in relation to the value of the services performed, total compensation should be an allowable cost for Government contract purposes based upon the contractor's normal method of computation. Reasonableness should govern and any departure from this can only result in arbitrary and inequitable rules for determining allowable costs.

The burden of proof of unreasonableness in any individual instance should be on the Government and its representatives should show a realistic basis for setting aside any portion as unreasonable in amount. The subject of unreasonable compensation should be a matter for negotiation and related discussions should be held with contracting officers involved.

The contract cost principles, Section XV of the Armed Services Procurement Regulation, have been undergoing complete revision in the Department of Defense for some time. The question of allowability of management incentive compensation together with contributions to profit sharing plans has been among those under consideration. It is understood that these proposed revisions will ultimately be coordinated with industry before their release. The recent action of the Air Force

appears to be unilateral in nature and is therefore unfair and inequitable.

It is recommended that the points indicated herein be given consideration in connection with the proposed revision of the Cost Principles.

March 24, 1955

NSIA 4/21/55

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

DEPRECIATION ON EMERGENCY FACILITIES COVERED BY NECESSITY CERTIFICATES FOR CONTRACT PRICING PURPOSES

Introduction

The subject of depreciation on emergency facilities covered by Necessity Certificates for contract pricing purposes continues to be a pressing problem to industry. The fact that the Department of Defense and the Military Services have been unable or unwilling to accept amounts certified as a practical and acceptable measure of true depreciation for purposes of determining cost in negotiated contract pricing is continuing to waste many man hours of work both of the audit groups and the accounting departments of contractors without any real benefit to the Government.

The acquisition costs of facilities required for the expanded emergency program must be recovered by contractors in the prices charged for the products sold. However, the procurement policy now followed by the Department of Defense with respect to the allowability of a proper charge for depreciation, wear and tear and obsolescenceof such facilities does not fully recognize this principle and therefore is inequitable. It requires the manufacturer to assume risks which he is not required to assume in normal commercial transactions. This is explained in further detail below.

Original Policy Intended Full Cost Recovery

In January 1951 the Munitions Board recognized the policy of full cost recovery when it issued the following:

> "The Board approves the policy with respect to original pricing and price redetermination under fixed price contracts, as well as the allowance of cost under cost type contracts, that facilities for which Certificates of Necessity have been granted shall be depreciated on the basis of spreading the cost of such facilities as if no Certificates of Necessity had been granted."

This policy was subsequently withdrawn. The principle was adhered to, however, when the Department of Defense in April 1951 took a more equitable position in testifying before the House Committee on Expenditures in the Executive Departments. In referring to the allowance of a charge against Government contracts for depreciation, wear and tear and obsolescense of such facilities, their memorandum recommended that

> "Amortization [of these emergency facilities] should be allowed in full as a cost in product pricing for initial product pricing as well as in repricing under the Renegotiation process, as required by statute, and as a matter of consistency with the principle of partial certification."

The memorandum also stated that

> "The real incentive provided by the amortization program is the recovery by contractors, through prices of their products, of the full amount covered by Certificates of Necessity."

This position was endorsed by the majority of the House Committee and is a clear recognition of the philosophy that only through the product prices can a contractor recover 100% of the cost of such facilities.

The desirability of prescribing such a policy was referred to the Director of Defense Mobilization in April 1951. After considerable study, the Director of Defense Mobilization issued DMO No. 11 on August 14, 1951, which stated in the directive that

> "For purposes of cost computations in negotiated contract pricing, accelerated amortization shall be allowed only to the extent that the percentage certified is based on an estimate of post five-year period usefulness."

At this point industry believed a procurement policy would be promptly established which would alleviate the uncertainty which existed with respect to how and when the costs of emergency facilities were to be recovered by defense contractors. Although DMO No. 11 fell considerably short of recognizing accelerated amortization as a cost on the basis of the amounts certified, it did clearly establish an intent to allow as a cost in negotiated contract pricing more than normal depreciation where the emergency period occasioned additional depreciation or obsolescence. Moreover, contractors felt that the spirit and intent of full cost recovery would continue to be recognized.

Limitations Placed Upon Cost Recovery

The implementing directives of the Department of Defense and the Services, however, have placed limitations on the full allowance of "true depreciation" which have been appropriate neither to the spirit and intent of DMO No. 11, nor to the necessities of administration. Paragraph II-B of DOD Directive 4105.34 has the following limitations with respect to the recovery of retroactive true depreciation applicable to the emergency period:

> "These principles and procedures shall be applicable to all negotiated contracts placed after the effective date hereof /December 10, 1952/ and to all existing negotiated contracts (including letters of intent) at that date where firm prices have not fully been finally determined or redetermined and to all existing cost-reimbursement type contracts not completed at that date except as to predetermined overhead rates or fixed amounts of overhead which have finally been agreed upon for particular periods."

With respect to depreciation applicable to emergency facilities in contract pricing in the post-emergency period, industry was originally assured from discussions of this matter with Department of Defense officials that depreciation would be based upon the entire balance of the cost of the facility not recovered through "true depreciation" allowances during the emergency period, and that contractors would be permitted to spread that balance over the remaining life of the facility. Paragraph III-H of DOD 4105.34, however, provides as follows:

> Contract pricing for the post-emergency period will be based upon allowing as a cost, depreciation on emergency facilities, computed by allocating the undepreciated cost of such facilities at the end of the emergency period (cost less true depreciation for that period) over the estimated remaining life of the facilities."

Here, the military contractor is penalized further by being unable to fully recover the cost of emergency facilities in the post-emergency period in that the undepreciated balance to be spread over such period is determined by using cost less "true depreciation" for the emergency period, even though retroactive portions of such "true depreciation" may not have been fully recovered.

Other Difficulties Encountered

Difficulties have also been encountered by contractors in obtaining true depreciation determinations in view of the attempt which has been made to make a meticulous determination of "true depreciation" rather than to rely on reasonable judgment as prescribed by paragraph III-G of DOD 4105.34.

> ". . . The procedures for determining such allowances must be such as will expedite determination; this requires avoidance of an impossible perfectionism. . ."

The tedious procedures which have been developed have also placed additional impediments on the contracting process with the result that the process is carrying more burden than is appropriate to efficient procurement.

The problem of cost recovery to contractors has been further aggravated by extensive delays experienced by contractors in receiving true depreciation determinations. Some contractors advise that they are still awaiting approval of applications for determinations of true depreciation. This lag in their issuance has seriously affected the recovery of retroactive portions of "true depreciation" by contractors which in many instances are substantial in amount.

Because of the above limitations, many contractors are now questioning the practicability of claiming "true depreciation" allowances. However, the Department of Defense Directive and the Procurement Regulations fail to define adequately that full cost recovery of emergency facilities through normal depreciation will be recognized in the event "true depreciation" is not claimed.

Although some representatives of the Department of Defense and the Military Services have indicated that, if "true depreciation" is not claimed, the contractor would be allowed a normal charge for depreciation as an element of cost for contract pricing purposes over the entire life of the facilities until they have been fully depreciated at normal rates, contractors have no assurance that this policy would be followed.

Recommendations

It is therefore recommended that the Department of Defense promptly issue a policy statement indicating that a contractor holding Certificates of Necessity may elect not to use a determination of true depreciation for the emergency period for contract pricing purposes and that, under such circumstances, if true depreciation is not claimed, the contractor would be allowed to allocate depreciation on emergency facilities on a normal basis during the emergency period and the post emergency period.

To correct the inequity now existent with respect to a contractor electing to use a determination of true depreciation, it is recommended that Department of Defense Directive #4105.34 of December 10, 1952, be modified to clearly indicate that a contractor will recover in the post-emergency period as an element of contract cost his original cost of the facility less "true depreciation" actually recovered as a cost during the emergency period. This change is necessary to assure the contractor of the recovery of the total cost of emergency facilities, and particularly that portion of "true depreciation" which may not have been recovered during the emergency period.

To accomplish this end it is recommended that Section III Par. H of Department of Defense Directive #4105.34 be amended to read as follows:

> "H. Contract pricing for the post-emergency period will be based upon allowing as a cost, depreciation on emergency facilities, computed by allocating the undepreciated cost of such facilities at the end of the emergency period (cost less depreciation actually allowed as a cost for that period) over the estimated remaining life of the facilities."

March 24, 1955

NSIA 4/21/55

American Institute of Accountants

INCORPORATED UNDER THE LAWS OF THE DISTRICT OF COLUMBIA

THE NATIONAL ORGANIZATION OF CERTIFIED PUBLIC ACCOUNTANTS

270 MADISON AVENUE, NEW YORK 16, N. Y.

June 30, 1955

Honorable Thomas P. Pike
Assistant Secretary of Defense
(Supply and Logistics)
Washington 25, D. C.

Dear Sir:

Comments on proposed revision of ASPR,
Section XV, Contract Cost Principles,
dated 11 April 1955

At the request of Mr. Howard Bordner, Deputy Comptroller for Acccunting Policy, Office of the Assistant Secretary of Defense, the Committee on National Defense submits its comments. It is our understanding that this Section is intended to apply only to cost reimbursement-type contracts and we recommend that it be made clear that it should not be used for negotiation or redetermination proceedings in connection with fixed-price contracts.

We feel that the document would be in more useful form if it identified in separate lists the following three categories of costs:

1. Costs which should be considered at the time the contract is drawn.

2. Costs which are generally allowable.

3. Costs which are generally not allowable.

There would, of course, be an overlapping between the first category and the other two. Mr. Peloubet of our Committee, has given the draft an especially thorough review and a copy of his personal comments is attached. The Committee is in agreement with his comments with the exception of that dealing with Par. 15-204.22(b). The Committee generally feels that interest should not be allowed

and that cash discounts on purchases should be credited to costs. To the list of paragraphs mentioned by Mr. Peloubet for consideration when the contract is drawn, the Committee suggests adding Par. 15-204.35(b).

In connection with Mr. Peloubet's comments on Par. 15-204.27(e), it should also be pointed out that this question arises in Par. 15-204.6(e). This seems to be a point on which judgment will have to be exercised in particular circumstances. On the one hand, it might be unreasonable fully to allow contributions to profit-sharing and pension plans, if in a particular year, the "catching up" was of a large proportion even though it fell within the carry-over provisions. On the other hand, as Mr. Peloubet points out, a strict interpretation of this provision could result in unfairness to the contractor by preventing him from recouping his fair costs.

In addition to the points raised by Mr. Peloubet, we submit the following:

Par. 15-201(b)(iv)

Is not the language of this part of the paragraph covered by the immediately preceding language "exercise of good business judgment in incurrence of costs"? The contractor might be justified in deviations in practice even though they substantially increase the contract cost.

Par. 15-204.6(f)(iv)
and

Par. 15-204.6(g)

There is an implication that costs arising from distribution of stock bonuses will be allowed even though the employee does not have an irrevocable right to receive the stock. Generally, stock bonus plans do have some sort of "good conduct" clause and this should not nullify the allowability of the bonus awarded to the employee. However, if there are contingencies in a particular case beyond such a normal type clause, the question arises as to the allowability under such a condition.

The limitation of 15% prescribed for each employee might not be fair. Presumably this percentage figure was derived from the tax rule, but should it not be similarily applied as with the tax rule to the aggregate for all employees under the plan rather than to individual employees separately?

Par. 15-204.7

Would it not be desirable to insert the word "reasonable" in front of the word "certainty"? There can be costs which are properly allowable but which are not completely certain as to time or intensity.

Par. 15-204.8

In appraising the propriety of contributions and donations, would it not be desirable to take into consideration the amount of donations made by other companies in the community of similar size? After all, under today's conditions, each business concern has a responsibility to the community to make donations measured by its size and ability to pay.

Par. 15-204.15

Should not the discussion of "starting load" costs deal with cases where the contractor defers such costs in one accounting period for absorption in the subsequent period? Unless this is done, it seems to us that the higher production costs typically occurring at the beginning of the contract do not present any special accounting problems. They should be subject, of course, to the tests cited in Par. 15-201(b).

Par. 15-204.16(f)

What does "self insurance" mean? Is it intended to require that funds be set aside or merely that an appropriate reserve account be provided in an orderly fashion?

Par. 15-204.20(b)

Should not this paragraph deal only with unusual cases? There seems to be an inconsistency in saying, on the one hand, that costs for maintenance done in the current period which could have been performed in a prior period are not to be allowed unless provided for in the contract; and on the other hand, that no allowance will be made in the current period for repair work which for some good reason, is not done until a subsequent period. The combination of these two provisions could result in the contractor losing any reimbursement at all for important repair costs.

Par. 15-204.22(e)(i)

We assume that "write-downs" is intended to refer to adjustments to lower of cost or market, and is not intended to include proper adjustments for obsolescence and damage.

Par. 15-204.44(d)

The reference to costs of premium transportation seems to us overly to emphasize the application of government rules to the operations of the contractor. Again, here the test should be of general reasonableness.

Yours very truly,

COMMITTEE ON NATIONAL DEFENSE

Herman W. Bevis
Price Waterhouse & Co.
George R. Catlett
Arthur Andersen & Co.
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Henry W. Sweeney & Co.

For the Committee

John W. McEachren, Chairman
Touche, Niven, Bailey & Smart

JWM:hp
Encl.

PROPOSED REVISION OF
ASPR SECTION XV
CONTRACT COST PRINCIPLES

April 11, 1955

(REIMBURSEMENT CONTRACTS)

One of the first impressions which I get from this revision is that it is full of recommendations or advice on points which should be considered before the contract is finally drawn. It seems to me confusing to have these spread through the whole contract. I do not think the text should be changed, but I do think a checklist should be prepared indicating the points which should be considered in pre-contract negotiations or taken up with the contracting officer. I will merely give the paragraph numbers here as I quite agree that the idea of pre-contract negotiation on these points is a good one; and I have no criticism in substance, merely as to arrangement. The paragraph numbers are:

15-204.4	15-204.32
15-204.5	15-204.35c
15-204.6-e(3)i	15-204.36
15-204.20b	15-204.37
15-204.22d	15-204.40b
15-204.27f(1)	15-204.42c
15-204.29	15-204.44f

I believe this is about all the paragraphs that should be covered by the checklist, but it is possible that there may be others. In any event, it seems only fair that the contractor should be given a complete descriptive checklist of items of pre-contract negotiation, or which should be settled with the contracting officer.

15-203.3

This treatment of selling expenses seems entirely satisfactory to me, and is in agreement with good industrial and contract practice.

15-204.11

While there is no objection to this paragraph as it stands, I think it would be advisable to point out as was done in the "green book" in the war, that certain expenditures which appear to be entertainment are in fact deductible. For example, official ceremonies such as launching of vessels or ceremonies where a contractor is given a government award.

15-204.22(b)

It seems to me that if interest is not to be allowed as a cost, with which I agree, cash discount should not be required to be taken as a credit against cost as it is a financial expense very largely in the nature of interest.

15-204.25

I agree with this and think it is a necessary provision, very clearly expressed.

15-204.27(e)

It seems to me that the result of the application of this provision might mean that part at least of a year's pension cost might be entirely lost to the contractor as a deduction.

15-204.34

The allowance of rental payments under sale and lease-back arrangements, as described in this paragraph, is correct in principle. In Section (b) of this paragraph I am at a loss to see how the reasonableness of a rental can be measured by "normal costs". It seems to me that one of the tests of a reasonable rental is whether it is substantially equal to the usual rental charges for the

particular type of equipment or building. Rentals must in their very nature exceed "normal costs" as they include two additional factors, a risk factor and a financing factor.

If it is the custom of a contractor to lease automobiles for the use of his employees, the rentals on such automobiles, provided they were used for legitimate business purposes, should be the rentals paid to the lessor, which would almost certainly exceed what is described in this paragraph as "normal costs". Furthermore, a lessee is in no position to determine the normal cost of the lessor, and it seems to be a most unfair requirement to ask him to make such a determination.

All of the foregoing is based on the assumption which I think is entirely sound, that there is no difference between property covered by a sale and lease-back arrangement and property which might be, for the sake of argument, put under lease as soon as it was in shape to operate. We might easily have two identical pieces of equipment, on one of which rent was paid to a lessor who had purchased the property new, and rent might be paid on the other under a sale and lease-back agreement. The two rentals might be at the same rate. It is almost certain that these rentals would be larger than the "normal costs" described in this paragraph. I do not think there should be this discrimination made between rentals on leased property, based on the former ownership of the property.

All of the foregoing is, of course, based on the assumption that the lease under the sale and lease-back is a bona fide lease without any provision for repurchase or repossession, and with a genuinely independent third party. I agree that a transaction which

is merely put through to substitute an unreasonably high rental for a low or nonexistent depreciation charge should be disregarded, the same as any other transaction which is not entered into at arms length, and is entered into for a purpose different than its ostensible one. I think the paragraph could be cured by perhaps making subparagraph (b) read "Rentals specified in sale and lease-back agreements under (ii) above are allowable only to the extent that such rentals do not exceed reasonable rentals on comparable property and only on condition that the lease is made with an independent third party, and that there is no provision in the lease for repurchase or repossession".

With the foregoing exceptions, the proposed revision seems to be acceptable and is, I think, particularly to be commended for its generally clear expression and precise and careful definitions.

Maurice E. Peloubet

June 6, 1955

WASHINGTON
TRANSPORTATION BUILDING

CABLE ADDRESS
AUTOMAKERS

NEW YORK
366 MADISON AVENUE

AUTOMOBILE MANUFACTURERS ASSOCIATION

NEW CENTER BUILDING - DETROIT 2, MICHIGAN

WILLIAM J. CRONIN, *Managing Director*

June 17, 1955

L. H. Thomas, Rear Admiral, SC, USN
Staff Director
Purchasing and Contracting Policies Division
Department of Defense
Washington 25, D. C.

Dear Admiral Thomas:

Your letter of April 11, 1955 to Mr. J. G. Ellis of our Washington Office, together with the draft of the proposed revision to Part 2, Section XV of the ASPR, has been reviewed by the Controllers Committee of the Automobile Manufacturers Association. The members of this committee have requested that I forward to you their comments which I shall endeavor to set forth herein.

The members of this committee are impressed with the efforts of the Department of Defense to amplify and improve upon the provisions of the present Section XV and believe that the results, as exemplified by the proposed Part 2 revision, are to be commended. In certain areas, however, it is believed that the provisions are not acceptable to industry, while in others, further amplification or clarification would be beneficial. The specific comments are as follows:

15-200 Scope of Part

Although the recently issued Department of Defense Instruction No. 4105.11 specifically cancels permission to use these Cost Principles as a "working guide" it is believed that, until such time as this paragraph clearly states that it is not applicable to fixed-price contracts including those providing for price redetermination, there will be Procurement Agency and Audit Agency personnel who will continue to use it as a guide in connection with such contracting. It is, therefore, strongly recommended that this paragraph be expanded to incorporate such a statement.

15-201 Basic Principles and Standards

It is believed that the factors affecting allowability of costs, as set forth under b. of this subparagraph, particularly items (i) and (iii), should be used as a guide by Contracting Officers but that Audit Agencies should not be allowed to pass judgment on these types of determination, which limitation should be clearly stated in this subparagraph.

15-203.5 Base Period for Allocation of Indirect Expenses

This subparagraph was found to be vague and susceptible to varied interpretation. It is recommended that the language be made more specific to clearly set forth the intent of the item.

15-204.1 Advertising

It is recommended that this subparagraph be deleted, in entirety, and that the principles of ASPR, Section 8-402 b.(1) be substituted in lieu thereof.

15-204.3 Bidding Expense

The last sentence should be revised to read "Bidding Expense will be accepted if found to be reasonable and equitable."

15-204.4 Cafeterias, Dining Rooms, and Other Food Services

It is suggested that the words "when it is determined that the contractor is intending to operate such services at no loss or profit" at the end of the third sentence, and the entire last sentence, in this subparagraph be deleted, without substitution. Reasonable losses from the operation of such services should be allowable, as are other employee morale, health and welfare costs under the provisions of subparagraph 15-204.10, and should not be dependent upon the intention of the Contractor to operate the activity at either a profit or a loss.

15-204.5 Civil Defense

It is suggested that the last sentence in this subparagraph, which disallows contributions to local civil defense funds or projects not on the Contractor's premises which are not specifically provided in the contract, be deleted, without substitution. Due to the changing situation in civil defense, it is possible that a Contractor may be placed in a position of having to cooperate with local Governmental Authorities by contributing substantially to some local civil defense project, for the good of his community. Such an expense should be an allowable item of cost in contract pricing even though it may not be specifically provided in the contract.

15-204.6 Compensation for Personal Services

This proposed revised subparagraph makes certain arbitrary and unreasonable changes to the current version which provides for the allowance of compensation for personal services subject only to the test of reasonableness of total compensation for the services rendered. Specifically, the suggested changes in this proposed subparagraph are as follows:

Subparagraph c. provides that the cost of employee stock options is not allowable as an item of cost. The cost of such options should be allowable

if total compensation is reasonable, since such payments are an accepted method of employee remuneration just as much as other compensation plans. This medium is often utilized to acquire the services of an individual who may be essential to the performance of the Government contract.

It is suggested that items d.(1) and d.(7) be deleted, without substitution. These sentences are unnecessary.

The sentence under item d.(2) should be expanded to read "Reasonable in amount when considered in light of total compensation."

The sentence under item d.(3) should be revised to read "Incurred for current services actually rendered by employees."

Item d.(5) of this subparagraph provides that bonuses to employees are allowable if they are, among other provisions, "allowable as an ordinary or necessary business expense for tax purposes." It is suggested that the words "when paid or accrued" be inserted after the word "allowable" in this sentence. In certain instances such bonuses are allowable for tax purposes in one year on an accrual basis although not actually paid until the succeeding year, which procedure is with Internal Revenue Service approval.

The words "supplemental compensation" should be used in lieu of the words "profit sharing" as used in the heading and throughout subparagraph e.

The sentence under e.(1) should be changed to read "As used herein, supplemental compensation is construed to be compensation paid or obligation incurred under any plan (immediate or deferred - regardless of method of payment or participation) which is in any manner measured by, dependent upon, or contingent upon, earnings, sales, unit volume, or any other recognized method of performance evaluation."

The words "and g. below" should be deleted from items e.(2)(i), e.(2)(ii) and f., since it is believed that the 15% limitation on the cost of immediately payable profit sharing plans and stock bonus plans is arbitrary and unreasonable. It could very well be that the writers of the proposed revision were thinking about the limitation imposed by Section 404.(a)(3) of the Internal Revenue Code on contributions to deferred stock bonus and profit-sharing trusts. However, this limitation should not be applied to immediate distribution plans for which the test should be reasonableness in amount when considered as part of total compensation.

Item e.(2)(iii) should be deleted, in entirety, without substitution. It is arbitrary and discriminatory and, if such a provision were to be permitted, it could result in the Contractor withholding his best talent from Government business. If the total compensation is reasonable and necessary to attract and retain capable personnel the degree to which a Contractor is engaged in Government work should not be a factor.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

C O P Y

April 22, 1955

Honorable W. J. McNeil
Assistant Secretary of Defense (Comptroller)
The Pentagon
Washington 25, D. C.

Dear Mr. Secretary:

The subject of depreciation on emergency facilities covered by Necessity Certificates for contract pricing purposes continues to be a problem to the industry members of the National Security Industrial Association and others. Although it appears that the original intent of the Department of Defense was to recognize full cost recovery of such emergency facilities through depreciation allowances as a cost in contract pricing over the life of such emergency facilities, a number of limitations have been placed upon this full cost recovery in the emergency and post-emergency periods and therefore the current policy is inequitable. Details of problems encountered are presented in the attached statement.

To correct these inequities, it is recommended that, if a contractor elects not to use a determination of "true depreciation," a policy statement be issued indicating that the contractor would be allowed to allocate depreciation on emergency facilities on a normal basis during the emergency period and the post-emergency period. With respect to a contractor electing to use a determination of "true depreciation," it is recommended that the Department of Defense Directive 4105.34, Section 3, paragraph H, be modified to clearly indicate that a contractor will recover in the post-emergency period as an element of cost his original cost of the facility less true depreciation actually recovered as a cost during the emergency period.

For your consideration, a paper is inclosed on this subject which outlines the position of the National Security Industrial Association, prepared by our Accounting and Auditing Task Committee. After your review, it would be appreciated if a meeting could be arranged between your policy group and representatives of our Association for the purpose of discussing this problem in detail at the convenience of your representatives.

The attached statement was prepared prior to the release for industry comment of the proposed revision of Cost Principles, Section XV of ASPR. It is believed that this principle is of sufficient importance to warrant your prompt consideration since the points of issue are either at variance with the proposed revision of ASPR or are not adequately covered therein.

An identical letter has also been addressed to the Honorable Thomas P. Pike, Assistant Secretary of Defense (Supply & Logistics).

Cordially,

S/

J. K. Richards
Executive Director

Inclosure

NATIONAL SECURITY INDUSTRIAL ASSOCIATION
Incorporated

NATIONAL HEADQUARTERS: *1107 19th Street, N.W. · Washington 6, D.C. / REpublic 7-7474*

NSIA Bulletin... Procurement Information

No. 91-55 April 21, 1955

To: All Members of the National Security Industrial Association

Subject: Allowability of Management Incentive Bonuses for Contract Pricing Purposes.

Attached is a copy of a letter addressed to the Honorable Thomas P. Pike, Assistant Secretary of Defense (Supply & Logistics), which includes an industry statement regarding the allowability of management incentive bonuses for contract pricing purposes.

Copies of this letter and inclosure have been sent to the Honorable F. H. Higgins, Assistant Secretary of the Army (L&RD), Honorable Raymond H. Fogler, Assistant Secretary of the Navy, (Material) and Honorable Roger Lewis, Assistant Secretary of the Air Force (Material).

Frank L. Fuller

Frank L. Fuller
Procurement Advisory Committee Executive

1 Inclosure
cc ltr to Hon. T. P. Pike w/
industry statement

(see over)

FLF/gf

This Bulletin is designed to set forth activities of Association committees dealing with military procurement procedures. Comments, criticisms and suggestions expressed herein represent the views of committee members only. It remains for each member to make its own policy decisions and to deal with the Military Establishment as it sees fit.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

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East Maple Street
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NATIONAL SECURITY INDUSTRIAL ASSOCIATION

C O P Y

April 21, 1955

Honorable Thomas P. Pike
Assistant Secretary of Defense (Supply & Logistics)
The Pentagon
Washington 25, D. C.

Dear Mr. Secretary:

Recently, an important development took place which was precipitated by the recent action of the U. S. Air Force in instructing all procurement personnel to exclude consideration of management incentive compensation in all new contract negotiations. Further action is also contemplated with respect to existing contracts.

It is our understanding that as the result of this recent action, the entire problem of allowable compensation is under consideration in connection with the redrafting of the cost principles under Section XV of ASPR.

The use of generally accepted accounting principles as the basis for solving problems, which develop in the accounting or auditing fields under Government contracts, has been supported by this Association for a long time. In this recent course of action, however, it appears that the acceptance of these principles has been completely abandoned and that this position is even in direct conflict with the cost principles under Section XV of the Armed Services Procurement Regulation, paragraph 15-204(c) and paragraph 15-201, which provide for the applications of tests of reasonableness and allocability in the determination of allowable compensation.

This instruction to disallow management incentive compensation represents an unjustified disinclination on the part of the Government to share in the normal costs of doing business from which the Government derives clear and demonstrable benefits. It is therefore recommended that, in the absence of a determination of unreasonableness in relation to the value of services performed, total compensation should be regarded as an allowable cost for Government contract pricing purposes.

For your consideration, there is inclosed herewith a paper on this subject which outlines the position of the National Security Industrial Association as prepared by our Accounting and Auditing Task Committee. After your review, we would appreciate your arranging a meeting between your policy group and representatives of our Association for the purpose of discussing this problem in detail at the convenience of your representatives.

The attached statement was prepared prior to the release for industry comment of the proposed revision of Cost Principles, Section XV of ASPR. It is believed that this principle is of sufficient importance to warrant your prompt consideration since the points of issue are either at variance with the proposed revision of ASPR or are not adequately covered therein. In this connection, it has been noted that an article on page 2 of the April 13th issue of the Wall Street Journal reported that the final decision on incentive plans has not yet been made.

Specific comments on the draft of Section XV will be submitted at a later date.

Cordially,

S/

J. K. Richards
Executive Director

Inclosure

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

ALLOWABILITY OF MANAGEMENT INCENTIVE BONUSES FOR CONTRACT PRICING PURPOSES

Introduction

A recent important development has taken place concerning the disallowance of management incentive compensation as a Government contract cost for contract pricing purposes which is unfair and inequitable and demands immediate corrective action. This situation applies not only to cost-plus-fixed-fee type contracts but also to initial pricing and price redetermination under fixed price type contracts.

This problem has been precipitated by the recent action of the U. S. Air Force in instructing all procurement personnel to exclude consideration of management incentive compensation in all new contract negotiations. Further instructions are also contemplated with respect to existing contracts. No Air Force directive on this subject has been made public but it is understood that it is under consideration in connection with the redrafting of the Cost Principles - ASPR Section XV.

Although it appears that the Air Force is attempting to recognize distinctions between management incentive compensation plans limited to top executives and those extended to all or most of a company's employees, in practice such compensation paid to all employees above certain levels of management responsibility is being disallowed. This position amounts to a general condemnation of all types of incentive compensation plans for the personnel affected regardless of the merits of individual plans and completely abandons the tests of reasonableness and allocability previously followed in the application of generally accepted accounting principles and practices.

Conflict With Cost Principles

This position is in direct conflict with the cost principles under Section XV of the Armed Services Procurement Regulation, paragraph 15-204(c) which provides the following:

> "Subject to the requirements of paragraph 15-201 with respect to the general basis for determining allowability of costs, and irrespective of whether the particular costs are treated by the contractor as direct or indirect, the following items of costs are considered allowable within the limitations indicated:
>
> - - - - - - - - - - - - -
>
> "(c) Compensation of corporate officers, executives and department heads. (The term 'compensation' includes all amounts paid or set aside, such as pension and retirement benefits in accordance with the interpretation set forth in paragraph 15-601, salaries, royalties, license fees, bonuses, and deferred compensation benefits. 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.)"

Paragraph 15-201 also provides that

> "The tests used in determining the allowability of cost also include (i) reasonableness, (ii) application of generally accepted accounting principles and practices and (iii) any limitations as to types or amounts of cost items set forth

in this part 2 of Section XV or otherwise included in the contract. Failure to mention any items of cost in this part is not intended to imply that it is either allowable or not allowable."

Variance From Generally Accepted Accounting Principles

The position of the U. S. Air Force is also completely at variance with generally accepted accounting principles and practices which have always regarded any form of compensation for personal services rendered by employees, including incentive bonuses, as an ordinary and necessary cost of doing business. This principle has also been consistently applied in the requirements of the Internal Revenue Code, subject to the tests of reasonableness which have been well established under regulations and court decisions.

The argument frequently presented by the Services for not allowing bonuses is that they are based upon or contingent upon profits or constitute a distribution of profit. Actually, from the standpoint of a cost of doing business, this method of compensation is no different in principle from any other type of incentive payment or provision for a fringe benefit. Moreover, it should be recognized that the adoption of a management incentive bonus plan establishes a moral if not a legal obligation between the contractor and his employer and hence establishes a cost which must be incurred before profits are determined. As a practical matter, the obligation for payment having been established, the basis of profits is usually one of limiting the total amount of such compensation that can be paid.

It is immaterial whether such cost is determined before profits or after profits, providing the cost is reasonable in amount and is in accord with the accepted concept of a cost of doing business. The principal factor to be considered

is one of whether it is an ordinary and necessary business expense which other contractors may provide for by a different method.

If situations exist where certain executives are recipients of unreasonable bonuses, existing cost principles are adequate for dealing with such situations. A determination of the reasonableness of an executive's total compensation should be made on the basis of the value of such services to the contractor rather than on the manner in which the compensation is paid.

It should be recognized that there has been a strong trend on the part of industry in recent years to adopt manifold compensation plans emphasizing incentive features and providing for supplemental payments in addition to basic salaries. The adoption of such plans has been dictated frequently by variations in volume, complexity and efficiency of the contractor. If it were not for such forms of compensation it would be necessary to readjust salaries from time to time, either upwards or downwards to reflect broad changes in quality of performance and results obtained.

Invariably such compensation programs have stimulated efficiency in meeting production schedules, have maintained high standards of quality and have kept costs within budgets, all of which have been of direct benefit to the Government.

Conclusion

In conclusion, we believe that the current action of disallowing management incentive compensation represents an unjustified disinclination on the part of the Government to share in the normal costs of doing business from which the Government derives clear and demonstrable benefits. This cost is a normal and regular charge of doing business and it contributes to the productive ability of any business enterprise just as certainly as those costs which can be directly allocated to a

particular contract. To the extent that the Government shares in the benefits which derive from a firm's productive capacity and efficiency, these benefits are no less real because they are indirect.

It is believed that this recent action now introduces the judgment of Government personnel in the place of the judgment of the directors of industrial concerns in the matter of determining the method of compensation for key employees. It fails to recognize the compensation levels necessary to pay for services performed as well as to protect and hold competent management personnel under prevailing market conditions.

In the absence of a determination of unreasonableness in relation to the value of the services performed, total compensation should be an allowable cost for Government contract purposes based upon the contractor's normal method of computation. Reasonableness should govern and any departure from this can only result in arbitrary and inequitable rules for determining allowable costs.

The burden of proof of unreasonableness in any individual instance should be on the Government and its representatives should show a realistic basis for setting aside any portion as unreasonable in amount. The subject of unreasonable compensation should be a matter for negotiation and related discussions should be held with contracting officers involved.

The contract cost principles, Section XV of the Armed Services Procurement Regulation, have been undergoing complete revision in the Department of Defense for some time. The question of allowability of management incentive compensation together with contributions to profit sharing plans has been among those under consideration. It is understood that these proposed revisions will ultimately be coordinated with industry before their release. The recent action of the Air Force

appears to be unilateral in nature and is therefore unfair and inequitable.

It is recommended that the points indicated herein be given consideration in connection with the proposed revision of the Cost Principles.

March 24, 1955

NSIA 4/21/55

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

DEPRECIATION ON EMERGENCY FACILITIES COVERED BY NECESSITY CERTIFICATES FOR CONTRACT PRICING PURPOSES

Introduction

The subject of depreciation on emergency facilities covered by Necessity Certificates for contract pricing purposes continues to be a pressing problem to industry. The fact that the Department of Defense and the Military Services have been unable or unwilling to accept amounts certified as a practical and acceptable measure of true depreciation for purposes of determining cost in negotiated contract pricing is continuing to waste many man hours of work both of the audit groups and the accounting departments of contractors without any real benefit to the Government.

The acquisition costs of facilities required for the expanded emergency program must be recovered by contractors in the prices charged for the products sold. However, the procurement policy now followed by the Department of Defense with respect to the allowability of a proper charge for depreciation, wear and tear and obsolescenceof such facilities does not fully recognize this principle and therefore is inequitable. It requires the manufacturer to assume risks which he is not required to assume in normal commercial transactions. This is explained in further detail below.

Original Policy Intended Full Cost Recovery

In January 1951 the Munitions Board recognized the policy of full cost recovery when it issued the following:

> "The Board approves the policy with respect to original pricing and price redetermination under fixed price contracts, as well as the allowance of cost under cost type contracts, that facilities for which Certificates of Necessity have been granted shall be depreciated on the basis of spreading the cost of such facilities as if no Certificates of Necessity had been granted."

This policy was subsequently withdrawn. The principle was adhered to, however, when the Department of Defense in April 1951 took a more equitable position in testifying before the House Committee on Expenditures in the Executive Departments. In referring to the allowance of a charge against Government contracts for depreciation, wear and tear and obsolescense of such facilities, their memorandum recommended that

> "Amortization /of these emergency facilities/ should be allowed in full as a cost in product pricing for initial product pricing as well as in repricing under the Renegotiation process, as required by statute, and as a matter of consistency with the principle of partial certification."

The memorandum also stated that

> "The real incentive provided by the amortization program is the recovery by contractors, through prices of their products, of the full amount covered by Certificates of Necessity."

This position was endorsed by the majority of the House Committee and is a clear recognition of the philosophy that only through the product prices can a contractor recover 100% of the cost of such facilities.

The desirability of prescribing such a policy was referred to the Director of Defense Mobilization in April 1951. After considerable study, the Director of Defense Mobilization issued DMO No. 11 on August 14, 1951, which stated in the directive that

> "For purposes of cost computations in negotiated contract pricing, accelerated amortization shall be allowed only to the extent that the percentage certified is based on an estimate of post five-year period usefulness."

At this point industry believed a procurement policy would be promptly established which would alleviate the uncertainty which existed with respect to how and when the costs of emergency facilities were to be recovered by defense contractors. Although DMO No. 11 fell considerably short of recognizing accelerated amortization as a cost on the basis of the amounts certified, it did clearly establish an intent to allow as a cost in negotiated contract pricing more than normal depreciation where the emergency period occasioned additional depreciation or obsolescence. Moreover, contractors felt that the spirit and intent of full cost recovery would continue to be recognized.

Limitations Placed Upon Cost Recovery

The implementing directives of the Department of Defense and the Services, however, have placed limitations on the full allowance of "true depreciation" which have been appropriate neither to the spirit and intent of DMO No. 11, nor to the necessities of administration. Paragraph II-B of DOD Directive 4105.34 has the following limitations with respect to the recovery of retroactive true depreciation applicable to the emergency period:

> "These principles and procedures shall be applicable to all negotiated contracts placed after the effective date hereof /December 10, 1952/ and to all existing negotiated contracts (including letters of intent) at that date where firm prices have not fully been finally determined or redetermined and to all existing cost-reimbursement type contracts not completed at that date except as to predetermined overhead rates or fixed amounts of overhead which have finally been agreed upon for particular periods."

With respect to depreciation applicable to emergency facilities in contract pricing in the post-emergency period, industry was originally assured from discussions of this matter with Department of Defense officials that depreciation would be based upon the entire balance of the cost of the facility not recovered through "true depreciation" allowances during the emergency period, and that contractors would be permitted to spread that balance over the remaining life of the facility. Paragraph III-H of DOD 4105.34, however, provides as follows:

> Contract pricing for the post-emergency period will be based upon allowing as a cost, depreciation on emergency facilities, computed by allocating the undepreciated cost of such facilities at the end of the emergency period (cost less true depreciation for that period) over the estimated remaining life of the facilities."

Here, the military contractor is penalized further by being unable to fully recover the cost of emergency facilities in the post-emergency period in that the undepreciated balance to be spread over such period is determined by using cost less "true depreciation" for the emergency period, even though retroactive portions of such "true depreciation" may not have been fully recovered.

Other Difficulties Encountered

Difficulties have also been encountered by contractors in obtaining true depreciation determinations in view of the attempt which has been made to make a meticulous determination of "true depreciation" rather than to rely on reasonable judgment as prescribed by paragraph III-G of DOD 4105.34.

> ". . . The procedures for determining such allowances must be such as will expedite determination; this requires avoidance of an impossible perfectionism. . ."

The tedious procedures which have been developed have also placed additional impediments on the contracting process with the result that the process is carrying more burden than is appropriate to efficient procurement.

The problem of cost recovery to contractors has been further aggravated by extensive delays experienced by contractors in receiving true depreciation determinations. Some contractors advise that they are still awaiting approval of applications for determinations of true depreciation. This lag in their issuance has seriously affected the recovery of retroactive portions of "true depreciation" by contractors which in many instances are substantial in amount.

Because of the above limitations, many contractors are now questioning the practicability of claiming "true depreciation" allowances. However, the Department of Defense Directive and the Procurement Regulations fail to define adequately that full cost recovery of emergency facilities through normal depreciation will be recognized in the event "true depreciation" is not claimed.

Although some representatives of the Department of Defense and the Military Services have indicated that, if "true depreciation" is not claimed, the contractor would be allowed a normal charge for depreciation as an element of cost for contract pricing purposes over the entire life of the facilities until they have been fully depreciated at normal rates, contractors have no assurance that this policy would be followed.

Recommendations

It is therefore recommended that the Department of Defense promptly issue a policy statement indicating that a contractor holding Certificates of Necessity may elect not to use a determination of true depreciation for the emergency period for contract pricing purposes and that, under such circumstances, if true depreciation is not claimed, the contractor would be allowed to allocate depreciation on emergency facilities on a normal basis during the emergency period and the post emergency period.

To correct the inequity now existent with respect to a contractor electing to use a determination of true depreciation, it is recommended that Department of Defense Directive #4105.34 of December 10, 1952, be modified to clearly indicate that a contractor will recover in the post-emergency period as an element of contract cost his original cost of the facility less "true depreciation" actually recovered as a cost during the emergency period. This change is necessary to assure the contractor of the recovery of the total cost of emergency facilities, and particularly that portion of "true depreciation" which may not have been recovered during the emergency period.

To accomplish this end it is recommended that Section III Par. H of Department of Defense Directive #4105.34 be amended to read as follows:

> "H. Contract pricing for the post-emergency period will be based upon allowing as a cost, depreciation on emergency facilities, computed by allocating the undepreciated cost of such facilities at the end of the emergency period (cost less depreciation actually allowed as a cost for that period) over the estimated remaining life of the facilities."

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Terminology Bulletin No. 1, paragraph 56). In those cases where the expected productivity or revenue-earning power of the asset is relatively greater during the earlier years of its life, or where maintenance charges tend to increase during the later years, the declining-balance method may well provide the most satisfactory allocation of cost. The conslusions of this Bulletin also apply to the other methods, including the "sum-of-the-years-digits" method, which produce substantially similar results."

Accordingly, it should be noted that the American Institute has found the new methods to be acceptable for public statement purposes.

Summary

(1) The Congress in adopting the new methods has determined that they result in timing of allowances more nearly in accord with the actual pattern of loss of economic usefulness, and that such new methods conform to sound accounting principles.

(2) The accounting profession has recognized the new methods as meeting its requirements of being "systematic and rational", and has approved their use for public statement purposes as providing an acceptable allocation of cost.

(3) The new methods are limited to new property acquired after January 1, 1954, having an estimated useful life of three or more years, and do not allow more than two-thirds depreciation in the first half of the useful life of the item.

(4) The failure to recognize these new methods would require some contractors to maintain two sets of records and would complicate the accounting and administrative burden to both contractor and the Government.

Recommendation

The Department of Defense is therefore urged to issue promptly a policy statement permitting recognition for contract pricing purposes of alternative depreciation methods authorized by the 1954 Internal Revenue Code.

March 24, 1955

NSIA 21 April '55

NATIONAL SECURITY INDUSTRIAL ASSOCIATION
Incorporated

NATIONAL HEADQUARTERS: *1107 19th Street, N.W. · Washington 6, D.C.* / *REpublic 7-7474*

NSIA Bulletin . . . Procurement Information

No. 92-55 22 April 1955

To: All Members of the National Security Industrial Association

Subject: Depreciation on Emergency Facilities Covered by Certificates of Necessity.

Inclosed is a letter addressed to the Honorable W. J. McNeil, Assistant Secretary of Defense (Comptroller) with an attached industry statement regarding depreciation on emergency facilities covered by necessity certificates for contract pricing purposes.

Copies of this letter have also been sent to the following:

Honorable F. H. Higgins, Assistant Secretary of the Army (L&RD)
Honorable Raymond H. Fogler, Assistant Secretary of the Navy (Material)
Honorable Roger Lewis, Assistant Secretary of the Air Force (Material)
Honorable Wm. B. Franke, Comptroller, Department of the Army
Lt. General C. B. Stone III, Comptroller, Department of the Air Force
Major General K. E. Webber, Auditor General, Department of the Air Force
Rear Admiral C. G. Warfield, Assistant Comptroller Audit, Department of the Navy
Brigadier General C. H. Royce, Chief Army Audit Agency
Mr. Warren Webster, Jr., Director of Procurement & Production Policies, Office of the Assistant Secretary of Defense (Supply & Logistics)
Mr. Howard W. Bordner, Deputy Comptroller for Accounting Policy, Office of the Assistant Secretary of Defense (Comptroller)

Frank L. Fuller

Frank L. Fuller
Procurement Advisory Committee Executive

1 Inclosure
cc ltr to Hon. W.J. McNeil w/
industry statement

Note: Membership of the Accounting and Auditing Committee was included in Procurement Information Bulletin No. 91-55.

FLF/ff

This Bulletin is designed to set forth activities of Association committees dealing with military procurement procedures. Comments, criticisms and suggestions expressed herein represent the views of committee members only. It remains for each member to make its own policy decisions and to deal with the Military Establishment as it sees fit.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

C O P Y

April 22, 1955

Honorable W. J. McNeil
Assistant Secretary of Defense (Comptroller)
The Pentagon
Washington 25, D. C.

Dear Mr. Secretary:

The subject of depreciation on emergency facilities covered by Necessity Certificates for contract pricing purposes continues to be a problem to the industry members of the National Security Industrial Association and others. Although it appears that the original intent of the Department of Defense was to recognize full cost recovery of such emergency facilities through depreciation allowances as a cost in contract pricing over the life of such emergency facilities, a number of limitations have been placed upon this full cost recovery in the emergency and post-emergency periods and therefore the current policy is inequitable. Details of problems encountered are presented in the attached statement.

To correct these inequities, it is recommended that, if a contractor elects not to use a determination of "true depreciation," a policy statement be issued indicating that the contractor would be allowed to allocate depreciation on emergency facilities on a normal basis during the emergency period and the post-emergency period. With respect to a contractor electing to use a determination of "true depreciation," it is recommended that the Department of Defense Directive 4105.34, Section 3, paragraph H, be modified to clearly indicate that a contractor will recover in the post-emergency period as an element of cost his original cost of the facility less true depreciation actually recovered as a cost during the emergency period.

For your consideration, a paper is inclosed on this subject which outlines the position of the National Security Industrial Association, prepared by our Accounting and Auditing Task Committee. After your review, it would be appreciated if a meeting could be arranged between your policy group and representatives of our Association for the purpose of discussing this problem in detail at the convenience of your representatives.

The attached statement was prepared prior to the release for industry comment of the proposed revision of Cost Principles, Section XV of ASPR. It is believed that this principle is of sufficient importance to warrant your prompt consideration since the points of issue are either at variance with the proposed revision of ASPR or are not adequately covered therein.

An identical letter has also been addressed to the Honorable Thomas P. Pike, Assistant Secretary of Defense (Supply & Logistics).

Cordially,

S/

J. K. Richards
Executive Director

Inclosure

NATIONAL SECURITY INDUSTRIAL ASSOCIATION
Incorporated

NATIONAL HEADQUARTERS: *1107 19th Street, N.W. · Washington 6, D.C. / REpublic 7-7474*

NSIA Bulletin... Procurement Information

No. 91-55 April 21, 1955

To: All Members of the National Security Industrial Association

Subject: Allowability of Management Incentive Bonuses for Contract Pricing Purposes.

Attached is a copy of a letter addressed to the Honorable Thomas P. Pike, Assistant Secretary of Defense (Supply & Logistics), which includes an industry statement regarding the allowability of management incentive bonuses for contract pricing purposes.

Copies of this letter and inclosure have been sent to the Honorable F. H. Higgins, Assistant Secretary of the Army (L&RD), Honorable Raymond H. Fogler, Assistant Secretary of the Navy, (Material) and Honorable Roger Lewis, Assistant Secretary of the Air Force (Material).

Frank L. Fuller

Frank L. Fuller
Procurement Advisory Committee Executive

1 Inclosure
cc ltr to Hon. T. P. Pike w/
industry statement

(see over)

FLF/gf

This Bulletin is designed to set forth activities of Association committees dealing with military procurement procedures. Comments, criticisms and suggestions expressed herein represent the views of committee members only. It remains for each member to make its own policy decisions and to deal with the Military Establishment as it sees fit.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

List of the Members of the NSIA - Accounting and Auditing Committee:

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Dallas, Texas

J. J. Douglas
Automatic Electric Company
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138 River Street
Waltham 54, Mass.

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100 Kingsland Road
Clifton, New Jersey

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J. W. Sprague
Western Elec. Co. Inc.
120 Broadway
New York 5, New York

H. W. Sweeney
Henry W. Sweeney & Co.
52 Wall Street
New York, New York

R. H. Yanney
The Hoover Company
East Maple Street
North Canton, Ohio

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

C O P Y

April 21, 1955

Honorable Thomas P. Pike
Assistant Secretary of Defense (Supply & Logistics)
The Pentagon
Washington 25, D. C.

Dear Mr. Secretary:

Recently, an important development took place which was precipitated by the recent action of the U. S. Air Force in instructing all procurement personnel to exclude consideration of management incentive compensation in all new contract negotiations. Further action is also contemplated with respect to existing contracts.

It is our understanding that as the result of this recent action, the entire problem of allowable compensation is under consideration in connection with the redrafting of the cost principles under Section XV of ASPR.

The use of generally accepted accounting principles as the basis for solving problems, which develop in the accounting or auditing fields under Government contracts, has been supported by this Association for a long time. In this recent course of action, however, it appears that the acceptance of these principles has been completely abandoned and that this position is even in direct conflict with the cost principles under Section XV of the Armed Services Procurement Regulation, paragraph 15-204(c) and paragraph 15-201, which provide for the applications of tests of reasonableness and allocability in the determination of allowable compensation.

This instruction to disallow management incentive compensation represents an unjustified disinclination on the part of the Government to share in the normal costs of doing business from which the Government derives clear and demonstrable benefits. It is therefore recommended that, in the absence of a determination of unreasonableness in relation to the value of services performed, total compensation should be regarded as an allowable cost for Government contract pricing purposes.

For your consideration, there is inclosed herewith a paper on this subject which outlines the position of the National Security Industrial Association as prepared by our Accounting and Auditing Task Committee. After your review, we would appreciate your arranging a meeting between your policy group and representatives of our Association for the purpose of discussing this problem in detail at the convenience of your representatives.

The attached statement was prepared prior to the release for industry comment of the proposed revision of Cost Principles, Section XV of ASPR. It is believed that this principle is of sufficient importance to warrant your prompt consideration since the points of issue are either at variance with the proposed revision of ASPR or are not adequately covered therein. In this connection, it has been noted that an article on page 2 of the April 13th issue of the Wall Street Journal reported that the final decision on incentive plans has not yet been made.

Specific comments on the draft of Section XV will be submitted at a later date.

Cordially,

S/

J. K. Richards
Executive Director

Inclosure

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

ALLOWABILITY OF MANAGEMENT INCENTIVE BONUSES FOR CONTRACT PRICING PURPOSES

Introduction

A recent important development has taken place concerning the disallowance of management incentive compensation as a Government contract cost for contract pricing purposes which is unfair and inequitable and demands immediate corrective action. This situation applies not only to cost-plus-fixed-fee type contracts but also to initial pricing and price redetermination under fixed price type contracts.

This problem has been precipitated by the recent action of the U. S. Air Force in instructing all procurement personnel to exclude consideration of management incentive compensation in all new contract negotiations. Further instructions are also contemplated with respect to existing contracts. No Air Force directive on this subject has been made public but it is understood that it is under consideration in connection with the redrafting of the Cost Principles - ASPR Section XV.

Although it appears that the Air Force is attempting to recognize distinctions between management incentive compensation plans limited to top executives and those extended to all or most of a company's employees, in practice such compensation paid to all employees above certain levels of management responsibility is being disallowed. This position amounts to a general condemnation of all types of incentive compensation plans for the personnel affected regardless of the merits of individual plans and completely abandons the tests of reasonableness and allocability previously followed in the application of generally accepted accounting principles and practices.

Conflict With Cost Principles

This position is in direct conflict with the cost principles under Section XV of the Armed Services Procurement Regulation, paragraph 15-204(c) which provides the following:

> "Subject to the requirements of paragraph 15-201 with respect to the general basis for determining allowability of costs, and irrespective of whether the particular costs are treated by the contractor as direct or indirect, the following items of costs are considered allowable within the limitations indicated:
>
> - - - - - - - - - - - - - -
>
> "(c) Compensation of corporate officers, executives and department heads. (The term 'compensation' includes all amounts paid or set aside, such as pension and retirement benefits in accordance with the interpretation set forth in paragraph 15-601, salaries, royalties, license fees, bonuses, and deferred compensation benefits. 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.)"

Paragraph 15-201 also provides that

> "The tests used in determining the allowability of cost also include (i) reasonableness, (ii) application of generally accepted accounting principles and practices and (iii) any limitations as to types or amounts of cost items set forth

in this part 2 of Section XV or otherwise included in the contract. Failure to mention any items of cost in this part is not intended to imply that it is either allowable or not allowable."

Variance From Generally Accepted Accounting Principles

The position of the U. S. Air Force is also completely at variance with generally accepted accounting principles and practices which have always regarded any form of compensation for personal services rendered by employees, including incentive bonuses, as an ordinary and necessary cost of doing business. This principle has also been consistently applied in the requirements of the Internal Revenue Code, subject to the tests of reasonableness which have been well established under regulations and court decisions.

The argument frequently presented by the Services for not allowing bonuses is that they are based upon or contingent upon profits or constitute a distribution of profit. Actually, from the standpoint of a cost of doing business, this method of compensation is no different in principle from any other type of incentive payment or provision for a fringe benefit. Moreover, it should be recognized that the adoption of a management incentive bonus plan establishes a moral if not a legal obligation between the contractor and his employer and hence establishes a cost which must be incurred before profits are determined. As a practical matter, the obligation for payment having been established, the basis of profits is usually one of limiting the total amount of such compensation that can be paid.

It is immaterial whether such cost is determined before profits or after profits, providing the cost is reasonable in amount and is in accord with the accepted concept of a cost of doing business. The principal factor to be considered

is one of whether it is an ordinary and necessary business expense which other contractors may provide for by a different method.

If situations exist where certain executives are recipients of unreasonable bonuses, existing cost principles are adequate for dealing with such situations. A determination of the reasonableness of an executive's total compensation should be made on the basis of the value of such services to the contractor rather than on the manner in which the compensation is paid.

It should be recognized that there has been a strong trend on the part of industry in recent years to adopt manifold compensation plans emphasizing incentive features and providing for supplemental payments in addition to basic salaries. The adoption of such plans has been dictated frequently by variations in volume, complexity and efficiency of the contractor. If it were not for such forms of compensation it would be necessary to readjust salaries from time to time, either upwards or downwards to reflect broad changes in quality of performance and results obtained.

Invariably such compensation programs have stimulated efficiency in meeting production schedules, have maintained high standards of quality and have kept costs within budgets, all of which have been of direct benefit to the Government.

Conclusion

In conclusion, we believe that the current action of disallowing management incentive compensation represents an unjustified disinclination on the part of the Government to share in the normal costs of doing business from which the Government derives clear and demonstrable benefits. This cost is a normal and regular charge of doing business and it contributes to the productive ability of any business enterprise just as certainly as those costs which can be directly allocated to a

particular contract. To the extent that the Government shares in the benefits which derive from a firm's productive capacity and efficiency, these benefits are no less real because they are indirect.

It is believed that this recent action now introduces the judgment of Government personnel in the place of the judgment of the directors of industrial concerns in the matter of determining the method of compensation for key employees. It fails to recognize the compensation levels necessary to pay for services performed as well as to protect and hold competent management personnel under prevailing market conditions.

In the absence of a determination of unreasonableness in relation to the value of the services performed, total compensation should be an allowable cost for Government contract purposes based upon the contractor's normal method of computation. Reasonableness should govern and any departure from this can only result in arbitrary and inequitable rules for determining allowable costs.

The burden of proof of unreasonableness in any individual instance should be on the Government and its representatives should show a realistic basis for setting aside any portion as unreasonable in amount. The subject of unreasonable compensation should be a matter for negotiation and related discussions should be held with contracting officers involved.

The contract cost principles, Section XV of the Armed Services Procurement Regulation, have been undergoing complete revision in the Department of Defense for some time. The question of allowability of management incentive compensation together with contributions to profit sharing plans has been among those under consideration. It is understood that these proposed revisions will ultimately be coordinated with industry before their release. The recent action of the Air Force

appears to be unilateral in nature and is therefore unfair and inequitable.

It is recommended that the points indicated herein be given consideration in connection with the proposed revision of the Cost Principles.

March 24, 1955

NSIA 4/21/55

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

DEPRECIATION ON EMERGENCY FACILITIES COVERED BY NECESSITY CERTIFICATES FOR CONTRACT PRICING PURPOSES

Introduction

The subject of depreciation on emergency facilities covered by Necessity Certificates for contract pricing purposes continues to be a pressing problem to industry. The fact that the Department of Defense and the Military Services have been unable or unwilling to accept amounts certified as a practical and acceptable measure of true depreciation for purposes of determining cost in negotiated contract pricing is continuing to waste many man hours of work both of the audit groups and the accounting departments of contractors without any real benefit to the Government.

The acquisition costs of facilities required for the expanded emergency program must be recovered by contractors in the prices charged for the products sold. However, the procurement policy now followed by the Department of Defense with respect to the allowability of a proper charge for depreciation, wear and tear and obsolescenceof such facilities does not fully recognize this principle and therefore is inequitable. It requires the manufacturer to assume risks which he is not required to assume in normal commercial transactions. This is explained in further detail below.

Original Policy Intended Full Cost Recovery

In January 1951 the Munitions Board recognized the policy of full cost recovery when it issued the following:

> "The Board approves the policy with respect to original pricing and price redetermination under fixed price contracts, as well as the allowance of cost under cost type contracts, that facilities for which Certificates of Necessity have been granted shall be depreciated on the basis of spreading the cost of such facilities as if no Certificates of Necessity had been granted."

This policy was subsequently withdrawn. The principle was adhered to, however, when the Department of Defense in April 1951 took a more equitable position in testifying before the House Committee on Expenditures in the Executive Departments. In referring to the allowance of a charge against Government contracts for depreciation, wear and tear and obsolescense of such facilities, their memorandum recommended that

> "Amortization [of these emergency facilities] should be allowed in full as a cost in product pricing for initial product pricing as well as in repricing under the Renegotiation process, as required by statute, and as a matter of consistency with the principle of partial certification."

The memorandum also stated that

> "The real incentive provided by the amortization program is the recovery by contractors, through prices of their products, of the full amount covered by Certificates of Necessity."

This position was endorsed by the majority of the House Committee and is a clear recognition of the philosophy that only through the product prices can a contractor recover 100% of the cost of such facilities.

The desirability of prescribing such a policy was referred to the Director of Defense Mobilization in April 1951. After considerable study, the Director of Defense Mobilization issued DMO No. 11 on August 14, 1951, which stated in the directive that

> "For purposes of cost computations in negotiated contract pricing, accelerated amortization shall be allowed only to the extent that the percentage certified is based on an estimate of post five-year period usefulness."

At this point industry believed a procurement policy would be promptly established which would alleviate the uncertainty which existed with respect to how and when the costs of emergency facilities were to be recovered by defense contractors. Although DMO No. 11 fell considerably short of recognizing accelerated amortization as a cost on the basis of the amounts certified, it did clearly establish an intent to allow as a cost in negotiated contract pricing more than normal depreciation where the emergency period occasioned additional depreciation or obsolescence. Moreover, contractors felt that the spirit and intent of full cost recovery would continue to be recognized.

Limitations Placed Upon Cost Recovery

The implementing directives of the Department of Defense and the Services, however, have placed limitations on the full allowance of "true depreciation" which have been appropriate neither to the spirit and intent of DMO No. 11, nor to the necessities of administration. Paragraph II-B of DOD Directive 4105.34 has the following limitations with respect to the recovery of retroactive true depreciation applicable to the emergency period:

> "These principles and procedures shall be applicable to all negotiated contracts placed after the effective date hereof /December 10, 1952/ and to all existing negotiated contracts (including letters of intent) at that date where firm prices have not fully been finally determined or redetermined and to all existing cost-reimbursement type contracts not completed at that date except as to predetermined overhead rates or fixed amounts of overhead which have finally been agreed upon for particular periods."

With respect to depreciation applicable to emergency facilities in contract pricing in the post-emergency period, industry was originally assured from discussions of this matter with Department of Defense officials that depreciation would be based upon the entire balance of the cost of the facility not recovered through "true depreciation" allowances during the emergency period, and that contractors would be permitted to spread that balance over the remaining life of the facility. Paragraph III-H of DOD 4105.34, however, provides as follows:

> Contract pricing for the post-emergency period will be based upon allowing as a cost, depreciation on emergency facilities, computed by allocating the undepreciated cost of such facilities at the end of the emergency period (cost less true depreciation for that period) over the estimated remaining life of the facilities."

Here, the military contractor is penalized further by being unable to fully recover the cost of emergency facilities in the post-emergency period in that the undepreciated balance to be spread over such period is determined by using cost less "true depreciation" for the emergency period, even though retroactive portions of such "true depreciation" may not have been fully recovered.

Other Difficulties Encountered

Difficulties have also been encountered by contractors in obtaining true depreciation determinations in view of the attempt which has been made to make a meticulous determination of "true depreciation" rather than to rely on reasonable judgment as prescribed by paragraph III-G of DOD 4105.34.

> ". . . The procedures for determining such allowances must be such as will expedite determination; this requires avoidance of an impossible perfectionism. . ."

The tedious procedures which have been developed have also placed additional impediments on the contracting process with the result that the process is carrying more burden than is appropriate to efficient procurement.

The problem of cost recovery to contractors has been further aggravated by extensive delays experienced by contractors in receiving true depreciation determinations. Some contractors advise that they are still awaiting approval of applications for determinations of true depreciation. This lag in their issuance has seriously affected the recovery of retroactive portions of "true depreciation" by contractors which in many instances are substantial in amount.

Because of the above limitations, many contractors are now questioning the practicability of claiming "true depreciation" allowances. However, the Department of Defense Directive and the Procurement Regulations fail to define adequately that full cost recovery of emergency facilities through normal depreciation will be recognized in the event "true depreciation" is not claimed.

Although some representatives of the Department of Defense and the Military Services have indicated that, if "true depreciation" is not claimed, the contractor would be allowed a normal charge for depreciation as an element of cost for contract pricing purposes over the entire life of the facilities until they have been fully depreciated at normal rates, contractors have no assurance that this policy would be followed.

Recommendations

It is therefore recommended that the Department of Defense promptly issue a policy statement indicating that a contractor holding Certificates of Necessity may elect not to use a determination of true depreciation for the emergency period for contract pricing purposes and that, under such circumstances, if true depreciation is not claimed, the contractor would be allowed to allocate depreciation on emergency facilities on a normal basis during the emergency period and the post emergency period.

To correct the inequity now existent with respect to a contractor electing to use a determination of true depreciation, it is recommended that Department of Defense Directive #4105.34 of December 10, 1952, be modified to clearly indicate that a contractor will recover in the post-emergency period as an element of contract cost his original cost of the facility less "true depreciation" actually recovered as a cost during the emergency period. This change is necessary to assure the contractor of the recovery of the total cost of emergency facilities, and particularly that portion of "true depreciation" which may not have been recovered during the emergency period.

To accomplish this end it is recommended that Section III Par. H of Department of Defense Directive #4105.34 be amended to read as follows:

> "H. Contract pricing for the post-emergency period will be based upon allowing as a cost, depreciation on emergency facilities, computed by allocating the undepreciated cost of such facilities at the end of the emergency period (cost less depreciation actually allowed as a cost for that period) over the estimated remaining life of the facilities."

March 24, 1955

NSIA 4/21/55

American Institute of Accountants

INCORPORATED UNDER THE LAWS OF THE DISTRICT OF COLUMBIA

THE NATIONAL ORGANIZATION OF CERTIFIED PUBLIC ACCOUNTANTS

270 MADISON AVENUE, NEW YORK 16, N. Y.

June 30, 1955

Honorable Thomas P. Pike
Assistant Secretary of Defense
(Supply and Logistics)
Washington 25, D. C.

Dear Sir:

Comments on proposed revision of ASPR,
Section XV, Contract Cost Principles,
dated 11 April 1955

At the request of Mr. Howard Bordner, Deputy Comptroller for Acccunting Policy, Office of the Assistant Secretary of Defense, the Committee on National Defense submits its comments. It is our understanding that this Section is intended to apply only to cost reimbursement-type contracts and we recommend that it be made clear that it should not be used for negotiation or redetermination proceedings in connection with fixed-price contracts.

We feel that the document would be in more useful form if it identified in separate lists the following three categories of costs:

1. Costs which should be considered at the time the contract is drawn.

2. Costs which are generally allowable.

3. Costs which are generally not allowable.

There would, of course, be an overlapping between the first category and the other two. Mr. Peloubet of our Committee, has given the draft an especially thorough review and a copy of his personal comments is attached. The Committee is in agreement with his comments with the exception of that dealing with Par. 15-204.22(b). The Committee generally feels that interest should not be allowed

and that cash discounts on purchases should be credited to costs. To the list of paragraphs mentioned by Mr. Peloubet for consideration when the contract is drawn, the Committee suggests adding Par. 15-204.35(b).

In connection with Mr. Peloubet's comments on Par. 15-204.27(e), it should also be pointed out that this question arises in Par. 15-204.6(e). This seems to be a point on which judgment will have to be exercised in particular circumstances. On the one hand, it might be unreasonable fully to allow contributions to profit-sharing and pension plans, if in a particular year, the "catching up" was of a large proportion even though it fell within the carry-over provisions. On the other hand, as Mr. Peloubet points out, a strict interpretation of this provision could result in unfairness to the contractor by preventing him from recouping his fair costs.

In addition to the points raised by Mr. Peloubet, we submit the following:

Par. 15-201(b)(iv)

Is not the language of this part of the paragraph covered by the immediately preceding language "exercise of good business judgment in incurrence of costs"? The contractor might be justified in deviations in practice even though they substantially increase the contract cost.

Par. 15-204.6(f)(iv)
and

Par. 15-204.6(g)

There is an implication that costs arising from distribution of stock bonuses will be allowed even though the employee does not have an irrevocable right to receive the stock. Generally, stock bonus plans do have some sort of "good conduct" clause and this should not nullify the allowability of the bonus awarded to the employee. However, if there are contingencies in a particular case beyond such a normal type clause, the question arises as to the allowability under such a condition.

The limitation of 15% prescribed for each employee might not be fair. Presumably this percentage figure was derived from the tax rule, but should it not be similarily applied as with the tax rule to the aggregate for all employees under the plan rather than to individual employees separately?

Par. 15-204.7

Would it not be desirable to insert the word "reasonable" in front of the word "certainty"? There can be costs which are properly allowable but which are not completely certain as to time or intensity.

Par. 15-204.8

In appraising the propriety of contributions and donations, would it not be desirable to take into consideration the amount of donations made by other companies in the community of similar size? After all, under today's conditions, each business concern has a responsibility to the community to make donations measured by its size and ability to pay.

Par. 15-204.15

Should not the discussion of "starting load" costs deal with cases where the contractor defers such costs in one accounting period for absorption in the subsequent period? Unless this is done, it seems to us that the higher production costs typically occurring at the beginning of the contract do not present any special accounting problems. They should be subject, of course, to the tests cited in Par. 15-201(b).

Par. 15-204.16(f)

What does "self insurance" mean? Is it intended to require that funds be set aside or merely that an appropriate reserve account be provided in an orderly fashion?

Par. 15-204.20(b)

Should not this paragraph deal only with unusual cases? There seems to be an inconsistency in saying, on the one hand, that costs for maintenance done in the current period which could have been performed in a prior period are not to be allowed unless provided for in the contract; and on the other hand, that no allowance will be made in the current period for repair work which for some good reason, is not done until a subsequent period. The combination of these two provisions could result in the contractor losing any reimbursement at all for important repair costs.

Par. 15-204.22(e)(i)

We assume that "write-downs" is intended to refer to adjustments to lower of cost or market, and is not intended to include proper adjustments for obsolescence and damage.

Par. 15-204.44(d)

The reference to costs of premium transportation seems to us overly to emphasize the application of government rules to the operations of the contractor. Again, here the test should be of general reasonableness.

Yours very truly,

COMMITTEE ON NATIONAL DEFENSE

Herman W. Bevis
Price Waterhouse & Co.
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For the Committee

John W. McEachren, Chairman
Touche, Niven, Bailey & Smart

JWM:hp
Encl.

PROPOSED REVISION OF
ASPR SECTION XV
CONTRACT COST PRINCIPLES

April 11, 1955

(REIMBURSEMENT CONTRACTS)

One of the first impressions which I get from this revision is that it is full of recommendations or advice on points which should be considered before the contract is finally drawn. It seems to me confusing to have these spread through the whole contract. I do not think the text should be changed, but I do think a checklist should be prepared indicating the points which should be considered in pre-contract negotiations or taken up with the contracting officer. I will merely give the paragraph numbers here as I quite agree that the idea of pre-contract negotiation on these points is a good one; and I have no criticism in substance, merely as to arrangement. The paragraph numbers are:

15-204.4	15-204.32
15-204.5	15-204.35c
15-204.6-e(3)i	15-204.36
15-204.20b	15-204.37
15-204.22d	15-204.40b
15-204.27f(1)	15-204.42c
15-204.29	15-204.44f

I believe this is about all the paragraphs that should be covered by the checklist, but it is possible that there may be others. In any event, it seems only fair that the contractor should be given a complete descriptive checklist of items of pre-contract negotiation, or which should be settled with the contracting officer.

15-203.3

This treatment of selling expenses seems entirely satisfactory to me, and is in agreement with good industrial and contract practice.

15-204.11

While there is no objection to this paragraph as it stands, I think it would be advisable to point out as was done in the "green book" in the war, that certain expenditures which appear to be entertainment are in fact deductible. For example, official ceremonies such as launching of vessels or ceremonies where a contractor is given a government award.

15-204.22(b)

It seems to me that if interest is not to be allowed as a cost, with which I agree, cash discount should not be required to be taken as a credit against cost as it is a financial expense very largely in the nature of interest.

15-204.25

I agree with this and think it is a necessary provision, very clearly expressed.

15-204.27(e)

It seems to me that the result of the application of this provision might mean that part at least of a year's pension cost might be entirely lost to the contractor as a deduction.

15-204.34

The allowance of rental payments under sale and lease-back arrangements, as described in this paragraph, is correct in principle. In Section (b) of this paragraph I am at a loss to see how the reasonableness of a rental can be measured by "normal costs". It seems to me that one of the tests of a reasonable rental is whether it is substantially equal to the usual rental charges for the

particular type of equipment or building. Rentals must in their very nature exceed "normal costs" as they include two additional factors, a risk factor and a financing factor.

If it is the custom of a contractor to lease automobiles for the use of his employees, the rentals on such automobiles, provided they were used for legitimate business purposes, should be the rentals paid to the lessor, which would almost certainly exceed what is described in this paragraph as "normal costs". Furthermore, a lessee is in no position to determine the normal cost of the lessor, and it seems to be a most unfair requirement to ask him to make such a determination.

All of the foregoing is based on the assumption which I think is entirely sound, that there is no difference between property covered by a sale and lease-back arrangement and property which might be, for the sake of argument, put under lease as soon as it was in shape to operate. We might easily have two identical pieces of equipment, on one of which rent was paid to a lessor who had purchased the property new, and rent might be paid on the other under a sale and lease-back agreement. The two rentals might be at the same rate. It is almost certain that these rentals would be larger than the "normal costs" described in this paragraph. I do not think there should be this discrimination made between rentals on leased property, based on the former ownership of the property.

All of the foregoing is, of course, based on the assumption that the lease under the sale and lease-back is a bona fide lease without any provision for repurchase or repossession, and with a genuinely independent third party. I agree that a transaction which

is merely put through to substitute an unreasonably high rental for a low or nonexistent depreciation charge should be disregarded, the same as any other transaction which is not entered into at arms length, and is entered into for a purpose different than its ostensible one. I think the paragraph could be cured by perhaps making subparagraph (b) read "Rentals specified in sale and lease-back agreements under (ii) above are allowable only to the extent that such rentals do not exceed reasonable rentals on comparable property and only on condition that the lease is made with an independent third party, and that there is no provision in the lease for repurchase or repossession".

With the foregoing exceptions, the proposed revision seems to be acceptable and is, I think, particularly to be commended for its generally clear expression and precise and careful definitions.

Maurice E. Peloubet

June 6, 1955

WASHINGTON
TRANSPORTATION BUILDING

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AUTOMAKERS

NEW YORK
366 MADISON AVENUE

AUTOMOBILE MANUFACTURERS ASSOCIATION

NEW CENTER BUILDING - DETROIT 2, MICHIGAN

WILLIAM J. CRONIN, *Managing Director*

June 17, 1955

L. H. Thomas, Rear Admiral, SC, USN
Staff Director
Purchasing and Contracting Policies Division
Department of Defense
Washington 25, D. C.

Dear Admiral Thomas:

Your letter of April 11, 1955 to Mr. J. G. Ellis of our Washington Office, together with the draft of the proposed revision to Part 2, Section XV of the ASPR, has been reviewed by the Controllers Committee of the Automobile Manufacturers Association. The members of this committee have requested that I forward to you their comments which I shall endeavor to set forth herein.

The members of this committee are impressed with the efforts of the Department of Defense to amplify and improve upon the provisions of the present Section XV and believe that the results, as exemplified by the proposed Part 2 revision, are to be commended. In certain areas, however, it is believed that the provisions are not acceptable to industry, while in others, further amplification or clarification would be beneficial. The specific comments are as follows:

15-200 Scope of Part

Although the recently issued Department of Defense Instruction No. 4105.11 specifically cancels permission to use these Cost Principles as a "working guide" it is believed that, until such time as this paragraph clearly states that it is not applicable to fixed-price contracts including those providing for price redetermination, there will be Procurement Agency and Audit Agency personnel who will continue to use it as a guide in connection with such contracting. It is, therefore, strongly recommended that this paragraph be expanded to incorporate such a statement.

15-201 Basic Principles and Standards

It is believed that the factors affecting allowability of costs, as set forth under b. of this subparagraph, particularly items (i) and (iii), should be used as a guide by Contracting Officers but that Audit Agencies should not be allowed to pass judgment on these types of determination, which limitation should be clearly stated in this subparagraph.

15-203.5 Base Period for Allocation of Indirect Expenses

This subparagraph was found to be vague and susceptible to varied interpretation. It is recommended that the language be made more specific to clearly set forth the intent of the item.

15-204.1 Advertising

It is recommended that this subparagraph be deleted, in entirety, and that the principles of ASPR, Section 8-402 b.(1) be substituted in lieu thereof.

15-204.3 Bidding Expense

The last sentence should be revised to read "Bidding Expense will be accepted if found to be reasonable and equitable."

15-204.4 Cafeterias, Dining Rooms, and Other Food Services

It is suggested that the words "when it is determined that the contractor is intending to operate such services at no loss or profit" at the end of the third sentence, and the entire last sentence, in this subparagraph be deleted, without substitution. Reasonable losses from the operation of such services should be allowable, as are other employee morale, health and welfare costs under the provisions of subparagraph 15-204.10, and should not be dependent upon the intention of the Contractor to operate the activity at either a profit or a loss.

15-204.5 Civil Defense

It is suggested that the last sentence in this subparagraph, which disallows contributions to local civil defense funds or projects not on the Contractor's premises which are not specifically provided in the contract, be deleted, without substitution. Due to the changing situation in civil defense, it is possible that a Contractor may be placed in a position of having to cooperate with local Governmental Authorities by contributing substantially to some local civil defense project, for the good of his community. Such an expense should be an allowable item of cost in contract pricing even though it may not be specifically provided in the contract.

15-204.6 Compensation for Personal Services

This proposed revised subparagraph makes certain arbitrary and unreasonable changes to the current version which provides for the allowance of compensation for personal services subject only to the test of reasonableness of total compensation for the services rendered. Specifically, the suggested changes in this proposed subparagraph are as follows:

Subparagraph c. provides that the cost of employee stock options is not allowable as an item of cost. The cost of such options should be allowable

if total compensation is reasonable, since such payments are an accepted method of employee remuneration just as much as other compensation plans. This medium is often utilized to acquire the services of an individual who may be essential to the performance of the Government contract.

It is suggested that items d.(1) and d.(7) be deleted, without substitution. These sentences are unnecessary.

The sentence under item d.(2) should be expanded to read "Reasonable in amount when considered in light of total compensation."

The sentence under item d.(3) should be revised to read "Incurred for current services actually rendered by employees."

Item d.(5) of this subparagraph provides that bonuses to employees are allowable if they are, among other provisions, "allowable as an ordinary or necessary business expense for tax purposes." It is suggested that the words "when paid or accrued" be inserted after the word "allowable" in this sentence. In certain instances such bonuses are allowable for tax purposes in one year on an accrual basis although not actually paid until the succeeding year, which procedure is with Internal Revenue Service approval.

The words "supplemental compensation" should be used in lieu of the words "profit sharing" as used in the heading and throughout subparagraph e.

The sentence under e.(1) should be changed to read "As used herein, supplemental compensation is construed to be compensation paid or obligation incurred under any plan (immediate or deferred - regardless of method of payment or participation) which is in any manner measured by, dependent upon, or contingent upon, earnings, sales, unit volume, or any other recognized method of performance evaluation."

The words "and g. below" should be deleted from items e.(2)(i), e.(2)(ii) and f., since it is believed that the 15% limitation on the cost of immediately payable profit sharing plans and stock bonus plans is arbitrary and unreasonable. It could very well be that the writers of the proposed revision were thinking about the limitation imposed by Section 404.(a)(3) of the Internal Revenue Code on contributions to deferred stock bonus and profit-sharing trusts. However, this limitation should not be applied to immediate distribution plans for which the test should be reasonableness in amount when considered as part of total compensation.

Item e.(2)(iii) should be deleted, in entirety, without substitution. It is arbitrary and discriminatory and, if such a provision were to be permitted, it could result in the Contractor withholding his best talent from Government business. If the total compensation is reasonable and necessary to attract and retain capable personnel the degree to which a Contractor is engaged in Government work should not be a factor.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

C O P Y

April 22, 1955

Honorable W. J. McNeil
Assistant Secretary of Defense (Comptroller)
The Pentagon
Washington 25, D. C.

Dear Mr. Secretary:

The subject of depreciation on emergency facilities covered by Necessity Certificates for contract pricing purposes continues to be a problem to the industry members of the National Security Industrial Association and others. Although it appears that the original intent of the Department of Defense was to recognize full cost recovery of such emergency facilities through depreciation allowances as a cost in contract pricing over the life of such emergency facilities, a number of limitations have been placed upon this full cost recovery in the emergency and post-emergency periods and therefore the current policy is inequitable. Details of problems encountered are presented in the attached statement.

To correct these inequities, it is recommended that, if a contractor elects not to use a determination of "true depreciation," a policy statement be issued indicating that the contractor would be allowed to allocate depreciation on emergency facilities on a normal basis during the emergency period and the post-emergency period. With respect to a contractor electing to use a determination of "true depreciation," it is recommended that the Department of Defense Directive 4105.34, Section 3, paragraph H, be modified to clearly indicate that a contractor will recover in the post-emergency period as an element of cost his original cost of the facility less true depreciation actually recovered as a cost during the emergency period.

For your consideration, a paper is inclosed on this subject which outlines the position of the National Security Industrial Association, prepared by our Accounting and Auditing Task Committee. After your review, it would be appreciated if a meeting could be arranged between your policy group and representatives of our Association for the purpose of discussing this problem in detail at the convenience of your representatives.

The attached statement was prepared prior to the release for industry comment of the proposed revision of Cost Principles, Section XV of ASPR. It is believed that this principle is of sufficient importance to warrant your prompt consideration since the points of issue are either at variance with the proposed revision of ASPR or are not adequately covered therein.

An identical letter has also been addressed to the Honorable Thomas P. Pike, Assistant Secretary of Defense (Supply & Logistics).

Cordially,

S/

J. K. Richards
Executive Director

Inclosure

NATIONAL SECURITY INDUSTRIAL ASSOCIATION
Incorporated

NATIONAL HEADQUARTERS: *1107 19th Street, N.W. · Washington 6, D.C. / REpublic 7-7474*

NSIA Bulletin... Procurement Information

No. 91-55 April 21, 1955

To: All Members of the National Security Industrial Association

Subject: Allowability of Management Incentive Bonuses for Contract Pricing Purposes.

Attached is a copy of a letter addressed to the Honorable Thomas P. Pike, Assistant Secretary of Defense (Supply & Logistics), which includes an industry statement regarding the allowability of management incentive bonuses for contract pricing purposes.

Copies of this letter and inclosure have been sent to the Honorable F. H. Higgins, Assistant Secretary of the Army (L&RD), Honorable Raymond H. Fogler, Assistant Secretary of the Navy, (Material) and Honorable Roger Lewis, Assistant Secretary of the Air Force (Material).

Frank L. Fuller

Frank L. Fuller
Procurement Advisory Committee Executive

1 Inclosure
cc ltr to Hon. T. P. Pike w/
industry statement

(see over)

FLF/gf

This Bulletin is designed to set forth activities of Association committees dealing with military procurement procedures. Comments, criticisms and suggestions expressed herein represent the views of committee members only. It remains for each member to make its own policy decisions and to deal with the Military Establishment as it sees fit.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

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NATIONAL SECURITY INDUSTRIAL ASSOCIATION

C O P Y

April 21, 1955

Honorable Thomas P. Pike
Assistant Secretary of Defense (Supply & Logistics)
The Pentagon
Washington 25, D. C.

Dear Mr. Secretary:

Recently, an important development took place which was precipitated by the recent action of the U. S. Air Force in instructing all procurement personnel to exclude consideration of management incentive compensation in all new contract negotiations. Further action is also contemplated with respect to existing contracts.

It is our understanding that as the result of this recent action, the entire problem of allowable compensation is under consideration in connection with the redrafting of the cost principles under Section XV of ASPR.

The use of generally accepted accounting principles as the basis for solving problems, which develop in the accounting or auditing fields under Government contracts, has been supported by this Association for a long time. In this recent course of action, however, it appears that the acceptance of these principles has been completely abandoned and that this position is even in direct conflict with the cost principles under Section XV of the Armed Services Procurement Regulation, paragraph 15-204(c) and paragraph 15-201, which provide for the applications of tests of reasonableness and allocability in the determination of allowable compensation.

This instruction to disallow management incentive compensation represents an unjustified disinclination on the part of the Government to share in the normal costs of doing business from which the Government derives clear and demonstrable benefits. It is therefore recommended that, in the absence of a determination of unreasonableness in relation to the value of services performed, total compensation should be regarded as an allowable cost for Government contract pricing purposes.

For your consideration, there is inclosed herewith a paper on this subject which outlines the position of the National Security Industrial Association as prepared by our Accounting and Auditing Task Committee. After your review, we would appreciate your arranging a meeting between your policy group and representatives of our Association for the purpose of discussing this problem in detail at the convenience of your representatives.

The attached statement was prepared prior to the release for industry comment of the proposed revision of Cost Principles, Section XV of ASPR. It is believed that this principle is of sufficient importance to warrant your prompt consideration since the points of issue are either at variance with the proposed revision of ASPR or are not adequately covered therein. In this connection, it has been noted that an article on page 2 of the April 13th issue of the Wall Street Journal reported that the final decision on incentive plans has not yet been made.

Specific comments on the draft of Section XV will be submitted at a later date.

Cordially,

S/

J. K. Richards
Executive Director

Inclosure

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

ALLOWABILITY OF MANAGEMENT INCENTIVE BONUSES FOR CONTRACT PRICING PURPOSES

Introduction

A recent important development has taken place concerning the disallowance of management incentive compensation as a Government contract cost for contract pricing purposes which is unfair and inequitable and demands immediate corrective action. This situation applies not only to cost-plus-fixed-fee type contracts but also to initial pricing and price redetermination under fixed price type contracts.

This problem has been precipitated by the recent action of the U. S. Air Force in instructing all procurement personnel to exclude consideration of management incentive compensation in all new contract negotiations. Further instructions are also contemplated with respect to existing contracts. No Air Force directive on this subject has been made public but it is understood that it is under consideration in connection with the redrafting of the Cost Principles - ASPR Section XV.

Although it appears that the Air Force is attempting to recognize distinctions between management incentive compensation plans limited to top executives and those extended to all or most of a company's employees, in practice such compensation paid to all employees above certain levels of management responsibility is being disallowed. This position amounts to a general condemnation of all types of incentive compensation plans for the personnel affected regardless of the merits of individual plans and completely abandons the tests of reasonableness and allocability previously followed in the application of generally accepted accounting principles and practices.

Conflict With Cost Principles

This position is in direct conflict with the cost principles under Section XV of the Armed Services Procurement Regulation, paragraph 15-204(c) which provides the following:

> "Subject to the requirements of paragraph 15-201 with respect to the general basis for determining allowability of costs, and irrespective of whether the particular costs are treated by the contractor as direct or indirect, the following items of costs are considered allowable within the limitations indicated:
>
> - - - - - - - - - - - - -
>
> "(c) Compensation of corporate officers, executives and department heads. (The term 'compensation' includes all amounts paid or set aside, such as pension and retirement benefits in accordance with the interpretation set forth in paragraph 15-601, salaries, royalties, license fees, bonuses, and deferred compensation benefits. 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.)"

Paragraph 15-201 also provides that

> "The tests used in determining the allowability of cost also include (i) reasonableness, (ii) application of generally accepted accounting principles and practices and (iii) any limitations as to types or amounts of cost items set forth

in this part 2 of Section XV or otherwise included in the contract. Failure to mention any items of cost in this part is not intended to imply that it is either allowable or not allowable."

Variance From Generally Accepted Accounting Principles

The position of the U. S. Air Force is also completely at variance with generally accepted accounting principles and practices which have always regarded any form of compensation for personal services rendered by employees, including incentive bonuses, as an ordinary and necessary cost of doing business. This principle has also been consistently applied in the requirements of the Internal Revenue Code, subject to the tests of reasonableness which have been well established under regulations and court decisions.

The argument frequently presented by the Services for not allowing bonuses is that they are based upon or contingent upon profits or constitute a distribution of profit. Actually, from the standpoint of a cost of doing business, this method of compensation is no different in principle from any other type of incentive payment or provision for a fringe benefit. Moreover, it should be recognized that the adoption of a management incentive bonus plan establishes a moral if not a legal obligation between the contractor and his employer and hence establishes a cost which must be incurred before profits are determined. As a practical matter, the obligation for payment having been established, the basis of profits is usually one of limiting the total amount of such compensation that can be paid.

It is immaterial whether such cost is determined before profits or after profits, providing the cost is reasonable in amount and is in accord with the accepted concept of a cost of doing business. The principal factor to be considered

is one of whether it is an ordinary and necessary business expense which other contractors may provide for by a different method.

If situations exist where certain executives are recipients of unreasonable bonuses, existing cost principles are adequate for dealing with such situations. A determination of the reasonableness of an executive's total compensation should be made on the basis of the value of such services to the contractor rather than on the manner in which the compensation is paid.

It should be recognized that there has been a strong trend on the part of industry in recent years to adopt manifold compensation plans emphasizing incentive features and providing for supplemental payments in addition to basic salaries. The adoption of such plans has been dictated frequently by variations in volume, complexity and efficiency of the contractor. If it were not for such forms of compensation it would be necessary to readjust salaries from time to time, either upwards or downwards to reflect broad changes in quality of performance and results obtained.

Invariably such compensation programs have stimulated efficiency in meeting production schedules, have maintained high standards of quality and have kept costs within budgets, all of which have been of direct benefit to the Government.

Conclusion

In conclusion, we believe that the current action of disallowing management incentive compensation represents an unjustified disinclination on the part of the Government to share in the normal costs of doing business from which the Government derives clear and demonstrable benefits. This cost is a normal and regular charge of doing business and it contributes to the productive ability of any business enterprise just as certainly as those costs which can be directly allocated to a

particular contract. To the extent that the Government shares in the benefits which derive from a firm's productive capacity and efficiency, these benefits are no less real because they are indirect.

It is believed that this recent action now introduces the judgment of Government personnel in the place of the judgment of the directors of industrial concerns in the matter of determining the method of compensation for key employees. It fails to recognize the compensation levels necessary to pay for services performed as well as to protect and hold competent management personnel under prevailing market conditions.

In the absence of a determination of unreasonableness in relation to the value of the services performed, total compensation should be an allowable cost for Government contract purposes based upon the contractor's normal method of computation. Reasonableness should govern and any departure from this can only result in arbitrary and inequitable rules for determining allowable costs.

The burden of proof of unreasonableness in any individual instance should be on the Government and its representatives should show a realistic basis for setting aside any portion as unreasonable in amount. The subject of unreasonable compensation should be a matter for negotiation and related discussions should be held with contracting officers involved.

The contract cost principles, Section XV of the Armed Services Procurement Regulation, have been undergoing complete revision in the Department of Defense for some time. The question of allowability of management incentive compensation together with contributions to profit sharing plans has been among those under consideration. It is understood that these proposed revisions will ultimately be coordinated with industry before their release. The recent action of the Air Force

appears to be unilateral in nature and is therefore unfair and inequitable.

It is recommended that the points indicated herein be given consideration in connection with the proposed revision of the Cost Principles.

March 24, 1955

NSIA 4/21/55

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

DEPRECIATION ON EMERGENCY FACILITIES COVERED BY NECESSITY CERTIFICATES FOR CONTRACT PRICING PURPOSES

Introduction

The subject of depreciation on emergency facilities covered by Necessity Certificates for contract pricing purposes continues to be a pressing problem to industry. The fact that the Department of Defense and the Military Services have been unable or unwilling to accept amounts certified as a practical and acceptable measure of true depreciation for purposes of determining cost in negotiated contract pricing is continuing to waste many man hours of work both of the audit groups and the accounting departments of contractors without any real benefit to the Government.

The acquisition costs of facilities required for the expanded emergency program must be recovered by contractors in the prices charged for the products sold. However, the procurement policy now followed by the Department of Defense with respect to the allowability of a proper charge for depreciation, wear and tear and obsolescenceof such facilities does not fully recognize this principle and therefore is inequitable. It requires the manufacturer to assume risks which he is not required to assume in normal commercial transactions. This is explained in further detail below.

Original Policy Intended Full Cost Recovery

In January 1951 the Munitions Board recognized the policy of full cost recovery when it issued the following:

> "The Board approves the policy with respect to original pricing and price redetermination under fixed price contracts, as well as the allowance of cost under cost type contracts, that facilities for which Certificates of Necessity have been granted shall be depreciated on the basis of spreading the cost of such facilities as if no Certificates of Necessity had been granted."

This policy was subsequently withdrawn. The principle was adhered to, however, when the Department of Defense in April 1951 took a more equitable position in testifying before the House Committee on Expenditures in the Executive Departments. In referring to the allowance of a charge against Government contracts for depreciation, wear and tear and obsolescense of such facilities, their memorandum recommended that

> "Amortization /of these emergency facilities/ should be allowed in full as a cost in product pricing for initial product pricing as well as in repricing under the Renegotiation process, as required by statute, and as a matter of consistency with the principle of partial certification."

The memorandum also stated that

> "The real incentive provided by the amortization program is the recovery by contractors, through prices of their products, of the full amount covered by Certificates of Necessity."

This position was endorsed by the majority of the House Committee and is a clear recognition of the philosophy that only through the product prices can a contractor recover 100% of the cost of such facilities.

The desirability of prescribing such a policy was referred to the Director of Defense Mobilization in April 1951. After considerable study, the Director of Defense Mobilization issued DMO No. 11 on August 14, 1951, which stated in the directive that

> "For purposes of cost computations in negotiated contract pricing, accelerated amortization shall be allowed only to the extent that the percentage certified is based on an estimate of post five-year period usefulness."

At this point industry believed a procurement policy would be promptly established which would alleviate the uncertainty which existed with respect to how and when the costs of emergency facilities were to be recovered by defense contractors. Although DMO No. 11 fell considerably short of recognizing accelerated amortization as a cost on the basis of the amounts certified, it did clearly establish an intent to allow as a cost in negotiated contract pricing more than normal depreciation where the emergency period occasioned additional depreciation or obsolescence. Moreover, contractors felt that the spirit and intent of full cost recovery would continue to be recognized.

Limitations Placed Upon Cost Recovery

The implementing directives of the Department of Defense and the Services, however, have placed limitations on the full allowance of "true depreciation" which have been appropriate neither to the spirit and intent of DMO No. 11, nor to the necessities of administration. Paragraph II-B of DOD Directive 4105.34 has the following limitations with respect to the recovery of retroactive true depreciation applicable to the emergency period:

> "These principles and procedures shall be applicable to all negotiated contracts placed after the effective date hereof /December 10, 1952/ and to all existing negotiated contracts (including letters of intent) at that date where firm prices have not fully been finally determined or redetermined and to all existing cost-reimbursement type contracts not completed at that date except as to predetermined overhead rates or fixed amounts of overhead which have finally been agreed upon for particular periods."

With respect to depreciation applicable to emergency facilities in contract pricing in the post-emergency period, industry was originally assured from discussions of this matter with Department of Defense officials that depreciation would be based upon the entire balance of the cost of the facility not recovered through "true depreciation" allowances during the emergency period, and that contractors would be permitted to spread that balance over the remaining life of the facility. Paragraph III-H of DOD 4105.34, however, provides as follows:

> Contract pricing for the post-emergency period will be based upon allowing as a cost, depreciation on emergency facilities, computed by allocating the undepreciated cost of such facilities at the end of the emergency period (cost less true depreciation for that period) over the estimated remaining life of the facilities."

Here, the military contractor is penalized further by being unable to fully recover the cost of emergency facilities in the post-emergency period in that the undepreciated balance to be spread over such period is determined by using cost less "true depreciation" for the emergency period, even though retroactive portions of such "true depreciation" may not have been fully recovered.

Other Difficulties Encountered

Difficulties have also been encountered by contractors in obtaining true depreciation determinations in view of the attempt which has been made to make a meticulous determination of "true depreciation" rather than to rely on reasonable judgment as prescribed by paragraph III-G of DOD 4105.34.

> ". . . The procedures for determining such allowances must be such as will expedite determination; this requires avoidance of an impossible perfectionism. . ."

The tedious procedures which have been developed have also placed additional impediments on the contracting process with the result that the process is carrying more burden than is appropriate to efficient procurement.

The problem of cost recovery to contractors has been further aggravated by extensive delays experienced by contractors in receiving true depreciation determinations. Some contractors advise that they are still awaiting approval of applications for determinations of true depreciation. This lag in their issuance has seriously affected the recovery of retroactive portions of "true depreciation" by contractors which in many instances are substantial in amount.

Because of the above limitations, many contractors are now questioning the practicability of claiming "true depreciation" allowances. However, the Department of Defense Directive and the Procurement Regulations fail to define adequately that full cost recovery of emergency facilities through normal depreciation will be recognized in the event "true depreciation" is not claimed.

Although some representatives of the Department of Defense and the Military Services have indicated that, if "true depreciation" is not claimed, the contractor would be allowed a normal charge for depreciation as an element of cost for contract pricing purposes over the entire life of the facilities until they have been fully depreciated at normal rates, contractors have no assurance that this policy would be followed.

Recommendations

It is therefore recommended that the Department of Defense promptly issue a policy statement indicating that a contractor holding Certificates of Necessity may elect not to use a determination of true depreciation for the emergency period for contract pricing purposes and that, under such circumstances, if true depreciation is not claimed, the contractor would be allowed to allocate depreciation on emergency facilities on a normal basis during the emergency period and the post emergency period.

To correct the inequity now existent with respect to a contractor electing to use a determination of true depreciation, it is recommended that Department of Defense Directive #4105.34 of December 10, 1952, be modified to clearly indicate that a contractor will recover in the post-emergency period as an element of contract cost his original cost of the facility less "true depreciation" actually recovered as a cost during the emergency period. This change is necessary to assure the contractor of the recovery of the total cost of emergency facilities, and particularly that portion of "true depreciation" which may not have been recovered during the emergency period.

To accomplish this end it is recommended that Section III Par. H of Department of Defense Directive #4105.34 be amended to read as follows:

> "H. Contract pricing for the post-emergency period will be based upon allowing as a cost, depreciation on emergency facilities, computed by allocating the undepreciated cost of such facilities at the end of the emergency period (cost less depreciation actually allowed as a cost for that period) over the estimated remaining life of the facilities."

March 24, 1955

NSIA 4/21/55

Subparagraph g. should be deleted without substitution. No limitation should be placed upon the employer contribution, under supplemental compensation plans of any percentage of the total basic compensation paid or accrued to such employees in the year under consideration. There are already sufficient restraints in the area of reasonable costs. In certain instances, the salary or wage paid is nominal in relation to the supplemental compensation plan and without such plan the Contractor may not be able to attract and retain personnel necessary for both Government and non-Government business.

15-204.9 Depreciation

The second sentence under e. should be deleted in entirety and the following substituted therefor: "After the expiration of the emergency period for the facilities concerned where a determination of "true depreciation" has been made, the remaining unrecovered (during the emergency and/or post-emergency period) portion of the cost of such facility will be depreciated over its remaining useful life and will be recognized as an allowable cost." In those instances where the facilities are used in the performance of defense contracts in the post-emergency period the contractor should be permitted to recover in the post-emergency period as an element of contract cost his original cost or the applicable portion thereof of the facility less "true depreciation" actually recovered during the emergency period.

15-204.10 Employee Morale, Health and Welfare

It is recommended that the second sentence be reworded as follows: "Examples of these activities are house publications, recreation programs, health or first-aid clinics, and employee counselling services."

15-204.12 Excess Facilities

The words in this subparagraph should be deleted, in entirety, and the following substituted therefor: "Unless otherwise provided for in the contract, these costs are unallowable."

15-204.14 Fringe Benefits

The words "supplemental compensation" are suggested in lieu of "profit sharing" under a.

The words "that constitutes, in effect, an implicit agreement on the Contractor's part" should be deleted from the end of the sentence under b.

15-204.15 Initial Production Costs

To the extent that the provisions of Paragraph 8-402 of Section VIII (b.(13) and b.(24)) are applicable, such provisions should be inserted in this subparagraph in lieu of the presently proposed language. This change is desirable not only in the interest of consistency but to provide for preproduction costs which are not mentioned in this subparagraph, as proposed.

15-204.17 Interest and Other Financial Expenses

Under the provision of this subparagraph, interest on borrowings is not an allowable item of cost for contract pricing. This is contrary to b.(14) of Paragraph 8-402 of Section VIII which provides for "Interest on borrowings" with respect to costs to be considered in the settlement of termination claims.

Industry has, for many years, taken the stand that interest and other financial expenses are good costs and should be allowable in contract pricing. It is still believed that such costs should be allowable.

15-204.20 Maintenance and Repairs

The last sentence under a. should be deleted, in entirety. Subparagraph b. should be deleted, since this subparagraph forces the Contractor to anticipate what future abnormal conditions he may encounter, at the time he enters into a contract. Furthermore, it requires him 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.

15-204.27 Pension and Retirement Plans

The third sentence of b. should be reworded to read "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."

15-204.30 Professional Services - 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 c.

15-204.31 Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets

The provisions of this subparagraph are contrary to b.(16) of Paragraph 8-402 of Section VIII which allows the recovery of such items. It is suggested that the applicable provisions of Section VIII be substituted for the presently proposed language.

15-204.32 Reconversion Expenses

We can see no reason for disallowing any reconversion expenses as defined in this paragraph.

15-204.34 Rentals of Plant and Equipment

The restriction on amounts of allowable rent for facilities covered by sale and lease-back 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. In order to guard against abuses, the allowable rental on facilities covered by sale and lease-back agreements could be restricted to normal, competitive rentals for similar properties.

15-204.35 Research and Development

Under b.(1) (iii), general research is an allowable cost if, among other conditions, "the contractor agrees to divulge to the Government the results of such independent general research". This condition is unacceptable and should be deleted in its entirety, 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.

Item b.(1)(iv) should be deleted, without substitution.

With respect to "related research", as set forth under b.(2) of this subparagraph, the restriction that, to be allowable, such costs must be related to the contract or product line 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 impracticable to segregate the "related" costs from the total costs. Therefore, it is recommended that related research costs be allowable.

Subparagraph c. should be deleted, without substitution.

15-204.38 Severance Pay

The second paragraph should be reworded to read "The cost of severance pay is allowable 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 second sentence of subparagraph b. should be reworded with certain parts deleted. It should read "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."

15-204.39 Special Tooling

The last sentence of this subparagraph should be deleted. It is not within the purpose of Section XV to establish the contractor's liability with respect to Government property.

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The opportunity to present our views on this proposed revision and to make recommendations to your office is sincerely appreciated.

Very truly yours,

William J. Cronin
Managing Director

AIRCRAFT INDUSTRIES ASSOCIATION
OF AMERICA, INCORPORATED
610 SHOREHAM BUILDING, WASHINGTON 5, D. C., DISTRICT 7-2315

July 5, 1955.

Honorable Thomas P. Pike,
Assistant Secretary of Defense,
Supply and Logistics,
The Pentagon,
Washington 25, D. C.

Dear Mr. Pike:

The Aircraft Industries Association appreciates the opportunity to present its views to the Department of Defense with respect to the proposed provisions of Part 2 of Section XV of the Armed Services Procurement Regulation, a draft of which was forwarded to this Association for review and comment with a letter dated April 11, 1955, from Rear Admiral L. H. Thomas of your office, and which was supplemented by his further letters of April 12, 1955, and May 25, 1955.

The proposed revision of this portion of Section XV of the Armed Services Procurement Regulation has received the careful attention and study of the principal financial, accounting, and legal officers of the member companies of this Association. A detailed line-by-line analysis of the proposed revision has heretofore been submitted to your office, pursuant to the instructions which were set forth in the letters from Rear Admiral Thomas to which reference has already been made.

At the request of the Board of Governors of this Association, I would like especially to bring to your attention certain aspects of the proposed revision of Part 2 of ASPR Section XV which are considered to be of vital importance, not only to the aircraft manufacturing industry, but also to the Government, particularly the Military Services. These are briefly discussed in the remaining portion of this letter.

Method of Determining the Allowability of Costs.

The aircraft manufacturing industry is largely in business to serve the Government. As a result, over the years, many of the standards followed in this industry have been patterned, in many cases, after the Government rules and regulations, of which contract administration and cost accounting are leading examples. Government standards

of contract administration and accounting, in the fields governed by the provisions of the existing ASPR Section XV, have developed slowly, as a result of the efforts of countless lawyers, accountants, procurement officials, and contracting officers representing both industry and the Government. The process of negotiation, pooling of experience, give-and-take of ideas, and the resulting gradual resolution of problems in this complex field has been a process of slow evolution. Moreover, such cost accounting and legal principles which govern the defense industry today reflect not only the patient efforts of the Military Services and the defense industry, working together over a period of many years, but are also based on general legal and accounting principles which are fundamental to all commercial relationships.

Though far from perfect, and, thus, certainly capable of being considerably improved, the provisions of ASPR Section XV, as they exist today, contain contract cost principles which are comparatively simple and not administratively unwieldy. With the exception of a few specific items, which lie in the area in which improvement is needed, the existing cost principles have become generally accepted by the legal and accounting professions, when such principles are limited to the purpose for which they were designed. Such cost principles, having been the product of long development through experience, are, therefore, familiar to the numerous Government officials who administer them, and to the lawyers, accountants, and other businessmen in industry whose affairs are governed by them. The basic principle is, of course, the rule of reasonableness. Such principle is also basic with respect to all laws and regulations which govern industry in related fields, including taxation and renegotiation. As to what constitutes "reasonableness", lengthy regulations and printed interpretations, many of which are themselves the product of long experience, are widely understood and accepted. Because the present provisions of ASPR Section XV are a statement of principles, rather than a rule in itself, such provisions are considered adequate to protect the Government against unreasonable costs.

In contrast with the manner in which the present ASPR Section XV for the most part confines itself to stating principles governing cost allowability, the draft of the proposed revision thereof sets forth detailed instructions and arithmetical formulae to contracting officers and auditors and indirectly to all companies engaged in defense work. These detailed instructions and formulae thus become the rules themselves, inflexible and unchanging and not subject to the exercise of judgment. A rule is by definition something which governs exactly. That is what the proposed revision of ASPR Section XV purports to do. It leaves no latitude, no room for discretion. It provides, for example, that, if over 25% of a company's business is with the Military Services, certain costs are not allowable; but if only 24% of its competitor's business is with the Military Services, the competitor does not suffer from the

application of this rule. Further, if a company's business with the Military Services should be less than 25% of its total business, it can remain unaffected by the rule by refusing another contract which it might be uniquely competent to fulfill. Thus, a company is given an incentive to refrain from having more than 25% of its efforts devoted to the defense of the nation. In such a circumstance, or for other reasons, it should be decided that 25% was not a proper line of demarcation, it would then be necessary to determine a different rule. If the 25% rule is bad, would 20% be better? If experience should prove, as it is believed it certainly would, that no such percentage figure can be fixed with certainty, and that there can be no satisfactory substitute for judgment, the Department of Defense would be required to return to the existing standard of "reasonableness".

Changes in Accounting Methods and Procedures.

It has long been fundamental that a business concern should not be required to change its existing accounting methods and set up special procedures under Government contracts when the existing procedures of such concern conform to generally accepted accounting practices and principles. In a desire to obtain "uniformity", many of the provisions contained in the draft of the proposed revision of Part 2 of ASPR Section XV would require drastic changes in the accounting methods and procedures of defense contractors. This desire for uniformity is understandable, as an objective, from the Government's standpoint. Complete uniformity of this type, however, is simply not practically obtainable. "Consistency" of accounting methods, as contrasted with uniformity, is practicable. Consistency already exists. Virtually every accounting system worthy of the name is based upon accounting principles which are uniformly understood and which enable qualified accountants, lawyers, and businessmen to understand any given set of accounts and the information obtainable therefrom and to make comparisons and arrive at identical conclusions. As noted above, this is precisely why the reliance upon the widely understood accounting principles contained in the existing ASPR Section XV are so useful. Detailed differences in accounting practices are, however, inevitable among companies, simply because the companies themselves are not identical in their organization, products, or ways of doing business.

The proposed new version of ASPR Section XV supplements these generally accepted accounting standards and procedures which have been used for many years and would require the commencement and completion of a long period of learning and establishing new methods based upon new rules. The proposed revision of ASPR Section XV would require radical revisions in existing acceptable accounting and contract administration methods of countless companies throughout the country, either to cope with the regulation where it does apply or to prove that it does not apply. Such a reshuffling of existing accounting and administration methods would be costly and burdensome. To require industry to make so basic a departure from prevailing industrial practice would not only be costly but would also work hardship upon small business.

The new accounting and cost standards and procedures which would be required by the proposed revision of ASPR Section XV would not be applicable for tax, renegotiation, and other purposes. The burden inherent in having to calculate cost allowability on one basis to satisfy the Department of Defense and on a completely different basis for all other purposes which are of concern to a defense contractor would constitute a complication to the defense effort which is considered unwarranted and unwise.

Some companies engaged in defense work are still able to remain almost entirely on a fixed-price basis. These companies and all other companies in this industry as well, with respect to such of their business as is fixed-price, hope that the advice contained in the letter of April 11, 1955, from Rear Admiral Thomas, to which reference has heretofore been made, will continue to be the policy and practice of the Department of Defense and the Military Services. Such advice is that contracting officers have been directed not to use the provisions of the existing ASPR Section XV nor any proposed revision thereof, as a working guide under fixed-price types of contracts. Even though fixed-price type contracts should continue to be unaffected by anything contained in ASPR Section XV, it should be noted, however, that the increased technical complexity of aircraft and their components is tending to make the use of some form of cost-reimbursement type contract mandatory for all companies during initial design and testing phases for new items. Even the satisfaction which those companies who are still virtually wholly or almost entirely on a fixed-price basis now have in the non-applicability of ASPR Section XV to their business may thus be largely denied to them.

Incentive Compensation as a Cost.

A provision in the proposed revision of ASPR Section XV, which is of major concern to this industry is the paragraph entitled "Compensation for Personal Services". The definition of "profit-sharing" contained in that paragraph includes any method of compensation which "is in any manner measured by, dependent upon, or contingent upon profit". The two principal types of compensation which would fall under this restriction are:

(a) Any form of compensation, measured by profits, which is paid currently. In this class would fall bonuses, production or other work incentives, safety awards, and management incentives, including stock option plans; and

(b) Any form of compensation, measured by profit, the payment of which is deferred. Into this class would fall pension and retirement plans designed to provide retirement, disability, and termination benefits to employees, as well as any other bonuses or incentive compensation, the payment of which is deferred for any period.

The proposed revision of ASPR Section XV would disallow 75% of any such current or deferred compensation, if more than 25% of the contractor's business consists of Government work. As originally received by this Association, the draft of the proposed revision of ASPR Section XV provided for disallowing entirely the cost of such incentive compensation if more than 25% of such business was with the Government. Since then, the arithmetic has been changed. Please be assured that this change does not affect the industry's position with respect to this matter. Such change in policy merely adds an arbitrary distinction to an already existing one. It does, however, demonstrate the point already made, i.e., that reliance as a matter of method upon a precise and inflexible formula inevitably begets equally and necessarily inflexible amendments once the need for adjustment is recognized and the process of amendment begins. Of this very first amendment, it may be asked: If 25% of a defense contractor's profit-sharing cost is now to be considered desirable or allowable as a matter of principal, what reasoning requires the unallowability of the remaining 75%?

Compensation paid to employees, whether measured by the number of hours worked, the number of pieces produced, or the amount of profits, if any, earned by the company, is a cost of doing business. To disallow as a cost any compensation, in whole or in part, which is measured by profits would deny to the management of defense contractors what has proven to be one of the most effective methods of achieving increased efficiency. The purpose and effect of these incentive compensation plans, often referred to as profit-sharing plans, are to lower costs or improve products, or both.

Incentive compensation plans have in one form or another been in use for centuries. Probably one of the first plans which was used in this country was in a glass factory owned and operated by Albert Gallatin, Secretary of the Treasury under President Jefferson. Many and various methods have been sought, down the years, to instill in employees a feeling of identity of interest with their employer. All of these have been based in part upon the recognition that some means must be found to directly link, to a greater extent, the employee's interest with the fortunes of his company.

As recently as 1939, a Subcommittee of the Senate Finance Committee, after extended hearings on the subject, issued a monumental report on this method or technique of paying compensation to employees. This Subcommittee, known as the Vandenburg-Herring Subcommittee, headed by the late Senator Vandenburg of Michigan, found that so-called profit-sharing arrangements had made tremendous contributions to the success of those enterprises which had adopted them. As this Subcommittee viewed it, well-devised plans of this type had contributed importantly, not only to the elimination of strikes and other types of industrial

strife and the creation of a stable, contented labor force, but more especially to increased efficiency and productivity of employees and, therefore, to an actual overall decrease in the cost of operations. This Subcommittee reported that there were then in existence over 700 such plans. Today, it is estimated that there are over 12,000 such plans, covering several millions of employees. Incentive compensation plans have thus been established by thousands of companies in good faith and in reliance upon Government laws and regulations and what appeared to be enlightened business and public policy. For the Department of Defense now to disallow all, or a major portion of the payments made under such plans, which were previously allowed as proper costs, would be unfair to such companies and to the millions of their employees who have relied upon them.

Incentive compensation plans or the so-called profit-sharing plans, whether they be current or deferred plans, in virtually all cases apply in a non-discriminatory manner to a natural and often to a very large class of employees. Once in operation, such plans depend for their effectiveness upon being known by employees as an obligation of their company. They confer benefits in accordance with standards the fairness of which must be evident to the employees, or the very purposes for which they were established are defeated. Once in effect they cannot be "turned off" except after substituting some fixed cost of compensation, the avoidance of which may well have been one of the very reasons for their establishment in the first place.

With respect to such plans as are on a deferred basis, the majority thereof are designed to provide retirement, disability, and termination benefits to employees. The payment of such benefits are just as much a cost of doing business as other payments of compensation for personal services. In today's industrial society, there can be little question that deferred benefit plans are here to stay. They have been sponsored by the Government in the form of old age, social security, and unemployment legislation, largely out of recognition that industry has not, as yet, developed all of the techniques to handle this burden. Company contributions to a deferred type profit-sharing plan are deductible for tax purposes only if the plan itself has been approved in advance by the Internal Revenue Service. The standards and procedures established by the Internal Revenue Service constitute an impressive body of law which assures adequate protection to the Government's interest for cost control purposes, as well as for tax purposes and still preserve to industry and its employees, who are beneficiaries of these plans, the innumerable advantages which the proposed revision of ASPR Section XV would deny.

All industry and all departments of Government concerned with the allowability of compensation as a cost have operated for many years on the standard of "reasonableness". The main test has been whether or not total compensation paid to an employee is reasonable, regardless of the method or mechanics of payment. Thus, compensation has naturally been paid in many forms, depending upon the prevailing circumstances.

Some companies, especially those in more stable lines, have relied to a large extent upon fixed-rate compensation methods. Others have met competition for labor and managerial talent with bonuses, production incentives, stock option plans, and many other flexible compensation arrangements. This has been an especially sound practice where business volume has been subject to wide fluctuations, as is the case with respect to those concerns engaged primarily in defense work. This has also been true of the methods used in meeting demands for retirement benefits. Some companies have used fixed-cost benefit plans; others have relied upon a variety of profit-sharing formulae to build up retirement funds. In any event, companies in the defense industry must meet the market price in terms of total compensation, if they are to be able to attract and retain the technical and managerial talent needed. If it cannot be done through the mechanics of flexible arrangements, another basis will have to be substituted. The proposed revision of ASPR Section XV would not, therefore, reduce in any way the cost of defense products. We believe that it would, however, reduce the ability of this industry to manage efficiently and, thus, in the long run, would increase the cost of aircraft and their components.

General Research Expense.

In the proposed revision of ASPR Section XV, provision is made for the allowance of general research expense under certain conditions. The first of these conditions is that such expense must be "reasonable" and equitably allocable to all production work of the contractor. Though not purporting to be a definition of "reasonableness", the proposed revision nevertheless requires the application of the arithmetical formula to which reference elsewhere herein has been made, in order to determine whether or not such expense will be allowable. The application of such formula, with respect to general research carried on within this industry, would result in the disallowance of all such expense.

The draft of such proposed revision provides that, as the general rule, such expense shall not be allowable if more than 25% of the contractor's business is with the Government. If the costs incurred for general research are reasonable, they should be allowed regardless of the percentage of Government business the contractor is performing. To restrict the allowability of the allocable portion of "reasonable" general research expense on the basis of the percentage of the Government business the contractor is performing is considered to be unreasonable and unduly penalizes companies which devote substantially all of their production capabilities, or the major portion thereof, to the national defense program. If the increasing demands of the Military Services for new weapons are to be met, general research efforts should be increased and the engaging therein should be encouraged, not discouraged. Thus, any discrimination in connection with the allowability of costs of this type of research should be in favor of, not against, those engaged in the development of instruments of defense which are essential for national survival.

Industry-Government Meeting.

For approximately five years, the Department of Defense has had under consideration and active preparation its draft of this proposed revision of Part 2 of Section XV of the Armed Services Procurement Regulation. A very short period was afforded this industry to review and submit its comments with respect to such draft. In view of the fact that its contents are of vital importance to the aircraft manufacturing industry, it is hoped that the Department of Defense will give this industry an opportunity to discuss the various provisions which have been proposed as substitutes for those now contained in ASPR Section XV. Accordingly, it is requested that ample opportunity be afforded to this industry to discuss at one or more joint meetings the various principles which have been incorporated in the proposal of the Department of Defense.

Sincerely yours,

D. C. Ramsey

D. C. Ramsey.

AIRCRAFT INDUSTRIES ASSOCIATION
OF AMERICA, INCORPORATED
610 SHOREHAM BUILDING, WASHINGTON 5, D. C., DISTRICT 7-2315

June 20, 1955.

Admiral L. H. Thomas, Staff Director,
Purchasing and Contracting Policies Division,
Office of the Assistant Secretary of Defense,
Supply and Logistics,
Department of Defense,
Washington 25, D. C.

Dear Admiral Thomas:

In response to your letter of April 11, 1955, and your supplemental letters of April 12, 1955, and May 25, 1955, detailed comments and suggestions have been prepared by this Association with respect to the DOD draft of a proposed revision of Part 2 of Section XV of the Armed Services Procurement Regulation. Such comments and suggestions are set forth in a suggested redraft thereof, to which have been added, as preliminary explanations, reasons for each change which is suggested. Such reasons are, of course, by necessity, stated as concisely as possible. For your convenience, twenty-five copies of such suggested redraft are enclosed.

Within the next few days, a letter from this Association will be forwarded to Assistant Secretary of Defense Pike. In that letter, a fuller explanation will be given of the basic objections which the aircraft manufacturing industry has to this proposal of the Department of Defense.

This proposal of the Department of Defense has been under development for approximately five years. This Association has had a little over two months to review and submit its comments. There are many provisions in the DOD proposal whose purposes are not understood by this industry. Further, it is conceivable that the need for the changes suggested by this industry may not be completely understood by the Department of Defense. It would seem, therefore, that it would be highly desirable from the standpoint of the Department of Defense that a joint meeting between Government and aircraft manufacturing industry representatives, at an appropriate level, be held for the purpose of discussing the contents of the DOD proposal as well as the numerous suggestions thereto which are set forth in the attached redraft thereof. Such a meeting is earnestly requested by this Association.

Sincerely yours,

Robert W. McMillan

Robert W. McMillan, Secretary,
Accounting and Controllers Committee.

AIRCRAFT INDUSTRIES ASSOCIATION

DETAILED COMMENTS AND SUGGESTIONS REGARDING DEPARTMENT OF DEFENSE DRAFT OF A PROPOSED REVISION OF PART 2 OF SECTION XV OF THE ARMED SERVICES PROCUREMENT REGULATION.

The detailed comments and suggestions which are set forth in the attached material, Appendix "A" hereof, are the result of a careful review by the members of the A.I.A. Accounting and Controllers Committee of the contents of a draft which was forwarded to this Association for comment by Admiral L. H. Thomas, under date of April 11, 1955.

After an extensive review and discussion of the contents of the draft of the proposed revision of Part 2 of ASPR Section XV, which occurred at meetings of such A.I.A. Committee, it was concluded that the recommendation of this Association should be that this industry favors the existing cost principles which are now contained in ASPR Section XV, rather than the proposed revision which was submitted to this Association for its review and comment. While certainly not perfect, the cost principles now contained in ASPR Section XV and currently in effect, are comparatively simple and not administratively unwieldy. Such cost principles have come to be generally accepted (except for a few specific items), when limited to the purpose for which they were designed. The proposed revision would be not merely a new set of cost principles, but would become

a set of detailed instructions to auditors and contracting officers regarding the procedures to be followed in the determination of allowable costs under cost-reimbursement type contracts. If the pattern of the proposed revision is followed, such instructions, in most cases, would be confusing and subject to a variety of interpretations and, in addition, provide for the application of standards as tests for allowability and allocability of certain costs, which standards are considered to be arbitrary and unreasonable. Accordingly, therefore, it is the recommendation of this Association that the proposed revision or anything similar thereto should not be issued.

The objection which this Association has to specific provisions of the draft of the proposed revision and suggestions, for changes which are considered essential, are set forth in and made a part of the attached redraft thereof.

One additional general comment is, however, considered appropriate at this point. Such comment is that, since this Association has not received for review a draft of Part 1 of ASPR Section XV, it is assumed that a revision thereof is not presently contemplated; but, if such Part 1 is to be revised in any respect, it is further assumed that paragraph 15-101 thereof will not be materially changed and will continue to provide that "in the case of such contracts [cost-reimbursement type contracts] having predetermined overhead rates the applicable provisions [Part 2] of this section shall be used only as a basis for negotiating such rates but shall be followed for all other items of cost".

APPENDIX A

AIRCRAFT INDUSTRIES ASSOCIATION

ASPR SECTION XV, PART 2

Contract Cost Principles

For Supply and Research Contracts With Commercial Organizations

(In the following redraft of the DOD draft of a proposed revision of ASPR Section XV, Part 2, suggested deletions are lined out, and suggested insertions are indicated by underscoring.)

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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 organizations having commercial type accounting systems. However, this part does not apply to contracts for facilities ~~(unless~~ (1) ~~specifically provided for in the contract)~~, construction and architect-engineer services (2) related to construction. ~~This part does not prevent special treatment of any item of cost by contract provision. The fact that certain costs are not allowable as proper items of cost for cost-reimbursement type contracts shall not be construed as preventing the allocation or recognition of such costs with respect to all other business of a contractor.~~

Reason: (1) To permit application of this part to facilities contracts where the Government and the contractor mutually agree that such application is desirable. Ordinarily, it may be appropriate to apply the principles in this part to facilities contracts when the facilities contractor will use those facilities in performing supply, service, or research and development contracts.

Reason: (2) The regulation should not prevent mutual agreement between the contractor and the Services on special problems. Further, as indicated by Admiral L. H. Thomas, in his letter of April 11, 1955, to this Association, as well as in other official communications of the DOD, this regulation should state that it will not prevent proper allocations to business other than cost-type contracts.

15-201 BASIC PRINCIPLES AND STANDARDS

a. Composition of Total Cost. The total cost of a cost-reimbursement type contract is the net sum of (i) the allowable direct costs, (ii) the properly allocable portion of allowable indirect costs and (iii) applicable income and other credits.

b. Factors Affecting Allowability of Costs. The factors to be considered in determining the allowability of costs include (i) reasonableness, (ii) application of generally accepted accounting principles and practices, ~~(iii) exercise of good business judgment in incurrence of cost, (iv) significant deviations in the established practices of the contractor which substantially increase the contract costs, and (v)~~ and (iii) any limitations as to types or amounts of cost items set forth in this Part 2 of Section XV or otherwise included in the contract. (1)

Reason: (1) Clauses (iii) and (iv) above are ambiguous and redundant. The tests to be applied in connection with clause (i) above necessarily involve the question of whether or not good business judgment was exercised by the contractor at the time of the incurrence of the particular cost, on the basis of information then available. The test of reasonableness should be sufficient. It is unreasonable to require that every decision stand the test of subsequently-discovered facts not available at the time the original decision was made but available to some final judge who thus has the advantage of hindsight.

The tests to be applied in connection with clause (ii) above necessarily involve a determination as to whether or not equitable cost treatment is obtained under contractor's accounting practices and procedures irrespective of any significant deviations in the established practices of the contractor. Further, changes in established practices are required many times during the performance of Government contracts, and, again, the test of reasonableness should be sufficient in determining the allowability of costs incurred as a result thereof.

c. Credits. The applicable portion of income and other credits, rebates, and allowances ~~, and equivalent benefits accruing to~~ received by the contractor and (1)

which are related to any allowed cost will be credited to the Government either as a reduction in contract cost or by a cash refund, as appropriate.

Reason: (1) The reason for deleting the words "equivalent benefits" is that it is believed the words "other credits, rebates and allowances" cover the subject and that the words "equivalent benefits", thus, do not add anything. Further, what is intended to be included by the addition of such words is not understood.

d. 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). It is not the intent of this part

(1) to require the contractor to change its accounting procedures and practices which have been previously accepted for determining costs under Government contracts.

Reason: (1) This regulation and the present revision should not be used to change accounting practices now properly applied. It has long been fundamental that business should not be required to change its existing accounting methods and set up special procedures under Government contracts, when the existing procedures conform to generally accepted accounting practices and principles. As proposed to be revised, this regulation has so many mechanical requirements that contractors fear accounting principles, which have been consistently applied by them for years, might be radically revised in order to comply with the new governmental requirements. Furthermore, this might tend to discourage many companies (especially small business) from participating in the defense effort, thereby damaging the broad base desired by the Government.

15-202 DIRECT COSTS. Subject to the provisions of paragraph 15-201, allowable direct costs are those items of cost, or aggregate thereof, which can be identified specifically with any objective, service, program or project under the contract and are chargeable directly thereto. Major items of cost readily identifiable with the contract or with other work of the contractor should be charged directly thereto. This principle may often be applicable to such elements of expense as freight, travel, communications, engineering services, etc., as well as the normal items of materials and productive labor. However, when the contractor is engaged in mixed production, this principle must be applied consistently to the costing of both defense and non-defense products or services, in order to produce equitable results. When the accounting expense of direct costing of minor items would exceed the resulting benefits, individual items, otherwise allowable as direct costs, may be treated as indirect expenses.

15-202.1 DIRECT MATERIALS. The cost of direct materials includes the cost of items purchased, supplied, manufactured or fabricated, which enter directly into the end product or which are used or consumed directly in connection with furnishing such product.

15-202.2 DIRECT LABOR. The cost of direct labor includes salaries and wages specifically identifiable with and properly chargeable directly to the performance

(1) of contract or other work of the contractor. The cost of direct labor may be distributed to contracts on the basis of actual or average rates paid. It may also include other associated costs such as payroll taxes and workmen's compensation

(2) insurance~~, where it is the established practice of the contractor to treat these items as a part of direct labor costs~~.

Reason: (1) To permit the distribution of direct labor costs to contracts on the basis of average rates paid in accordance with the provisions of Section 15-202.2 of the present ASPR.

(2) To permit a change in Contractor's established practice if not prejudicial to the interests of the Government.

15-202.3 OTHER DIRECT COSTS. Where other items of cost are charged directly to the contract consistent with paragraph 15-202 above, the contractor must demonstrate that they are specifically related to the performance of the contract. When, however, items ordinarily chargeable as indirect costs are charged to a Government contract as direct costs, the cost of similar items applicable to other work of the contractor must be eliminated from indirect costs allocated to the contract.

15-203 INDIRECT COSTS.

(a) Indirect costs are expenses which are incurred for common or joint objectives, are accumulated for accounting purposes by departmental activity or other logical cost grouping and are charged to the contract and other work of the contractor by a process of allocation. Each element thereof is subject to the limitations of this part as to allowability.

(b) No specific rules can be stated as to the method of allocation of indirect costs because the actual condition in each instance must be taken into account in determining the most suitable method or methods. The objective should be the selection of a method or methods which will distribute the indirect costs in a fair and equitable manner. The method used in connection with Government contracts must, in order to be acceptable, conform with generally accepted accounting practices, be applied consistently, and produce equitable results. Any significant change, such as in the nature of the business, extent of subcontracting, fixed asset improvement programs, the volume of sales, the volume of production, manufacturing processes, or the products being produced, may require reconsideration of the methods previously in use to determine whether they continue to be equitable. Further discussion relative to allocation of the individual categories of indirect costs will be found in the subparagraphs below.

15-203.1 INDIRECT MANUFACTURING AND PRODUCTION EXPENSES. Indirect manufacturing and production expenses consist of costs which are necessary to the productive process as a whole and are not readily subject to treatment as direct costs in accordance with paragraph 15-202. Allocation of indirect manufacturing and production expenses on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable bases,

(1) in appropriate circumstances, include but are not limited to direct labor dollars

(2) ~~(exclusive of overtime premium),~~ units processed and prime costs of units processed. ~~In some instances, it may be necessary to departmentalize or establish cost centers in order to distribute equitably the indirect costs. The factors to be considered in determining the extent of departmentalization or establishment of cost centers include variety of products, complexity of processes and relative~~

(3) ~~labor and facility requirements for the various products.~~ The accumulation and distribution of indirect costs by departments, or by cost centers established for that purpose, is an acceptable practice, provided equitable results are obtained thereby. Some of the factors to be considered in determining the extent of departmentalization or establishment of cost centers are variety of products, complexity of processes and relative labor and facility requirements for the various products.

Reason: (1) There are many recognized methods of allocating overhead other than those specifically mentioned which may be more equitable for some companies.

(2) Limitation should not be in regulations applying to all contractors, since in some instances, it may be more equitable for some companies to include premium pay in the base distributing overhead expenses. Including overtime premium in direct labor has been recognized as a generally accepted accounting practice for many years.

(3) To give recognition to departmentalization as an acceptable basis for overhead distribution under certain circumstances and at the same time remove the inference that departmentalization is subject to direction by Government contracting officers or auditors.

15-203.2 INDIRECT ENGINEERING EXPENSES. Indirect engineering expenses consist

(1) ~~chiefly of engineering supervision, engineering administrative expense and engineering general supplies~~ of costs (i) which are incurred in the over-all operations of the engineering and certain technical departments and related activities, (ii) which are determined and classified as engineering expenses in accordance with contractor's generally accepted accounting practices and system, and (iii) which are not readily subject to treatment as direct costs.

(2) These expenses arise out of engineering activities which 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 expenses should be allocated to the benefited activities, i.e., contract and other work of the contractor on the basis of direct engineering man-hours expended, direct

(3) engineering labor dollars ~~(exclusive of overtime premium)~~, or other equitable basis. Direct costs of engineering activities should be charged directly to the benefited activities, i.e., contract and other work of the contractor in accordance with paragraph 15-202.

Reason: (1) To provide for a more complete definition of indirect engineering expenses and to recognize the differences which exist in the classification and treatment of engineering costs throughout industry.

(2) The specific engineering activities set forth in this paragraph are not uniformly treated as engineering activities throughout the industry. For this reason, it is considered desirable to make the classification permissive rather than mandatory.

(3) Limitation should not be in regulations applying to all contractors, since, in some instances, it may be more equitable for some companies to include premium pay in the base for distributing overhead expenses. Including overtime premium in direct labor has been recognized as a generally accepted accounting practice for many years.

15-203.3 SELLING AND DISTRIBUTION EXPENSES. ~~The expenses in this group consist~~

(1) ~~of items which represent the cost of marketing the contractor's products and include sales promotion, advertising, distribution costs and other related items. Generally, such expenses are not considered to be allowable as a charge to Government cost reimbursement type contracts for the reason that marketing, in the ordinary commercial sense, is not necessary for doing business with the Government. However, dependent upon a reasonable demonstration of benefits to Government contracts and subject to the other provisions of this part, there may be an allocation to government work of these expenses in this category which consist of technical, consulting and such other beneficial services (including related supervision and clerical expenses) which are for purposes such as application and adaptation of the contractor's products rather than pure selling. Such costs should first be allocated between the contractor's commercial line and its Government contracts. The amount allocated to the latter should then be charged to the individual contracts on any equitable basis. Because of the special problems that arise in this area, it is usually desirable for the contractor to identify in its records by means of sub accounts or otherwise, the items of these expenses considered properly allocable to Government contracts.~~ The expenses in this group consist of items which represent the cost of contract or order administration, negotiation, liaison between Government and other customer representatives and the contractor's personnel, advertising, marketing, and distribution costs, and other like services. Generally, such expenses, when incurred in the direct marketing and distribution of the Contractor's products in the ordinary commercial channels and not considered necessary for doing business with the Government are not considered allowable. However, such expenses are allowable upon a reasonable demonstration of benefits to Government contracts and subject to the other provisions of this part, provided the method of allocation to Government contract is reasonable.

In the event special problems arise in this area, it may be desirable for the contractor to identify in its records, by means of sub-accounts or otherwise, the items of these expenses considered properly allocable to Government contracts.

Reason: (1) To eliminate language which would cause considerable confusion in the application of this cost principle by more clearly defining the allowable and unallowable portions of such costs, and to avoid necessity of making separate allocations when such is not necessary and would only result in increasing accounting costs without providing more equitable distribution of the expenses.

15-203.4 GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses consist of costs incurred in the over-all management, supervision and conduct of the business. Any recognized method of allocating general and administrative

(1) expense is acceptable provided equitable results are thereby obtained. ~~Some of the factors that should receive consideration in determining whether the results are equitable are (i) the cost pattern of the Government contracts (that is, the percentage of the total cost of the contract, exclusive of general and administrative expenses, represented by each of the several cost components thereof) in relation to the cost pattern for the plant or activity as a whole, and (ii) the ultimate objective of distribution of these expenses in approximate ratio to the general and administrative effort involved in the two categories of work. In addition, consideration should be given to any significant variations of inventories between accounting periods, variations in the ratio of contract inventory levels to all other inventory levels, and any other relevant factors such as these mentioned in paragraph 15-203(b).~~

Reason: (1) The sentences deleted do not add anything to the interpretation which would not automatically be included in the first two sentences. The whole subject of the factors to be considered in determining whether methods of allocating indirect costs bring about equitable results is amply covered in paragraph 15-203(b).

15-203.5 BASE PERIOD FOR ALLOCATION OF INDIRECT EXPENSES. ~~The base period for~~

(1) ~~allocation of indirect expenses should approximate the period of contract performance or should be representative of that period. The base period should be sufficiently long to avoid inequities in the allocation of costs.~~ No specific

(1) rules can be stated as to the determination of the base period for allocation of indirect expenses, but in general, the contractor's established base period shall be recognized if it is consistent with generally accepted accounting principles.

Reason: (1) To conform the intent expressed in the paragraph with those outlined in paragraph 15-203(b), which states, in part, that "No specific rules can be stated as to the method of allocation of indirect costs," and the "method used...must, in order to be acceptable, conform with generally accepted accounting practices, be applied consistently," etc. The paragraph, as originally proposed, is believed to be ambiguous as well as impractical.

15-204 APPLICATIONS OF BASIC COST PRINCIPLES AND STANDARDS TO SELECTED ITEMS OF COST. This paragraph states, in some detail, applications of the basic cost principles and standards set forth in the preceding paragraphs of this part to certain selected items of cost. The statements herein apply irrespective of whether the particular item of cost is treated by the contractor as direct cost or as indirect cost. Failure to mention any particular item of cost herein is not intended to imply that it is either allowable or unallowable. With respect to those items not

(1) specifically covered, as well as all of the subparagraphs of this paragraph 15-204, determination as to allowability will be made in the light of the basic principles and standards ~~and, where appropriate, the treatment of similar or related items in~~

(1) ~~this Part. All of the subparagraphs below are subject to the basic principles and standards~~ set out in paragraph 15-201.

Reason: (1) Language clarified to indicate that principles and standards of paragraph 15-201 are also applicable to items not specifically covered.

15-204.1 ADVERTISING. Advertising expenses include the costs of advertising media

(1) and ~~corollary administrative expenses~~ expenses primarily related thereto. Advertising media include magazines, newspapers, radio and television programs, direct mail, trade

(2) papers, outdoor advertising, dealer cards and window displays, sales conventions, and sales exhibits, free goods and samples of a sales nature, and sales literature.

Reason: (1) To more clearly define and limit those expenses other than the costs of advertising media which are to be included as a part of advertising expense.

(2) Conventions, exhibits, free goods, and samples are properly classified under the general term "advertising" only when directly related to sales efforts. Other similar costs should not be treated hereunder.

(1) a. The following advertising costs ~~only~~ are allowable:

(1) ~~Advertising in trade and technical journals, provided such advertising does not offer specific products or services 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.~~ Institutional advertising, including advertising in trade and technical journals, provided the advertising does not offer specific products or services for sale or is not related to the direct marketing or distribution of the contractor's product.

Reason: (1) To provide for reimbursement of institutional advertising, displays, exhibits, etc., which are not designed to offer products for sale and are not related to marketing or distribution of contractor's product, but are for the purpose of presenting the company and the industry in its participation in the defense program. Such advertising is an important part of the business life of companies engaged in furnishing supplies and services to the military departments. It arouses the public's interest in such matters by disseminating information; it attracts potential employees, particularly the scientific, to companies and industries which have a great need for such personnel to continue technological advancement;

and elicits the support of local communities, which is so important to the day-to-day activities of every company. Basically, the institutional-type advertising is essential in keeping the name of the company before the public as a means of acquainting it with the past, present, and expected future accomplishments of the company. It identifies the contractor and its employees with the defense efforts in almost the same way that a uniform identifies the soldier, sailor, marine, or airman.

In the case of many defense contractors, some of the advertising is undertaken at the behest of, or in coordination with, the public information services of the military departments and supplements the programs undertaken directly by those military agencies, including recruitment and training programs. Advertising of this type is directed toward building and maintaining public confidence in the efforts taken by the Defense Department to preserve our national security and the parts played by the companies in those efforts. To the extent that military security requirements permit, military products are widely used in such advertising, but obviously are not offered for sale to the public, nor are they tied-in to any sales activity.

One of the objectives of such advertising is the building and maintaining of public confidence in the speed, safety, dependability, and economy of air travel and air freight in general.

To the extent that advertising stimulates the use of airplanes, it is possible to develop and manufacture newer and better airplanes. Experience shows that, in most cases, the Government has availed itself of the opportunity to procure these newer and better airplanes for Government use after the design and development of the commercial versions had taken place. In these cases, the Government benefitted materially from buying the planes at lower prices than would have been the case had not the commercial articles been manufactured.

Another point that should not be overlooked is that, over the long-haul, the Government has been the principal customer of the aircraft industry in peacetime and during emergency periods. Therefore, advertising programs within the aircraft industry are planned on the basis of this fact, and the allowance of a prorata portion of such advertising as a cost of performing Government contracts would not constitute a "windfall" by spreading the costs of advertising over a base which has been temporarily expanded by Government contract work not normally

expected to share in these costs.

In the aircraft industry, advertising is not a "selling" expense. It is a general administrative expense incurred for the conduct of the whole business and should be recognized as such in any cost principles, subject to the test of reasonableness, based upon the total advertising expenditures of the particular company. Having thus established a reasonable total figure, advertising expense should be allocated to all contracts on an equitable basis - e.g. basis used for other general and administrative expenses.

(2) Help wanted advertising, as set forth in paragraph 15-204.33

15-204.2 BAD DEBTS. Bad debt expenses consist of losses (whether actual or esti-

(1) mated) arising from uncollectible customers' accounts and other customer claims, and include collection expenses and related legal expenses. These costs are unallowable.

Reason: (1) The phrase "and other claims" is subject to broad interpretation and could, for instance, be construed to include uncollectible claims against vendors, uncollectible employees' accounts and similar items which are a normal part of doing business. It is believed that the suggested addition clearly defines the term "bad debts" as debts incurred by customers only.

15.204.3 BIDDING EXPENSE. Bidding expenses are the costs of preparing bid estimates on potential contracts or projects, including the development of engineering and cost data necessary to support the contractor's price proposal or estimated cost of work performance. Bidding expenses of the current accounting period of both successful and unsuccessful bids normally will be treated as indirect expenses and allocated currently to all business of the contractor, in which event no bidding expenses of past accounting periods will be chargeable to the Government contract. However, the contractor's established practice may be to treat bidding expenses by some other recognized method. Regardless of the method used, the results obtained may be accepted only if found to be reasonable and equitable.

15-204.4 CAFETERIAS, DINING ROOMS, AND OTHER FOOD SERVICES. This class of expenses consists of cost, less revenue, of operating or furnishing facilities for cafeterias, dining rooms, sales stores, canteens, lunch wagons, vending machines, or other types of services for contractors employees at the contractor's facilities. Profits accruing to the contractor from the operation from these services whether operated by the contractor or by a concessionaire, will be treated as a credit to costs of all production within the contractor's plant in which the services are furnished, except for services from which the profits are irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for the benefit of the employees

(1) ~~at the bid location.~~ Reasonable losses from operation from such services are

(2) allowable ~~when it is determined that the contractor is intending to operate such services at no loss or profit.~~ The gains or losses from these services must be appropriately allocated to all activities benefited including Government contracts.

(2) ~~When such services are intentionally furnished at a loss to the contractor, losses on such operation will not be allowed as a cost, unless authorized by special contract provision.~~

Reason: (1) For purposes of clarification. Employee welfare organization may encompass more than bid location and, likewise, work may not be performed at bid location.

(2) The prime purpose of operating such services is for the employees' benefit. The net cost of such services properly falls in the category of 15-204.10, Employee Morale, Health and Welfare. It is normal to operate such services at a reasonable loss, as the contractor usually has to pay higher wages than similar commercial operations, whereas prices charged must be comparable or less if the prime purpose of offering such services to employees is to be accomplished.

15.204.5 CIVIL DEFENSE. Civil defense costs are those incurred in the planning for and the protection of life and property against the possible effects of enemy attack. These costs are generally incurred pursuant to plans developed by local and state civil defense authorities. Examples of civil defense costs include cost in excess of normal plant protection expenses and may consist of first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions and other approved civil defense measures. Reasonable costs of 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. In the case of capital assets acquired for civil defense purposes the costs thereof will be depreciated over a reasonable number of years in conformity with generally accepted accounting

(1) principles. Except as specifically provided in the contract <u>or as may be approved by the contracting officer,</u> contributions to local civil defense funds or projects not on the contractor's premises are unallowable.

Reason: (1) Contractors are obligated to contribute to community expenditures for Civil Defense to provide protection for the community at large. It is desired to incorporate the suggested revision in order that the reasonable costs of such obligatory contributions, where not specifically provided for in the contract, can be approved by the Contracting Officer.

15-204.6 COMPENSATION FOR PERSONAL SERVICES.

a. This item includes all remuneration paid or accrued, such as bonuses,
(1) salaries, wages, incentive and deferred compensation and fringe benefits for services rendered to the contractor by employees as well as fees paid to directors and committee
(2) members. ~~Subject to specific limitations set forth hereunder, such~~ Such costs are allowable when the total compensation is reasonable in light of the services rendered.

Reason: (1) The definition of compensation should include all the various elements of compensation.

(2) Compensation, if reasonable, should not be limited to mechanics of payment.

b. Generally, the amount of compensation established by the contractor will be considered commensurate with the services rendered. However, compensation of individuals such as corporate officials, directors, executives, department heads, partners and sole proprietors may be subject to special consideration and limitation as to allowability for contract cost purposes where amounts appear excessive. Some situations which may give rise to excessive compensation are where (i) the individual or member of his immediate family owns or is committed to acquire a substantial financial interest in the contractor's organization; or (ii) ownership of the con-
(1) tractor is limited to a small cohesive group~~, or (iii) the volume of Government contracts when related to the contractor's total business is such as to influence the amount of compensation~~.

Reason: (1) This clause is discriminatory and susceptible to an adverse interpretation in the case of defense contractors.

(1) ~~c. The cost of options to purchase stock of the contractor corporation granted to employees is not allowable as an item of cost.~~

Reason: (1) Compensation, if reasonable, should not be limited by the methods of payment thereof.

(1) d. ~~Subject to the provisions of subparagraph e, below, bonuses~~ Bonuses to employees, ~~such as production~~ including but not limited to incentives ~~or safety awards~~ based on cost reductions or efficient performance, suggestion awards, and safety awards, but not including amounts paid under compensation plans contingent upon profit as defined in subparagraph e. hereof, represent a part of their total
(2) compensation and are allowable when appropriately allocated~~, if~~ to the extent they are:
(3) (1) Paid pursuant to an ~~arms length~~ agreement entered into in good faith between the contractor and the employees before the services are rendered or pursuant to an established plan consistently followed by the contractor which constitutes, in effect an implicit agreement on the part of the contractor.
(4) (2) ~~Reasonable in amount.~~ Total employee compensation is reasonable in amount for such services.

(3) Paid for current services actually rendered by employees.
(5) ~~(4) Available to all employees of the contractor or to all employees within a group or salary classification which is not unreasonably restricted.~~

(5) Allowable as an ordinary or necessary business expense for tax purposes.
(6) (6) Not restricted as to eligibility to officer or other employee stockholders or ~~are~~ not distributed on the basis of stockholdings.
(7) ~~(7) Total employee compensation is reasonable in amount for such services.~~

Reason: (1) Without the suggested change, the provisions of this subparagraph are discriminatory in the case of defense contractors. There has been injected into the DOD draft of the proposed revision, by the reference to subparagraph e(2)(iii), a statement that "bonuses to employees, such as production incentives and suggestion or safety awards", even though reasonable by the usual standards, shall not be fully allowable, unless the contractor has 75 percent commercial business, taking into account the contract in question. This results in a direct

blow at the aircraft industry, since none of the strictly aircraft companies could conceivably qualify; while concerns in industries whose business it not primarily with the Government can establish such plans and include the costs thereof in all contracts, Government as well as commercial. Thus, such concerns are encouraged to engage in proselyting and pirating from the aircraft industry its best management and technical talent. It should be noted that the disallowance of this type of compensation also affects all bonus and contingent plans and explicitly outlaws "production incentives and suggestion or safety awards." A policy indicating that the Government wants neither incentives, suggestions, nor safety is not understood.

(2) The use of the word "if" at this point indicates that, should the total payment be considered not to be reasonable in amount, the entire payment will be disallowed, whereas, the intent should be clear that only the excess over and above what is considered to be reasonable would be subject to disallowance.

(3) The term "arms length agreement" is subject to broad and variable interpretation when applied to specific transactions.

(4) Clause numbered (7) of the draft has been inserted as clause number (2) as more expressive and also as a means of avoiding repetition.

(5) This provision is subject to a variety of interpretations as to what constitutes an unreasonable restriction of the application of the particular type of compensation.

(6) It is conceivable that all persons eligible would be officers or stockholders without that fact being the basis for payment of this type of compensation. The suggested insert would, it is believed, clarify this matter.

(7) This clause has been deleted, since it is suggested that it be substituted for clause (2) above.

(1) e. ~~Profit-sharing plans.~~ Compensation plans contingent upon profit.

(1) As used herein ~~profit-sharing~~ a compensation plan contingent upon profit is construed to be any plan (immediate or deferred - regardless of method of payment or participation) which includes, in whole or in part, a formal sharing of profits or is in any manner measured by, dependent upon, or contingent upon profit.

(1) (2) The cost of ~~profit sharing~~ any such plans shall be allowable under the following conditions:

(i) Compensation payable under immediate distribution plans is

(2) allowable subject to the criteria set forth in subparagraph d. above ~~and g below~~.

(ii) Employer contributions under deferred distribution ~~profit~~

(1) ~~sharing plans~~ compensation plans contingent upon profit, to be allowable costs, must

(2) meet all pertinent conditions set forth under subparagraph d. above ~~and g. below~~ and, if subject to Internal Revenue Service consideration must have their approval. ~~The~~

(3) ~~carry over provisions of the regulations of Internal Revenue Service with respect to contributions under qualified deferred distribution profit sharing plans shall not be recognized for Government contract cost determination purposes.~~ Forfeitures of non-vested

(4) benefits under such ~~a profit sharing~~ plans will be ~~treated in accordance with the principles stated in paragraph 15-204.27(f)~~ taken into consideration in determining costs currently allocable.

(5) ~~(iii) If the business of the contractor is more than 75% with non governmental customers, the government's allocable share of the payments under the contractor's plan shall be allowable. However, where the business of the contractor is less than 75% with nongovernmental customers, the government will accept for payment only that portion of its allocable share which results in the payment of 25% of the contractor's total payments under its profit sharing plans. The ratio of government to non governmental business shall be determined on the basis of sales during the contractor's fiscal period to which the profit sharing is related.~~

Reason: (1) To more properly identify those compensation plans which are intended to be covered under this paragraph.

(2) See suggested deletion of subparagraph g.

(3) The regulations of the Internal Revenue Service have for many years permitted companies to pay into qualified plans more than the maximum amount

for which tax deductions were available that year, with the understanding that the excess could be claimed in a future year. This has induced some companies to accelerate payments into their plans in reliance upon this provision, instead of holding the money idle until the year in which the deduction was available. The proposed draft outlaws this practice and says that such a company will never have such payments recognized as a part of the contract cost. This is unjust.

(4) The effect of forfeiture under plans of this type will be so infinitesimal that it is considered unwise to require special agreements with respect thereto.

(5) Amounts paid under such plans are a part of the employee's compensation for services rendered. The allowability of such costs should be determined on the basis of reasonableness, and not on the basis of the amount of business a contractor is or is not performing for the Government. To restrict the allowability of such costs on the basis of the percentage of business being performed for the Government is not only arbitrary but is discriminatory. The inclusion of the wording under subparagraph e(2)(iii) penalizes, without justification, those companies which devote substantially all of their efforts to the defense of the nation.

The allowability of the cost of compensation for personal services, whether such compensation be in the form of salaries, wages, bonuses, payments under profit sharing plans, or fringe benefits, if reasonable in light of the services rendered, should unequivocably be allowable, regardless of the amount of business the contractor is performing for the Government.

Incentive plans fluctuating with or dependent upon profits are particularly appropriate to the aircraft industry. This fluctuating industry cannot afford the fixed salaries which would keep its cost high when business is low. Likewise, obligation for a retirement program may often be made dependent upon profits, since some contractors cannot incur a fixed charge when business declines. Besides providing cost-cutting incentives, a plan related to profits automatically reduces compensation when the volume of business and related responsibilities decline. Such a reduction in compensation in the light of the lesser responsibilities conforms

perfectly to the existing standard. However, the new draft says that reasonableness is not enough.

The incentive plans of many aircraft companies have other features designed to cut costs. Many defer payment of a part of the compensation, so that a modest expenditure will hold personnel through the troughs in business, build stable employee groups and prevent wasteful migration from employer to employer.

(1) f. Stock bonus plans. Stock bonuses ~~which are not disallowed by the provisions of subparagraph c. above~~ are acceptable as a form of compensation, and the costs thereof are allowable subject to all conditions pertinent under subparagraph d. (1) above ~~and g below~~ and provided they meet the following requirements:

(1) The valuation placed on the stock for the purpose of calculating such cost must be computed on a sound basis.

(2) In the case of unlisted stock having no current market, the contractor must demonstrate the values ascribed thereto are fair and reasonable.

(3) Bonuses paid in the form of previously unissued stock of an affiliate will not ordinarily be allowed unless it can be demonstrated that there exists a bona (2) fide ~~arms-length~~ agreement and the values ascribed to such stock are fair and reasonable.

(4) Claims for accruals of compensation under a stock bonus arrangement prior to acquisition of stock by employees will not be allowable unless arrangements are made for appropriate credit adjustment of costs in the event such stock is not acquired by employees.

Reason: (1) To simplify and correct cross references and to recognize deletion of subparagraph g. below.

(2) Term "arms-length" when applied to this situation seems superfluous and, further, is subject to broad and variable interpretation when applied to specific transactions.

(1) ~~g. For the purpose of determination of reasonableness, the employer contribution under profit sharing plans and stock bonus plans shall not exceed, in the aggregate for each participating employee, 15% of the total basic compensation paid or~~

~~accrued to such employees in the year under consideration.~~

Reason: (1) Since the compensation structure of various companies provides for the utilization to varying extents of bonuses and profit-sharing plans in the determination of total compensation, the existing language imposes unreasonable and arbitrary restrictions. It is submitted that the provisions of subparagraph d(2) above, in regard to reasonableness, are adequate for the protection of the interests of the Government.

h. The determination of allowability of the cost of pension and retirement plans, training expense, overtime, extra pay and multi-shift premiums and other

(1) fringe benefits will be in accordance with paragraphs 15-204.27, ~~15-204.43,~~ 15-204.42, 15-204.25, and 15-204.14 respectively. Any form of compensation to an employee not specifically mentioned in this part 2, in addition to those set forth in this paragraph, will be given consideration as a part of total compensation.

Reason: (1) To correct typographical error in paragraph number reference for "Training Expense".

15.204.7 CONTINGENCIES. This type of charge results from the creation and maintenance of reserves to provide for an event whose occurence cannot be foretold with certainty as to time, intensity or even an assurance of its happening. These costs are not allowable. (For self-insurance programs see paragraph 15-204.16).

15-204.8 CONTRIBUTIONS AND DONATIONS. Contributions and donations to established

(1) nonprofit 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

(1) 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.~~

Reason: (1) Contributions which are recognized for income-tax purposes should be allowable, subject to the usual tests of reasonableness and allocability.

15.204.9 DEPRECIATION.

a. Depreciation as described herein is a charge to current operations intended to distribute the cost of tangible capital assets, less estimated residual value, over their estimated useful life in a systematic and logical manner. It involves a process of allocation, not of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

b. Depreciation on a contractor's plant, equipment and other capital facilities is an allowable element of contract cost, provided the amount thereof is based upon original acquisition cost. Depreciation will be accounted for by consistent application to the asset(s) concerned of any generally accepted accounting principles and should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation charged in any accounting period may vary with volume of production or use of multishift operations, provided the method followed is consistent with basic objectives set forth in subparagraph a. above.

c. Charges for depreciation on idle or excess facilities will not be
(1) allowed except on such facilities as are reasonably necessary for ~~contract performance~~ standby purposes.

Reason: (1) This is not a proper test inasmuch as facilities are usually retained in a standby condition for future overall defense production purposes, which generally are not identifiable with the performance of any specific contracts.

d. Unless otherwise provided in the contract, no use charge will be allowed on assets still in use which have been, in accordance with the contractor's consistent accounting practice, fully depreciated on the contractor's books of account.

e. Where the contractor has applied for and received a determination of "true depreciation" from an Emergency Facilities Board covering emergency facilities acquired under certificates of necessity, the amounts so determined for "true depreciation" over the emergency period (5 years) will be recognized in lieu of normal depreciation. After the expiration of the emergency period

(1) for the facilities ~~concerned where a determination of "true depreciation" has been made~~ <u>covered by certificates of necessity issued under Section 124A of the Internal Revenue Code of 1939, where normal depreciation or "true depreciation" has been used for contract costing</u>, the remaining undepreciated portion of the cost of such facility <u>not previously allowed as a contract cost</u> will be depreciated over its remaining useful life and will be the only amount recognized as allowable cost, subject to paragraph 15-204.12. The contractor may elect to use normal depreciation rather than the "true depreciation" as determined by the Emergency Facilities Board. However, the method chosen after such determination of "true depreciation" must be followed consistently throughout the life of the

(2) emergency ~~facilities~~-<u>facility on which such election was made</u>.

Reason: (1) To more clearly set forth Contractor's right to include as contract cost after the end of the emergency period the undepreciated portion of the cost of such facilities not previously allowed as a contract cost irrespective of whether normal depreciation or true depreciation was used for contract costing during the emergency period.

(2) The existing language could be interpreted to require that the contractor make an over-all election to take either normal depreciation or "true depreciation" on all facilities on which a determination was received from the Emergency Facilities Board. The suggested wording clarifies the intent of the section, which is that such election is made on each facility for which a true depreciation determination was received.

15-204.10 EMPLOYEE MORALE, HEALTH AND WELFARE. Included in this category are
(1) expenses of health, recreational, and welfare activities incurred for the improvement of working conditions and the improvement of employer-employee
(1) relations, employee morale, and employee performance. Examples of these activities are house publications, health or first-aid clinics, and employee counselling services. These costs are allowable when incurred in accordance with the contractor's established practice or custom in the industry or area and are reasonable and equitably allocated to all classes of work performed in the contractor's plant. Income generated from any of these activities will be
(2) credited to the costs thereof, unless such income has been irrevocably set over to an employee welfare organization.

Reason: (1) The existing language may be subject to a restrictive interpretation by government administrators and audit personnel. It is believed that the revision suggested above will do much to clarify the intent of this paragraph.

(2) Most union agreements provide that the above shall be accomplished. Other companies have this in effect as a result of policies established prior to inception of CPFF contracts. Also, suggested change is consistent with statement contained in 15-204.4.

15-204.11 ENTERTAINMENT EXPENSE. This item includes the cost of amusement, (1) diversion, ~~social activities~~ and incidental costs relating thereto, such as meals, lodging, rentals, transportation and gratuities. These costs are unallowable.

Reason: (1) The use of general terminology, such as "social activies," could create a conflict with the provisions of 15-204.10 and 15-204.41.

15.204.12 EXCESS FACILITIES. This item includes the cost of maintaining and housing idle and excess facilities, except those reasonably necessary for (1) ~~contract-performance~~ standby purposes. These costs are unallowable. The costs of additional plant capacity reserved for defense production shall be the subject of a separate contract.

Reason: (1) This is not a proper test inasmuch as facilities are usually retained in a standby condition for future overall defense production purposes, which generally are not identifiable with the performance of any specific contracts.

15.204.13 FINES AND PENALTIES. Included in this item are those costs resulting from violations of, or failure of the contractor to comply with, local, state and Federal laws and regulations. These expenses are not allowable except when incurred as a result of compliance with specific provisions of the contract or instructions in writing from the contracting officer.

15-204.14 FRINGE BENEFITS. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries.

a. The determination as to the allowability of the cost of pension and retirement plans, profit sharing and other bonuses, and severance pay will be in accordance with subparagraphs 15-204.27, 15-204.6 and 15-204.38, respectively.

b. The cost of other fringe benefits such as pay for vacations, holidays, sick leave, military leave and employee insurance (but see subparagraph 15-204.16e) is allowable to the extent required by law, employer-employee agreement, or established policy of the contractor that constitutes, in effect, an implicit agreement on the contractor's part.

15-204.15 INITIAL PRODUCTION COSTS. Initial production costs, known also as "starting-load costs" are non-continuing costs that arise in early stages of production because of the contractor's lack of experience with particular materials, manufacturing processes or techniques involved. Such costs may (1) ~~consist of~~ include excessive material costs resulting from abnormal scrap losses, excessive direct labor costs and related overhead resulting from idle time due to testing and change in production methods, cost of training employees, and excessive defective work due to inexperienced labor.

While initial production costs are allowable, the contractor will be expected to work actively to minimize or eliminate them as rapidly as possible. In cases where these costs continue to an unwarranted extent after the contractor has been allowed reasonable time to learn to make the product efficiently, the excessive costs will be subject to disallowance.

Reason: (1) "Starting-load costs" do not necessarily "consist of" only or all of the costs mentioned in the second sentence. Accordingly, therefore, the word "include" is considered to be more appropriate.

15-204.16 INSURANCE AND INDEMNIFICATION

a. Included under this item are (1) those types of insurance which the contractor is required to carry under the terms of the contract, or by specific instruction of the contracting officer or his authorized representative, and (2) any other insurance for which the contractor seeks reimbursement under the contract. The kinds of insurance ordinarily included in the first category are set out in ASPR 10-501.

b. Costs of Government required insurance are allowable within the limitations as to the extent of coverage and premium rates approved by the Government. Costs of other insurance, except that applicable to Government-owned property, are allowable provided ~~(1) the insurance has been approved by the military department concerned or (2) in the absence of such approval requirement,~~ (1) the types of coverage, extent of coverage, and rates are reasonable under the circumstances. Costs allowed for use and occupancy insurance, however, will in principle be limited so as to exclude coverage of profit, interest, federal income taxes, and any other items of expense unallowable under this part.

Reason: (1) The cost principles should be limited to the bases for determining the allowability of costs and should not attempt to prescribe procedures which more properly fall within the scope of the contract insurance clauses. Also, to make it clear that, whether approval is or is not required, the allowability of such insurance costs (and the approval of the insurance if and when approval is required) is to be determined on the basis of the reasonableness of the types, extent, and rates of coverage.

c. The costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are not allowable except (i) to the extent that (1) the Government may have approved or required the contractor to carry such insurance or (2) (ii) to the extent that the Government does not by contract provision relieve contractor from liability for damage to or loss or destruction of Government property

arising by reason of risks against which insurance may be procured.

Reason: (1) In many instances while the Contracting Officer will not require certain insurance coverage, he will approve such insurance coverage upon demonstration by the contractor as to the necessity or desirability therefor.

(2) In certain instances the assumption of risk of loss from certain causes by the Government under contract provisions may leave the contractor with risks which are so substantial that it is prudent to insure against liability for such risks. In these instances it is believed that a contractor should not be prohibited from purchasing insurance covering the insurable risk that the contractor has in Government property.

d. The costs of a self insurance program are allowable provided the program has been approved by the military departments concerned. Actual losses sustained under such a self-insurance program are not allowable.

e. The costs of insurance on the lives of officers, partners or proprietors, are not allowable except where such insurance is part of an employee plan which is not unduly restricted.

f. Losses resulting from failure to insure (through self insurance or otherwise) against a contingent loss or damage, where a reasonably prudent business organization would have insured against such loss or damage, are not allowable.

g. Cost of indemnification will be allowable only to the extent expressly

(1) provided for in the contract or as approved by the contracting officer.

Reason: (1) Contractors may incur costs over the period of contract performance by reason of agreements of indemnity given others in the normal course of purchasing, leasing, borrowing, or using real and personal property or the services of others, which costs are not reimbursed under contractor's insurance program. Since it is not known at the time a contract is entered into whether it will be necessary to incur costs in connection with indemnifying other parties, and since the costs are of a non-recurring nature, it is desirable from an administrative standpoint to provide for approval of indemnification costs by the Contracting Officer.

15-204.17 INTEREST AND OTHER FINANCIAL EXPENSES. This item includes interest ~~paid~~ (1) ~~or accrued (regardless of the nature of the obligation which gives rise to the interest cost)~~ on borrowings (however represented), bond discount and expenses, and the cost of financing and refinancing operations as well as legal and professional fees paid in connection with the preparation of a prospectus, cost of preparation and issuance of stock rights and expenses related thereto. (See also 15-204.24). These costs are unallowable ~~except for interest assessed by State or local taxing~~ (1) ~~authorities under the conditions set forth in subparagraph 15-204.40.~~

Reason: (1) As a matter of equity, interest on tax deficiencies (other than Federal Income and Excess Profits Taxes and taxes in connection with financing, refinancing, or refunding operations) should be an allowable item of cost. In addition, there may be interest on other claims against the contractor that should be allowed. By limiting the specific disallowance to interest on borrowings (however represented), contractors are given the opportunity to seek reimbursement of other interest on its merits. Moreover, the suggested change is in accord with Section XV, as now in effect.

15-204.18 LABOR RELATIONS. This item covers expenses incurred in maintaining satisfactory relations between the contractor and his employees. It includes the cost of shop stewards, labor management committees, employee publications and other related activities. Costs incurred for these purposes are allowable.

(1) 15-204.19 LOSSES ON OTHER CONTRACTS. ~~This~~ Except for participating research and development contracts, this item covers any excess of costs over income under any and all other contracts, whether such other contracts are of a supply, research and development or other nature. Costs of this nature are now allowable as a cost of performance of the Government contract.

Reason: (1) To prevent the disallowance of the costs not paid for under participating research and development programs where it is intended that the amounts reimbursed under the participating programs will not cover all of the cost of the programs.

15-204.20 MAINTENANCE AND REPAIRS. ~~(a)~~ This item includes those costs necessary for the upkeep of property which neither adds to the permanent value of the property nor appreciably prolongs its intended life but keeps it in its efficient operating condition. These costs are allowable. Expenditures for plant and equipment which, according to generally accepted accounting principles, should be capitalized and subjected to depreciation will be allowable only on a depreciation basis. Cost of maintenance and repairs of excess facilities and of idle facilities (other than reasonable standby facilities) are not allowable.

(1) ~~b.--Deferred maintenance is defined as maintenance and repairs which for some reason such as abnormal operating conditions or lack of funds, is delayed to a future period.--The cost of maintenance and repairs which has been deferred from a period prior to the contract is not allowable unless specifically provided for in the contract.--Likewise, the estimated cost of maintenance and repairs normally required but not accomplished during the period of the contract will not be allowed as a cost unless specifically provided for in the contract.~~

Reason: (1) 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 of less than maximum efficiencies are to be avoided. Management's decision to to when to repair is usually based on whatever action, or inaction, as to maintenance will produce a maximum effect on cost. Deferred maintenance arises from such causes as (1) the inability to close a plant or part thereof, or remove a machine for repair without interferring 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; and (4) the lack of need for future efficiency as in the case

of an item which is to be disposed of. It is believed that 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. The retention of subparagraph b. will, therefore, cause an increase in the number of "costs questioned" and can only result in prolonged justification and argument and undue delay in settlement.

15-204.21 MANUFACTURING AND PRODUCTION ENGINEERING. Manufacturing and production engineering includes the cost of engineering activities in connection with (1) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement and (2) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production. These costs are allowable. ~~For purposes of distribution, such~~ Such costs should ordinarily be ~~divided into two categories: (i) those which directly benefit a contract, a project, or a product line and (ii) these expenses which are not subject to direct costing. Items in category (i) should be charged directly to the contract or project or allocated to the products in the product line. Costs in category (ii) should be allocated to all benefited work~~ distributed as provided in paragraphs 15-202 and 15-203.

(1)

Reason: (1) The purpose of this suggestion is to provide consistency with the referenced paragraphs.

15-204.22 MATERIALS AND SUPPLIES.

(1) a. This item includes the ~~net~~ costs of such items as raw materials, parts, sub-assemblies, components, and manufacturing supplies, whether purchased outside or manufactured by the contractor, and may include such collateral

(2) items as inbound transportation and intransit insurance. In computing materials costs consideration will be given to reasonable overruns, spoilage, or defective work. These costs are allowable subject, however, to the provisions of subparagrahs b through f below.

Reason: (1) The word "net" should be eliminated as it may be construed so as to preclude the application of adjustments for discounts, rebates, allowances and credits through overhead, which is a common practice in industry. See recommended revision to subparagraph b below.

(2) While it would appear to be the intent of the regulations to allow such costs, it is believed that specific reference to such allowability is desirable. The identical provision as suggested herein is now set forth in Section 15-202.1 of the present ASPR.

b. Costs of materials and supplies shall be suitably adjusted for applicable portions of income and other credits. Such income and other credits include trade discounts, refunds, rebates and allowances~~,~~, ~~Cash~~ cash discounts available, and credits for scrap and salvage and materials returned to

(1) vendors. Such discounts, rebates, allowances and credits may be applied directly to the charges for materials involved or may be apportioned through credits to indirect costs. However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond his control,

(2) or where it is the established practice of the contractor not to take certain discounts and such practice is approved by the Contracting Officer, such lost discounts will be allowed.

Reason: (1) This language is necessary to provide flexibility in those cases where these items cannot be identified to specific material costs as evidenced by the fact that such language appears in 15-202.1 of present Section XV.

(2) In certain cases it would not be prudent to make payment prior to inspection and product qualification solely for purpose of obtaining the cash discount. Also, in some cases it may be uneconomical to take discounts on invoices for nominal amounts.

c. When materials are purchased specifically for ~~and identifiable solely with performance under~~ a contract and not issued from stock (1) the actual purchase cost thereof should be charged to the contract.

Reason: (1) The above revision is necessary in order to recognize the practice followed by many contractors of routing materials purchased specifically for a contract through stores and using a generally recognized method of pricing such materials when issued from stores.

d. If materials are issued from stock, any generally recognized method of pricing such materials will be acceptable, provided the 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 and the Government may, by contract provision, agree upon the use of a method of pricing based upon the fair value of the materials as of the date of the contract, but not in excess of replacement cost on such date. Such agreement should include identification of the types or kinds of materials involved and should be made at the time the contract is entered into and provided for therein.

e. Reasonable charges arising from difference between periodic physical inventory quantities and related material control records will be included in arriving at the cost of materials, provided that such charges (i) do not include "write-downs" of values, and (ii) relate to the period of performance of the contract. All credit arising from differences between periodic physical inventory quantities and related material control records shall be taken into account.

f. Ordinarily sales or transfers of materials and supplies between plants, divisions, or organizations, under a common control, shall be stated on the basis of cost to the transferor. 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, provided that the price charged to the contract does not exceed the lower of (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.

15-204.23 ORGANIZATION EXPENSES. This item consists of expenditures in connection with organization or reorganization of a business. Examples of such costs are incorporation fee, attorneys fee, fees to promoters and organizers and costs of raising capital. These costs are unallowable. (See paragraph 15-204.17).

15-204.24 OTHER BUSINESS EXPENSES. Included in this item are such recurring expenses as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, proxy (1) solicitations, preparation and publication of ~~annual~~ reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies and incidental costs of directors and committee meetings. The above and similar costs are allowable when incurred in reasonable amounts in accordance with the contractor's established practices and are allocated on an equitable basis to all classes of work.

Reason: (1) The use of the word "annual" in this paragraph could be strictly construed to mean that the costs of reports to stockholders, other than an annual report, are unallowable. The issuance of periodic information reports to stockholders throughout the year is in accordance with established business practice. As an example, contractors are required, under certain circumstances, to issue periodic reports to stockholders in accordance with rules of the Securities Exchange Commission and other regulatory bodies. The clause in this paragraph which allows costs that are "in reasonable amount in accordance with the contractor's established practice" is sufficient to protect the Government's interest.

(1) 15-204.25 OVERTIME~~,--EXTRA-PAY-SHIFT-AND-MULTI-SHIFT~~ PREMIUMS. This item consists
(1) of the premium portion of overtime ~~and-shift~~ payments to employees. Such premiums
(2) may be classified as either direct or indirect labor costs~~,-but-the-amount-of-overtime~~
(2) ~~premium-should-be-separately-identified,--When-direct-labor-cost-is-the-base-for-distribution-of-overhead,-overtime-premiums-shall-not-be-included-therein.~~ Cost of over-
(1) time ~~and-shift~~ premiums are allowable only to the extent expressly provided for in the contract or otherwise authorized by the Government. See ASPR 12-102 for further information concerning the policy regarding such authorization. The amount of over-
(1) time ~~and-shift~~ premium cost charged on Government contracts shall be equitable in relation to the amount of such costs charged on non-Government work being concurrently performed in the contractor's plant and the factors which necessitate the incurrence of the cost.

Reason: (1) The deletion of all references to "shift" premiums is suggested, since present contract clauses provide the conditions under which overtime premiums are allowable but in most cases the contract does not provide a condition for reimbursement of shift differential or shift premium. All compensation including shift premium is subject to the same test of reasonableness as any other cost, and the contracting officer is furnished with the necessary data to assist him in making his determination. This does not require special contract provision.

It is true that new proposed clauses for inclusion in Contracts includes conditions for allowance of Premium Wage Compensation which is applicable to extra shifts. However, considerable objection to such a clause is being raised for good and sufficient reason, and it is believed that some success will be realized; and clause may, in final analysis, not be incorporated in contracts. Thus, inclusion of these words in this ASPR Section XV can only result in confusion. Also, the words are unnecessary even if clauses providing condition of reimbursement for extra-shift premium are incorporated in contracts as the contract provision will always be binding as it has in the past.

(2) With respect to the suggested deletion in the second sentence and the suggested deletion of the third sentence of this paragraph, it is impractical to identify overtime premium in records without changing established accounting records and procedures. Objections have been made to the requirement that overtime premium must not be included as direct labor, under paragraphs 15-203.1 and 15-203.2, and reasons are stated under those paragraphs. Objections have also been made to changing accounting systems which have been approved for recording costs under Government contracts under which premium pay is included as direct labor.

(1) 15-204.26 PATENT EXPENSES. Included in this item are such expenses as amortization of the cost of purchased patents and all costs leading to the issuance of patents, as well as the cost of infringement investigation and litigation. Amortization of the cost of purchased patents applicable to contract products or processes is allow-

(2) able. The cost of preparing ~~disclosures as required by the contract and of preparing assignment and other papers in connection with the filing of a patent application for the Government, and any expenses incident to patents incurred upon the written authorization of the contracting officer, are allowable. All other patent expenses~~

(2) ~~and charges~~ and filing applications for patents and patent licenses, as well as preparing disclosures and assignments to the Government as required by the contract

(3) or by the contracting officer and all expenses incident to such subject, including the defense of patent infringement litigation, are allowable. Costs and expenses for the use of patents where the Government has a license or the right to free use thereof, are unallowable. The cost of research and development work leading to patents is treated in subparagraph 15-204.35.

Reason: (1) The suggested insertion of the words "such expenses as" is considered necessary to avoid overly restrictive interpretations of types of expenses to be included under this heading.

(2) The existing language would disallow the cost of preparing a patent application unless such application were filed on behalf of the Government or the written authorization of the Contracting Officer was obtained. It is believed that the filing of patent applications by a contractor benefits production for the Government, even though the Government may not obtain any rights under the patents because, by obtaining a patent, a contractor avoids the necessity of eventually being required to pay a royalty to some other person who may obtain a patent on the same invention. Also, costs of the Patent Department of a large manufacturing company are a necessary cost to its over-all operation and should be considered one of the necessary costs of doing business.

(3) Inclusion of the words "including the defense of patent infringement litigation" is necessary in order to clearly set forth that costs incident to such defense are allowable whereas the costs of prosecuting such matters are unallowable under paragraph 15-204.30.

15-204.27 PENSION AND RETIREMENT PLANS.

a. A pension plan as used herein is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to his 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

(1) 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 will be considered a pension plan, if, under the plan, either the benefits payable to the employee or the required contributions by the contractor can be determined actuarially.

Reason: (1) Costs under a plan which has previously received the approval of the Internal Revenue Service and is otherwise acceptable should not be disqualified by reason of extremely remote contingencies recited in this preliminary definition. Adequate provision for the handling of credits has been made in subparagraph f. Detailed regulations of the Internal Revenue Service have for many years permitted companies to make payments into plans upon which

companies and their employees have come to rely. The proposed draft would outlaw valid established plans with the result that confidence in the premanency of such plans would be undermined.

b. Pension and retirement plans which are subject to the approval of the Internal Revenue Service must have been so approved prior to consideration by the Military Department; however, approval of the plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such plan by the Military Department. Consideration of the plans will be the responsibility of the Department to which audit cognizance is assigned and the subsequent action taken by that Department will generally be accepted by the other Departments. In cases where the Internal Revenue Service withdraws approval of a plan, amounts allocated to contract costs will be withdrawn accordingly. Where pension and retirement plans of non-profit or other tax-exempt organizations are not required to be reviewed and approved by the Internal Revenue Service, it will be the responsibility of the Department to which audit cognizance is assigned to give consideration to the acceptability of such plans.

c. The costs of acceptable pension and retirement plans, which are properly deductible from taxable income are allowable except as otherwise determined unallowable under this paragraph. The cost of retirement plans, which are based on profit sharing, shall be subject to paragraph 15-204.6e. Costs of acceptable pension and retirement plans established by nonprofit or other tax-exempt organizations are also allowable except as otherwise determined under this paragraph.

d. Pension and retirement costs constitute a part of the total compensation by a contractor to the individuals covered by the plan, and accordingly, are subject to the provisions of this section with respect to reasonableness of the total compensation paid to the individual for the services rendered. (See 15-204.6)

e. The amount of the contribution subject to allocation as a contract cost will be limited to the maximum amount required to fund an

(1) approved plan, or the amount actually contributed, ~~during~~ for

(2) the taxable year, whichever is the lesser. ~~The carryover provisions of the Internal Revenue Code with respect to contributions under pension and retirement plans shall not be recognized for the purpose of determining allowable pension and retirement costs under Government contracts.~~

Reasons: (1) Since amounts contributed may not always be "during" the taxable year, for good and valid reasons, it is suggested that the word "for" be inserted in lieu of the word "during".

(2) The regulations of the Internal Revenue Service have for many years permitted companies to pay into qualified plans more than the maximum amount for which tax deductions were available that year, with the understanding that the excess could be claimed in a future year. This has induced some companies to accelerate payments into their plans in reliance upon this provision, instead of holding the money idle until the year in which the deduction was available. The proposed draft outlaws this practice and says that such a company will never have such payments recognized as a part of the contract cost. This is unjust.

f. Credits which arise under pension plans from various sources, such as dividends and cancellation of employee benefits which have not vested at the time of termination of their employment, must be taken into account in an equitable manner in the determination of the allowable pension and retirement contribution. Special provision for these credits is usually necessary when the contractor's

organization has substantially expanded for the performance of military contracts and there is a reasonable expectation that the employment of a large number of the additional employees will be terminated upon curtailment of military work. Under these circumstances, 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. There are ~~two~~ three general methods which may be used, individually or in combination, in making such arrangements:

(1) A lump sum or percentage discount of current pension costs negotiated and agreed upon in advance, or taken into account in the actuarial studies used as the basis for the computation of pension plan contributions. ~~Determination of such allowance generally is not an actuarial problem involving a calculation based upon known factors, but rather is an attempt to reach a negotiated agreement as to various uncertain or variable factors in a complex situation.~~

(1)

Reason: (1) In some cases, the credit is fully and properly reflected in the actuarial studies on which the pension plan contributions are based. This has been done with the full knowledge and approval of the cognizant Government authorities. Therefore, this regulation should be revised to permit the continuation of this mutually satisfactory arrangement.

(2) A retrospective determination at some time in the future when a more accurate estimate can be made by virtue of experience which may have developed. Until such determination, current costs, which should be net of current credits may be allowed provided an appropriate contractual agreement can be reached which reserves the Government's right to future credits.

(1) (3) Where the contractor can demonstrate that reasonable provision has been made for the effect of such reversionary credits in his method of determining pension contributions, no special provisions for these credits is required.

Reason: (1) Methods used by some contractors to determine pension contributions take into account unusual as well as normal fluctuations in employment and are susceptible to review to so demonstrate. Methods used by other contractors to determine contributions may be found to be inadequate to provide for such fluctuations and may thereby make it necessary for the Government to require special provisions for reversionary credits. In such instances no particular methods should be prescribed but each case should be handled by whatever method is mutually agreed to be appropriate in the light of all the circumstances.

g. The costs of lump sum purchases of annuities or of lump sum cash payments or periodic cash payments made to provide pension or retirement benefits for retiring or retired employees other than incurred under approved pension and retirement plans are allowable only to the extent specifically (1) provided for in the contract or as approved by the contracting officer.

Reason: (1) It may be more practicable to obtain the specific approval of the Contracting Officer for a meritorious cost instead of trying to spell out the facts in affected contracts.

15-204.28 PLANT PROTECTION EXPENSES. This item includes the cost of plant

(1) protection measures ~~such as~~ wages of ~~guards~~, firemen, investigators, and related supervisory and clerical personnel; supplies, expenses, and equipment ~~of guards~~ plant protection organization (uniforms, firearms, firefighting materials, etc.), and depreciation on plant protection capital assets. For the purpose of contract costing, these expenses are divided into two categories, namely, normal plant protection expenses and special plant protection expenses. Normal plant protection costs are allowable and are allocable to all work in the plant. Special plant protection costs, which term refers to an extension of the contractor's normal plant protection program are also allowable and allocable to specific Government contracts requiring special protection upon the specific

(2) direction ~~and~~ or approval of the contracting officer.

Reasons: (1) To include under this paragraph provision for plant protection in addition to guards. Fire departments and investigation activities are inherent in plant protection responsibilities. Also, the supporting services of supervisory and clerical personnel are required in the administration of such matters.

(2) When contractor is directed by contracting officer, there is no need for additional approval. If approved by contracting officer, prior direction thereby should not also be required as a prerequisite to allowability.

15-204.29 PRECONTRACT COSTS. Precontract costs are those which are incurred prior to the effective date of the contract and which would have been allowable thereunder if incurred after such date. Such costs will not be allowed unless specifically set forth in the contract and may be limited to a period of time as well as to the type and amount of such costs.

15-204.30 PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER.

a. This item includes the cost of professional services rendered by the members of the particular profession separately engaged. These costs generally are allowable when reasonable in relation to the services rendered and are not contingent upon recovery of the costs from the Government.

b. Factors to be considered (among others) in determining the allowability of costs in a particular case are: (i) 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 organization; and (iv) whether or not the proportion of Government work to the contractor's total business is such as to influence the contractor in favor of incurring the cost, particularly where the services rendered are not of a continuing nature and have little relationship to work under Government contracts. Retainer fees to be allowable must be reasonably supported by evidence of services rendered.

c. The costs of legal, accounting and consulting services and related expenses incurred in connection with organization or reorganization, prosecution of
(1) patent infringement litigation (except as provided for in 15-204.26), unsuccessful
(2) defense of anti-trust suits brought by the Government, and the unsuccessful prosecution of claims against the Government are unallowable.

Reason: (1) A broad interpretation of the language in the draft could result in the disallowance of the costs of defending suits by private parties under the anti-trust laws and the cost of successfully defending an anti-trust suit brought by the United States Government.

(2) The costs of prosecution of successful claims against the Government are ordinary, necessary and proper expenses of doing business and should be considered allowable costs.

15-204.31 PROFITS AND LOSSES ON DISPOSITION OF PLANT, EQUIPMENT OR OTHER CAPITAL ASSETS. Included herein are gains or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments. Profits or losses on sale or exchange of capital assets, including investments, will be excluded in computing contract costs.

15-204.32 RECONVERSION EXPENSES. Reconversion expenses are those incurred in the restoration of the contractor's facilities to approximately the same physical arrangement and condition existing immediately prior to commencement of the military contract

(1) work and include the cost of removal of Government property. ~~Reconversion expenses are not allowable except that the cost of removing Government property and the restoration costs caused by such removal~~ The costs of removing Government property and restoration costs related to such removal are allowable. Other reconversion expenses are allowable if specifically provided for in the contract.

Reason: (1) The proposed wording of this paragraph restricts the reconversion expenses that can be provided for by contractual provision. Since the cost of removing Government property and the restoration costs caused by such removal should be allowable costs under any circumstances, the wording has been changed to provide for such allowance. In addition, the suggested wording provides for the allowance of other reconversion costs on the basis of specific contract provision as now provided for in Section 15-202 of present ASPR.

15-204.33 RECRUITING EXPENSE. This item includes the costs of "help wanted" advertising and the operating costs of an employment office necessary to secure and maintain an adequate labor force. It further includes the costs of operating an educational and aptitude testing program, travel expenses of employees while engaged in recruiting personnel, and travel expenses of applicants for interviews for prospective employment. These costs are allowable. Where the contractor uses private employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are not

(1) allowable <u>unless approved by the contracting officer</u>.

Reason: (1) The restriction of the allowability of costs to those that conform to the "standard practices in the industry" would require a determination of the applicable standards. Establishment of standards to cover all cases would be extremely difficult. Since numerous factors affect the special benefits offered prospective employees, it is considered desirable to provide for contracting officer approval when the available standards do not cover the specific case being considered, or the particular circumstances warrant a deviation from the standard.

15-204.34 RENTALS OF PLANT AND EQUIPMENT. This item includes expenses for (i) use
(1) of land, buildings, and equipment or other personal property~~, and (ii) rental expenses under sale-and-lease-back agreements incurred by contractors through sale of plant facilities to investment organizations (such as insurance companies) or to private investors and concurrently leasing back the same facilities.~~

a. Rentals of plant and equipment ~~under (i) above~~ are allowable if the rates are reasonable in light of the type, condition and value of the facilities leased, options available and other provisions of the rental agreement.

(1) ~~b. Rentals specified in sale-and-lease-back agreements under (ii) above are allowable only to the extent that such rentals do not exceed normal costs (such as depreciation, taxes, insurance and maintenance expenses) which would have been incurred had the contractor retained legal title to the facilities.~~

Reason: (1) All references to sale and lease-back of facilities have been deleted on the grounds that they represent an attempt to write into the ASPR a sole test of reasonableness for such transactions whereas there may be many others depending upon the circumstances involved in each transaction. Moreover, these references are not required because all rentals must meet the test of reasonableness; and if a rental meets that test in the light of all of the circumstances it should not be disallowed merely because a sale and lease-back is involved. The deleted provisions would actually penalize contractors who have sale and lease-back arrangements as contracted with contractors holding 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 the rental rate is equivalent to only "normal costs, such as depreciation, taxes, insurance and maintenance expenses."

The interests of the Government are amply protected by the factors that may be taken into account in determining reasonableness.

15.204.35 RESEARCH AND DEVELOPMENT. Research and development expenses (sometimes referred to as general engineering expenses) for the purpose of contract costing are divided into two major categories, namely:

a. General research, also referred to as basic research, fundamental research, pure research and blue-sky research.

b. Related research or development, also referred to as applied research, product research and product line research.

(1) General research is that type of research which is directed towards increase of knowledge in science. It is research where the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. The costs of a contractor's independent general research (that which is not sponsored by a contract or grant or is not otherwise reimbursed to a contractor) shall be an allowable cost in all cost type contracts under the following conditions:

(i) The amount of such costs is reasonable.

(ii) The costs are equitably allocated to all work of the contractor other than its independent general and related research.

(1) ~~(iii) The contractor agrees to divulge to the Government the results of such independent general research.~~

(2) ~~(iv) The business of the contractor at the time of entering the contract is predominently (75% or more) with non-Governmental customers. If less than 75% of the time of entering the contract, allowance may be authorised by special contract provision.~~

(3) ~~The above conditions will also apply in the negotiation of predetermined overhead rates.~~

Reason: (1) The results of research work is what the Government buys when it contracts specifically for the performance of such work. To determine whether research costs are properly includable in the pools of costs allocated over all business, it may be necessary for the contractor to disclose the nature and/or purpose of the research work, but <u>not</u> the results thereof.

(2) If costs incurred for general research are reasonable, they should be allowed regardless of the percentage of non-Government business the contractor is performing. To restrict the allowability of the allocable portion of reasonable general research costs on the basis of the percentage of Government business the contractor is performing is arbitrary and discriminatory. The determination of the allowability of general research costs on the basis of whether a contractor is or is not performing a certain portion of its business with the Government is without justification and unduly penalizes companies which devote substantially all of their production capabilities to the National Defense program. If the increasing demands of the Military Services for new weapons are to be met, basic or general research efforts should be increased and the engaging therein should be encouraged, not discouraged. Thus, any discrimination in connection with the allowability of costs of this type of research should be in favor of, not against, those engaged in the development of instruments of defense which are essential for national survival.

(3) This statement is unnecessary and, therefore, redundant.

(2) Related research is that type of research which is directed toward practical application of science, and "development" is the systematic use of scientific knowledge directed toward the production of useful materials, devices, (1) methods, or processes, exclusive of <u>detail product</u> design, manufacturing, and production engineering (See 15-204.21). The costs of a contractor's independent (2) related research <u>and development</u> (that which is not sponsored by a contract or (3) grant or is not otherwise reimbursed to a contractor) ~~may, if allocated on the basis of all production, be allowed~~ <u>is allowable</u> as a cost under any cost type ~~production~~ (3) contract if the research is related to the contract product or product line <u>and is allocated on the basis of all work performed on such product or product line</u>. ~~No portion of such research will be allowable under cost type research and development contracts.~~

Reason: (1) If all desi, is excluded, it will permit a Government auditor to disallow design related to and in reality constituting a proper part of related research.

(2) Excluding the terms "and development" would exclude "the systematic use of scientific processes", which is not intended.

(3) Related research often has a reasonable relationship to the end products of research and development contracts. Furthermore, it is necessary for a contractor in certain instances to carry on related research programs in support of work being performed under such contracts. The suggested revision would permit the allocation of such expense to research and development contracts where such allocation is warranted. Also, it is not practical to define "cost-type research and development contracts" so that it would not be possible to determine those contracts on which such research would not be allowable.

c. Research and development costs, regardless of the nature, which were incurred in accounting periods prior to the award of a particular military contract, (including amounts capitalized and the cost of patents obtained) will not be

(1) allocated to that contract unless <u>approved by the contracting officer</u> or allowable as pre-contract costs (Paragraph 15-204.29).

Reason: (1) Revision 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 as the time the proper disposition can be determined.

(1) 15-204.36 ROYALTY PAYMENTS. This item covers amounts paid or payable for the right to use patents. Where the use of such patent is necessary for the proper performance of the contract and where the Government does not already have a license

(2) or other right to use such patents, the royalties are allowable ~~to the extent expressly provided for elsewhere in the contract or otherwise authorized by the contracting~~ officer.

Reason: (1) To provide for amounts accrued.

(2) The contractor should be permitted to manufacture products, under license agreements, which they otherwise would have to purchase. If a royalty is necessary to perform a contract, the payment should not be subject to an arbitrary decision by a contracting officer.

15-204.37 SERVICE AND WARRANTY EXPENSES. This item includes the costs of servicing the product installation, training personnel in the use, operation

(1) and maintenance of the product, ~~correcting product defects, replacing defective~~

(1) ~~parts,~~ and other related operations or practices. Such costs are allowable.

(1) Actual costs of correcting product defects and replacing defective parts are ~~to be reimbursed to the contractor will be in accordance with~~ allowable, subject to any limitations in the clause of the contract entitled "Inspection of Supplies and Correction of Defects", (See Paragraph ASPR 7-203.5), or as otherwise provided in the contract.

Reason: (1) It is believed that the suggested changes better express the intent of this paragraph. Without such changes, the paragraph is ambiguous. Paragraph (b) of ASPR 7-203.5 provides that the costs of replacement and corrective action shall be determined as provided in the clause entitled "Allowable Costs" and by the proposed revision such costs are clearly more allowable subject only to disallowance by reason of fraud, etc., as set forth in paragraph (c) of ASPR 7-203.5.

15-204.38 SEVERANCE PAY. Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated.

The cost of severance pay is allowable only to the extent that, in each case, it is required by (i) law, (ii) employer-employee agreements, (iii) established policy that constitutes, in effect, an implicit agreement on the contractor's part, or (iv) the circumstances of the particular employment.

For contract costing purposes severance pay is divided into two categories as follows:

a. Normal Turnover Severance Pay. The cost of severance payments is allowable and must be allocated to all classes of work being performed in the contractor's plant at the time of payment. However, 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.

b. Mass Severance Pay. The cost of abnormal or mass severance pay actually made upon cessation of work when there is no reasonable prospect of

(1) 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 entire period of employment with the contractor and equitably apportioning such cost to all business of the contractor performed during that period.~~

A reservation in the final release of claims (See ASPR 7-203.4) may be made in the case of completed cost-reimbursement type contracts when it is reasonable to assume that severance pay allocable to the contract will be made in the future.

Reasons: (1) These cost principles should not prescribe accounting treatment which is administratively impractical and unworkable. Such costs should be handled, as in the past, on a basis conforming with generally accepted accounting principles and practices, taking into consideration all of the facts involved and the circumstances bringing about such mass terminations.

15-204.39 SPECIAL TOOLING. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or to the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special taps, special gauges, and special test equipment. The cost of special tooling, when acquired for and its usefulness is limited to government contracts, is allowable and will

(1) be charged directly to the government contracts. ~~When such special tooling is acquired it shall be subject to the provisions of the contract clause set forth in ASPR 13-603 entitled "Government Property".~~

Reason: (1) This provision is unnecessary, since the subject is governed by ASPR Section XIII.

15-204.40 TAXES. Taxes are charges levied by a government unit. They do not include fines and penalties except as otherwise provided herein.

(1) a. In general, taxes (including state and local income taxes) which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except (i) for Federal income and excess profits taxes; (ii) taxes in connection with financing, refinancing or refunding operations (see paragraph 15-204.17); ~~(iii) taxes from which exemptions~~

(2) ~~are available to the contractor directly or available to the contractor based on an exemption afforded the Government;~~ and ~~(iv)~~ (iii) special assessments on land which represent capital improvements.

Reasons: (1) Municipal and other income taxes, other than Federal, should be allowable. The suggested insert avoids limiting allowability of income taxes to "state" income taxes.

(2) The reason for this is that although many theoretical exemptions from excise taxes are afforded to the Government, it is not clear that the contractor is free to obtain exemption from tax unless the Government takes affirmative action. In many cases, the cost of securing the exemption exceeds the amount to be saved and neither the Government nor the contractor wants the exemption claimed.

b. Taxes otherwise allowable under a. above, but which may be illegally or erroneously assessed may be allowed as a cost of work performed, provided that the contractor, prior to payment of such taxes, (i) promptly requests instructions from the contracting officer concerning such taxes; (ii) agrees to comply with such instructions; and (iii) if so directed by the contracting officer also agrees

(1) to take all necessary action in cooperation with ~~and~~ the Government and other defense contractors for the benefit of the Government, to determine the legality of such assessment or, as the case may be, to secure a refund of such taxes and any interest or penalties thereon. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer shall be

allowable as a cost. Reasonable expenses of any proceeding instituted by the contractor at the direction of the contracting officer to determine the legality of such an assessment or to secure a refund of such taxes, interest or penalties for the benefit of the Government, shall also be allowable as costs.

Reason: (1) For purposes of clarification.

/This subparagraph b should be revised generally to allow cost of taxes, interest, penalties, and expenses of contractors' acts in resisting assessments or attempting to secure refunds, in certain situations where contractor cannot possibly or reasonably (1) does not request instructions from the contracting officer, (2) does not agree to such instructions, or (3) does not receive direction from the contracting officer prior to time action was or must be taken. Revision is, therefore, necessary in order to allow costs of taxes, interest, and penalties which may be illegally or erroneously assessed, as well as expenses of resisting assessments, or attempting to secure refunds under such special situations without the imposition of these restrictions./

c. Any refund of taxes, penalties or interest thereon shall be credited to contract costs in the proportion in which contract costs absorbed the costs of

(1) taxes, interest or penalties or in such other manner as approved by the contracting officer. If at the time the refund is received by the contractor, no defense contracts are being performed, the amount otherwise to be credited to contract costs shall be paid directly to the Government.

Reason: (1) The requirement that contracts be credited in the same proportion that costs were charged is impractical in many cases. Distributions by other methods can produce satisfactory results that do not result in significant differences in the over-all credit to Government contracts. For example, even though a refund of State Unemployment Compensation taxes is distributed on the basis of overhead rates applicable to a year subsequent to the year in which the original overhead distribution of the applicable taxes was made, the Government's participation in the refund may not be materially distorted. The addition of this clause will permit the Contracting Officer to approve other methods of distribution where circumstances so warrant.

15-204.41 TRADE, BUSINESS AND PROFESSIONAL ACTIVITIES.

a. Memberships. This item includes costs of membership in trade,

(1) business, service, technical and professional organizations and such costs are allowable.

Reason: (1) It is believed that the cost of membership in service and technical organizations should also be allowable.

b. Subscriptions. This item includes the cost of subscriptions to trade, business, professional, or technical periodicals. Such costs are allowable.

(1) c. Meetings, Conferences, and Exhibitions. Expenses representing the purchase of meals, transportation, rental of facilities for meetings, and costs incidental thereto, when the primary purpose of the incurrance of such expenses

(1) is the dissemination of ~~technical~~ information ~~or the stimulation of production~~ intended to improve the overall effectiveness of the contractor, are allowable.

Reason: (1) It has been the experience of many contractors that exhibition expense is a required cost of doing business and is as normal and essential as expenses incident to meetings and conferences. It is believed that the addition of this item of expense to the heading of sub-paragraph c. is proper. It is also believed that sub-paragraph c., as set forth in the draft, is unduly restrictive in that it refers only to technical information or information that is aimed at the stimulation of production. Meetings, conferences, and exhibitions for the purpose of improving overall coordination of the business or various segments thereof or the dissemination of information about the business to the trade, the public, prospective employees, etc., are just as important to the successful performance of government contracts as are technical and production meetings.

15-204.42 TRAINING EXPENSES.

a. This item includes the costs of preparing and maintaining a program of instruction designed to increase the overall effectiveness of employees. Included are the costs of the director of training and staff, training materials and text books when the training program is controlled by the contractor, and tuition, fees, training materials and text books when the training is in educational institutions.

b. Such costs which are limited to on the job training are allowable when properly allocated.

c. Costs of training in educational institutions are not allowable, (1) except to the extent specifically provided in the contract <u>or approved by the contracting officer</u>.

Reasons: (1) In the past it has been necessary to incorporate training in educational institutions owing to the shortage of engineers and other highly skilled technicians. These costs were necessary and are presently considered allowable without specific provision in the contract which cannot be ascertained at the time contracts are negotiated.

15-204.43 TRANSPORTATION EXPENSES. Transportation expenses include the cost of freight, express, cartage and postage relating either to goods purchased, in process, or delivered.

When such costs can readily be identified with the items involved they may be direct costed or added to the cost of such material. (See paragraph 15-204.22). Where identification with the materials received cannot readily be made, inbound transportation expense may be charged to the appropriate indirect expense accounts, provided the contractor follows a consistent procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as direct charges.

15-204.44 TRAVEL EXPENSES. This includes costs of transportation, lodging, subsistence and incidental expenses incurred by contractor personnel in a travel

(1) status while on ~~official~~ company business.

Reason: (1) The word "official" is superfluous and its inclusion would result in misinterpretation by reason of more significance being attached to the word than is intended.

a. Travel expense incurred in the normal course of overall administration of the business and applicable to the entire business are allowable when properly allocated.

b. Travel expenses directly attributable to contract performance may be charged to the contract in accordance with the principle of direct costing.

c. Subsistence and lodging including tips or similar incidental expenses may be reimbursed either on an actual or per diem basis. The basis selected should be consistently followed.

(1) d. Costs of premium transportation ~~may be allowed when it is shown to be necessary to performance of the contract~~ are allowable when incurred by contractor personnel in accordance with the contractor's normal business practice.

Reason: (1) The words "necessary to the performance of the contract" are unnecessarily restrictive in the light of the basic principles and standards set forth in ASPR Paragraph 15-201.

e. Entertainment expenses are not allowable.

f. Costs of personnel movement of a special or mass nature are allowable only when authorized or approved in writing by the Contracting Officer.