

Binder #4

"Contract Cost Principle

November 1959



ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON 25, D. C.

SUPPLY AND LOGISTICS  
CD

JUN 18 1958

MEMORANDUM FOR THE SECRETARY OF DEFENSE

SUBJECT: Contract Cost Principles

Since 1949, the Armed Services Procurement Regulation has contained a very brief statement of the principles relating to the allowability of manufacturers' costs for use in connection with payments under contracts which are on a cost reimbursement basis. This statement has contained principally three listings, first, those types of costs which are regularly allowable, second, those which are regularly unallowable and, third, those which are allowable only to the extent specially treated in the contract. The regulations have contained no principles or policy guidance with respect to the method of dealing with costs or cost estimates in contracts of types other than cost reimbursement contracts.

For nearly five years there has been increasingly intensive pressure on the Department for the development of a new set of cost principles which would both give more detailed and precise policy guidance in the treatment of many cost elements and would be applicable to all types of contracting or contract settlement situations. Specifically, the adoption of such a uniform, comprehensive set of cost principles has been strongly advocated by the House Appropriations Committee, the Comptroller General of the United States, and the Hoover Commission.

We have been in the process of developing such a comprehensive set of cost principles for several years. However, as I am sure you will recognize, this is a highly complicated and controversial subject and one which generates a wide variety of different views as to the treatment which should be afforded each detailed cost element. As a result, the obtaining of a degree of agreement on this set of cost principles has been a slow process. By last fall we had obtained sufficient agreement among the different elements within the Department of Defense to be able to issue a draft of the proposed principles to various industrial groups for their comment. These comments, which for the most part were quite critical of the proposed draft, have been reviewed, evaluated and thoroughly discussed with Assistant Secretary McNeil and the Materiel Assistant Secretaries of the three military departments preparatory to our undertaking discussions with industry groups in an effort to resolve our differences to the extent practical.

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Prior to our discussions with industry I believe that you should be aware of the policy approaches that we propose to take.

The industry comment was critical with respect to each element of cost, such as the cost of institutional and product advertising, which we had felt should not be charged to the government but which industry considered a normal cost of doing business. In other words they considered that all normal and proper costs of doing business should be allowed by the government to the extent they were reasonable and allocable under the contractor's accounting system even though some of such costs clearly have nothing to do with the conduct of government business. We feel that there are some costs, such as advertising or allowances for bad debts, which although necessary in the conduct of the business should not be allocated to government contracts.

2 The industry comment also made it clear that, so long as there were to be unallowable items of cost, industry did not favor the extension of the use of cost principles to incentive contracts, price redeterminable contracts and other negotiated "fixed price" type of contracts or to negotiated settlements of terminated contracts. The basis for this opposition seems to be a belief that the use of cost principles in these situations will lead to formula pricing rather than true negotiation. We believe that the description which we have included in the cost principles themselves of the methods of use of these principles in the pricing or settlement of these contracts is adequate to assure that they will not damage the negotiation process.

In our meetings with Mr. McNeil and the Materiel Assistant Secretaries consideration has been given to some twenty issues which were raised by industry. We have come to agreement among ourselves on all but one. On several of these issues we have agreed to accept the industry viewpoint whereas in a number of others we believe that we should not accept that viewpoint.

Tab A, attached, is a summary of the one remaining issue on which we do not have internal agreement and on which we seek your advice. This has to do with the allowability, as a part of total compensation to employees, primarily involving executive compensation, of that portion which is dependent upon or measured by profits. The Air Force is opposed to allowance whereas the Army, Navy, ASD(Comptroller) and ASD(Supply and Logistics) favor allowing. This problem has been with us for several years and it was previously decided by Mr. Wilson that such expenses should not be allowed as costs. The question is again raised by the industry comment and there is again a lack of agreement. The arguments on this subject are included in Tab A.

Tab B, attached, represents an identification and evaluation of significant remaining issues with industry. Internally we are in complete agreement that these industry views should not be accepted in the proposed regulation.

Tab C, attached, is an identification of the principal changes to which we have agreed as a result of the industry comments.

Tab D, attached, is our timetable for the completion of this project and the issuance of this section of the regulation.

*Perkins McGuire*  
PERKINS MCGUIRE

Assistant Secretary of Defense  
(Supply and Logistics)

4 Inclosures  
Tabs A, B, C and D

Issues Between the Air Force and Industry, (ASD(S&L), (COMP), Army and Navy)

**COMPENSATION**

**INDUSTRY VIEW**

(concurrent in by ASD(S&L), (Comp), Army and Navy)

Basic Contention: The critically important consideration underlying the compensation principle ought to be the reasonableness of the total compensation paid using any and all methods. The methods of compensation usable ought to be that determined by the contractor so long as the methods utilized are in keeping with sound accounting practices and the results achieved are reasonable in light of the services rendered.

**A. COMPENSATION PLANS BASED UPON MEASURED BY PROFITS.**

Specifically, industry contends that compensation plans based upon and measured by profits:

1. Are becoming increasingly more widely used as a means of compensating employees and officers for services rendered.
2. Are costs, as distinguished from a distribution of profits, by generally accepted accounting principles and practices.
3. Are allowable as costs for tax purposes and for renegotiation.

Are not logically separable into deferred or immediate distribution plans. The Air Force

**AIR FORCE POSITION**

Contentions: The Air Force position is that payments under profit-sharing plans should not be recognized as a cost of performing defense contracts.

1. Since January 1, 1955, the Air Force, in its negotiations with contractors, has taken the position that payments to management under profit-sharing plans are not allowable. The Air Force has no objection to profit-sharing plans as such. We do reject the philosophy that payments under such plans should be treated as a cost of performing the contract.

2. Profit-sharing is a method of distribution of profits realized. This is implicit in both the label and the conditions attached to this particular method of distributing corporate earnings. Distribution of profits under the various plans are, in general, determined in accordance with the profit position of a company at the end of the fiscal year. In a profit-sharing plan the contractor purports to be sharing his calculated profits with certain of his employees. If profit distributions are treated as costs in determining contract prices, the so-called "profit-sharing" is an illusion. For, while the contractor would be publicizing a program as "profit-sharing," the Government would, in fact, be bearing directly the cost of such plan.

position makes it clear that their opposition is only to "immediate distribution" plans and not to "deferred distribution" or "retirement" plans. Where each is based upon or measured by profits, it is difficult to see how one type can be considered a cost and the other not. The Air Force position does not explain this point.

5. Cannot logically be separated from bonuses (which are allowable), since both are treated alike by contractors for most purposes.
6. Were considered "essential to the ultimate maintenance of the Capitalistic System" in the one Congressional inquiry into such plans in 1939.

3. Under our contracting techniques we negotiate, contract by contract, a price based upon what the job is worth. This estimated profit is an incentive to the contractor and we allow him an opportunity, by reducing costs, to earn more profit. If, as a matter of corporate choice, profit-sharing is held out to the contractor's employees as an inducement to aid the contractor in earning more profit under the contract, the profits so earned should be the source of distribution of the rewards promised the employees. Having striven for the target profit, and, having achieved such profit or more and distributed a portion thereof to certain of its employees as "profit-sharing", the contractor should not confront the military department with a "voucher" for reimbursement of the profits distributed.

4. Profit-sharing is not necessarily identifiable with, nor measured by, efficiency. Net profits available for distribution may be the result of higher volume of business, sharp negotiations, or the peculiar tax situation of the contractor. In fact, a manufacturer who has not produced efficiently during a particular year could still, out of profits earned distribute bonuses measured by profits. The Government would not have derived any benefits from the operation of the profit-sharing plan.

5. Normally, management is confronted with conflicting interests of stockholders and

employees in the distribution of profits in the form of dividends for the former and profit-sharing plans, if any, for the latter. The normal pressures exerted by stockholders to prevent the indiscriminate distribution of profits under the profit-sharing plan disappears if the Government accepts payments under profit-sharing plans as an allowable cost, particularly in the case of companies predominantly in defense work.

6. It is significant that certain of our contractors, who have had profit-sharing plans in effect for a number of years, have never sought reimbursement for payments under such plans. The effect of a formal policy allowing payments under such plans would cause these companies to request reimbursement therefor and would stimulate interest in other companies to inaugurate such plans. The Air Force estimates existing profit-sharing plans could involve, for the Air Force alone, approximately \$25 million a year. Any general policy in favor of allowing payments under these plans could cause this amount to be increased significantly.

7. Our position is primarily addressed to profit-sharing plans of the "immediate" distribution type. We would not object to allowability of payments under profit-sharing "retirement" plans as presently contained in the latest DOD draft of the proposed cost principles, if such plans meet the requirements of the Internal Revenue Code and the regulations thereunder.

Identification and Evaluation of the Significant Remaining Issues  
with Industry

ISSUE 1

Should there be an attempt to get uniformity of cost treatment in all of the various types of contractual situations where costs are a factor in pricing?

Industry Position

With very slight exception industry agrees with the objective of uniformity of cost treatment but is seriously concerned lest the application of these principles lead government contracting personnel to resolve controversial points of negotiation by unilateral accounting solutions rather than by overall bargaining. Specifically they fear that the description, contained in the document itself, of the "applicability" of these cost principles to fixed price types of contracts may lead to formula pricing rather than to negotiation based upon factors other than estimated costs.

Government Position

The "applicability" section of these cost principles makes it clear that they are for use only when costs are a factor in pricing. They do not enlarge, or even affect, the number of types of transactions where costs are to be considered nor do they suggest that a specific treatment of costs shall be paramount to other considerations in cases where estimated costs are one of several factors affecting the negotiation. The present guidance, contained elsewhere in ASPR, with respect to negotiation and pricing techniques and methods (which has the solid support of industry) remains in effect and is the basis for judgment as to when costs or cost estimates should be importantly considered in pricing. It is only when costs are considered that these cost principles apply. Hence it is not felt that the danger of formula pricing would be increased by the adoption of these principles. Rather, they would encourage a consistent treatment of costs where costs are dealt with at all. However, we have agreed to revised language to make these points completely clear (See Tab C, Item 1).

ISSUE 2

Should the cost principles provide for the non-acceptance by the government of any cost which is normal, legal, and reasonably necessary in the conduct of the contractor's business?

### Industry Position

In general the industry view was that the government should accept its pro rata allocation of all normal and necessary costs of doing business. This view was very generally stated by all industry's groups as well as by the Comptrollers Institute.

### Government Position

This is probably the most difficult issue to resolve to the satisfaction of all parties. As a generality we agree that we should accept our share of the normal expenses of doing business. Nevertheless the difference between commercial business and government business is such that certain types of expense should not be allocated to us no matter what the accounting system of the contractor normally provides. Examples of such expenses are entertainment expense and reserves for commercial bad debts. We have also considered that certain other individual expense items such as product and institutional advertising and contributions and donations, should not be accepted by the government.

### ISSUE 3

Related to Issue 2 is the additional question as to whether the government should question the "reasonableness" or "allocability" to government work of a cost which is handled consistently under the contractor's normal accounting system in accordance with "generally accepted accounting principles". Stated differently, this question is whether the cost principles should contain rules or guidelines for determining the "reasonableness" or "allocability" of various cost elements or whether we should accept, as the criterion, "generally accepted accounting practices".

### Industry Position

Industry feels strongly and nearly uniformly that "reasonableness" and "allocability" of costs should be governed by good accounting practice as reflected in going accounting systems and that the government should not adopt special tests or criteria which require significant variations in industry's accounting systems. Hence, they feel that the cost principles should not attempt to prescribe how to evaluate the "reasonableness" or the "allocability" of any element of cost and, above all, that we should not say that a cost is not allocable to us.

### Government Position

"Generally accepted accounting principles" are broad standards for the evaluation of the financial position of an enterprise and for the measurement of income and expense over a given period of time. Thus a system may be maintained in accordance with such principles and fulfill the requirements of management, the stockholders, the taxing authorities, and others, and yet not yield cost data satisfactory for cost reimbursement or to support pricing judgments without some adjustments. Accordingly what may be "good accounting practice," for the purpose of determining the company's overall income and expense may be inappropriate when determining the price to be charged a particular customer or class of customers.

### ISSUE 4

The proposed cost principles point out that when we are buying from companies or industries actively engaged in commercial competition, we can normally rely on the restraints of competition to assure that certain items of expense, such as general research, are kept by management decision within reasonable bounds. However, where we are dealing with firms whose work is exclusively or predominantly with the government such competitive restraints do not exist. To provide appropriate control in such instances and to avoid unexpected disallowances of costs by the government, the cost principles suggest that, with respect to elements of cost where reasonableness is hard to determine, particularly with contractors whose work is predominantly with the government, there should be advance agreement as to the extent of allowability of such costs and that such agreements should be incorporated in the contracts. The issue is whether this provision is sound.

### Industry Position

The industry comment generally objected to this provision on the ground (a) that it favored companies in a strong negotiating position, (b) promoted lack of uniformity of treatment and (c) limited management's discretion to make sound business decisions by requiring approval in advance of incurring legitimate business expenses.

### Government Position

The industry comments seemed to assume that a failure to negotiate and agree on such costs would render them unallowable. This is erroneous. They would be unallowable only if subsequently found unreasonable which would not



happen if there had been an agreement. This point can undoubtedly be cleared by a clearer rewrite of this section of the principles. Nevertheless, the basic issues will to some degree remain. We consider it highly desirable that there be an advance agreement on the ground rules when we are dealing with traditionally difficult questions of cost particularly where there is no motivation through the needs of competition to keep such costs within normal and reasonable limits. This will not lead to any less uniformity of treatment, probably to more, than we would have by complete reliance on the concept of "reasonableness" advocated in the industry comments. As to the infringement on management decisions we are simply telling management that, if they want reimbursement from us for exceptional or unusual expenses in these troublesome fields, they should get our concurrence. The only way we could avoid such infringement would be to allow whatever they spend without regard to our judgment as to reasonableness.

## ISSUE 5

The subissues which follow have to do with our treatment of specific elements of cost. There are a number of minor points which are not considered in this paper. The following are the significant points which were commented on adversely by several or most industry groups.

### Advertising Costs

#### Industry Position

The industry comment strongly urged the allowability of institutional advertising in all media on the ground that it stimulates interest and the pursuit of careers in engineering and science, affects employee relations and, by keeping the company before the public assists the company in other ways which are of indirect advantage to the government, as in making it easier to attract investment capital. To a lesser extent industry urged the allowance of the costs of product advertising on the ground that the government benefits through cheaper prices for defense work from the creation of mass markets for commercial products.

#### Government Position

Product and institutional advertising are essentially selling expense and are designed to influence the general public. The costs thereof should be allocated to that portion of the contractor's business which is conducted with the general public. We have consistently held to this position for many years. We have, however, allowed advertising in trade and technical journals, provided products are not offered for sale. This we propose to continue.

## 5 b. Compensation for Personal Services

- (i) Compensation dependent upon or measured by profits. See Tab A.
- (ii) Stock Options.

### Industry Position

Stock options are a proper means of compensating employees, they are recognized as costs by generally accepted accounting principles and, under some circumstances, are deductible for tax purposes.

### Government Position

Stock options are not a cost of doing business in that they do not get on the contractors' statements of income and expense. In the form in which they are currently used by industry they are not deductible by the employer as a cost for tax purposes. They should not be allowed as a cost for pricing purposes.

## 5 c. Contributions and Donations

### Industry Position

The making of contributions is essential to the conduct of a business and the failure to do so adversely affects the contractor's standing in the community and, hence, his employee relations. Such contributions aid in the development of technical education and scientific research. These costs are deductible for tax purposes.

### Government Position

The allowance of contributions and donations would put contractors in the position of being able to give away the government's money. They bear no relation to the conduct of government work. As a matter of governmental policy these costs have never been allowed under any prior cost principles and we feel that we should not change this policy. X

#### 5 d. Interest

##### Industry Position

All industry comment indicates the belief that the interest on borrowings made necessary by our contracts should be allowed as a cost against our contracts.

##### Government Position

It is felt that the allowance of interest as a cost would provide a preference for one method of obtaining capital requirements over other methods and therefore would provide an incentive for borrowing for the performance of our contracts even where our cash requirements could be met out of available capital. The extent of capital requirements of our contracts should be considered in the fixing of fees or profits (See Tab C, Issue 2). ✓

#### 5 e. Plant Reconversion Costs

##### Industry Position

Reconversion from defense work to civilian work may be very costly. Where unusually heavy expense is involved, allowability should not be precluded by the cost principles.

##### Government Position

The government does allow all initial set-up expense as a charge to its work. In addition it allows the cost of removal of special government furnished machinery when special installations, such as large concrete foundations, are involved. This is considered equitable and it is felt that we should continue the policy of requiring that, upon completion of government work, set-up or make-ready expense for commercial work be charged against ensuing production.

#### 5 f. Research and Development

##### Industry Position

*draft of 10 Sept 58*  
Under the ~~proposed cost principles~~ pure research is allowed on a

Pro-rated basis as a charge against any contracts. Product research or development is allowed only as a charge against the product or product line which is benefited. Product research or development is not allowed as a charge against government research contracts. Some industry comment opposed the distinction between pure research and product research, claiming that this would require a difficult segregation. Others felt that product research should be allocable to government research contracts. Others, ~~principally the Aircraft Industries Association~~, objected to the requirement for negotiation to predetermine reasonableness of R&D expense. *there was some feeling that capitalization of development expenses with amortization over a reasonable period should be permitted.*

Government Position

The allowance of pure research to the extent of reasonableness is new. Previously it was not allowed unless specially agreed on. Product research has been allowable as part of the price of products which are benefited. We feel that this is a reasonably clear and uncomplex segregation and that, for instance, the sale of an atomic reactor should not bear any part of the cost of developing a new line of refrigerators. Recent discussions with various industry groups seem to indicate a better understanding and more willing acceptance of this principle than the initial written comments showed. The point raised by the AIA with respect to the necessity for pre-agreement on reasonableness is covered under Issue 4 above.

#### 5 g. Training and Educational Costs

##### Industry Position

The proposed cost principles:

- (i) allow in-training and out-training at vocational and non-college levels.
- (ii) allow part-time technical, engineering and scientific education, including materials, textbooks, fees, tuition, and, if necessary, straight time compensation for attendance of classes during working hours for 2 hours a week for the year (1 course).
- (iii) allow post-graduate tuition, fees, materials for full-time scientific and engineering education (BUT NO SALARY OR

Issues on Which the Industry Views Have Been Adopted in Whole  
or in Part

1. Industry Position

Industry strongly approves the existing section of ASPR that describes our negotiation and pricing policies. These policies emphasize negotiated bargaining toward reasonable overall pricing. The industry comments express the fear that the proposed new cost principles would undermine this policy and lead to formula pricing based solely on audit reports.

Government Position

Since the intent of the proposed draft was to continue our existing pricing policies and since this intent was not understood from a reading of the draft, the "Applicability" section of the draft is being rewritten to make this intent clear and, hence, to accommodate the industry views.

2. Industry Position

Industry strongly urges that interest on borrowings be allowed as

Government Position

While we do not feel that we should accede to this position (See Tab B, Issue 5 d), we have emphasized, elsewhere in ASPR, that the extent of the contractor's capital investment in the performance of the contract shall be taken into account in negotiating the amount of fee or profit.

3. Industry Position

Industry felt that the treatment of overtime pay, extra pay shift premiums and multi-shift premiums was unnecessarily complicated and would lead to confusion among the services to the disadvantage of industry.

Government Position

Since the original submission of the draft for industry comments, the policy with respect to overtime, extra pay shifts and multi-shifts has been greatly simplified in its administration and this simplification, carried into the cost principles, satisfies the industry objection.

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SUBSISTENCE), for bona fide employees for one school year for each employee so trained.

(iv) disallows grants to educational institutions since such grants are considered donations.

In connection with (ii), industry objects to the limitation of 2 hours a week for the study during working hours.

In connection with (iii), industry objects to the non-allowability of salary and subsistence. Finally, industry objects to the non-allowance of grants in (iv).

#### Government Position

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

It was felt, in connection with (ii), that this sort of activity was to be accomplished outside of working hours, but instances were found in which this was not possible. Two hours per work week appeared to be a reasonable solution. In connection with (iii) above, allocability of this expense against Government contracts is a tight question. As a matter of policy, therefore, we sought a reasonable solution and one in which a discipline to reasonableness would be provided. Sharing of the expenses provides this incentive. Grants, in (iv) above, were disallowed on the basis that grants are in fact donations and should be allowed only if contributions generally are allowable (See Item #4).

B New Proposals



Timetable for Completion

July 1958

Meetings with industry associations

September

Completion of revisions stemming from  
meetings with industry

October

Coordination of final proposal internally  
and with General Accounting Office

November

Publication

TITLE OF SECTION

In order to avoid the charge that ASPR Sec. IV is not "Cost Principles" as the present title would indicate, we recommend that the title be changed to "Contract Cost Principles and Procedures."

ADVANCE UNDERSTANDINGS

Modify 15-204.1(b) of the 21 August draft to read as follows:

"...Such agreement may be initiated by contracting officers individually or jointly for all defense work of the contractor, as may be appropriate. Any such agreement should be incorporated in cost-reimbursement type contracts or made a part of the contract file in the case of negotiated fixed-price type contracts, and should govern the cost determinations covered thereby throughout the performance of the related contract. The absence of such an advance agreement on any element of cost will not, in itself, serve to make that element either allowable or unallowable. However, the nature of certain costs is such that advance agreements are normally essential. These are:

- (i) pre-contract costs (ASPR 15-204.2 (dd));
- (ii) royalties (ASPR 15-204.2 (jj));
- (iii) travel costs, as related to special or mass personnel movement (ASPR 15-204.2 (ss)(5));

Examples of others for which such agreements are normally appropriate, though not essential, are:

- (iv) use charges for fully depreciated assets (ASPR 15-204.2 (i)(6));
- (v) compensation for personal services (ASPR 15-204.2 (f));
- (vi) deferred maintenance costs (ASPR 15-204.2 (t)(1)(ii));
- (vii) research and development costs (ASPR 15-204.2 (ii)(6)); and
- (viii) selling and distribution costs (ASPR 15-204.2 (kk)(2))."

DIRECT COSTING

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

15-202(a) Add:

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

ADVERTISING15-204.2 Listing of Costs.(a) Advertising Costs.

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

- (i) Advertising in trade and technical journals, provided such advertising does not offer specific products or services for sale but is placed in journals which are valuable for the dissemination of technical information within the contractor's industry; and
- (ii) help wanted advertising, as set forth in (gg) below, when considered in conjunction with all other recruitment costs.
- (iii) costs of participation in exhibits sponsored by the Government for the purpose of developing military applications of products.
- (iv) advertising relating to accomplishment of the contract mission for the purpose of obtaining scarce materials or equipment, or disposing of scrap or surplus materials.

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

CONTRIBUTIONS AND DONATIONS

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

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

12/9/58

### INTEREST ON BORROWINGS

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

"d. Extent of the Contractor's Investment.

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

### PLANT RECONVERSION COSTS

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

### RENTAL COSTS

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

Revise paragraph (1) of the principle to read as follows:

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

## **COST PRINCIPLES**

### **DIRECT COSTING**

**Draft as of 21 August 1958**

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

### **Special Working Group Recommendation**

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

### **Recommended Army Position**

**Concur in the Special Working Group recommendation.**



EIGHTY-SIXTH CONGRESS  
 HOUSE OF REPRESENTATIVES  
 COMMITTEE ON ARMED SERVICES  
 SUBCOMMITTEE FOR  
 SPECIAL INVESTIGATIONS

Monday  
 February 9, 1959

Hon. Perkins McGuire  
 Assistant Secretary of Defense  
 (Supply and Logistics)  
 Department of Defense  
 Washington 25, D. C.

Dear Mr. Secretary:

The subject of Section XV, Armed Services Procurement Regulations, concerning cost allowances on Department of Defense contracts is, again, on the agenda for this Subcommittee.

The staff has been informed of your interest and actions on the subject, from time to time.

As you must realize, the lack of Regulations over a period extending from 1953, to say nothing of the lack of uniformity among the Service Departments in their treatment of contractors during this period, has been a proper and continuing concern of this Subcommittee.

Now we are upon a new fiscal year and, so far, no answer or definitive policy has been laid down.

A reputable news agency has advised the Subcommittee that the information is that the Department of Air Force has directed the allowance of executive bonuses and pensions as a cost allowance under existing price redeterminable and incentive-type contracts.

I am unable to answer this inquiry and I, therefore, solicit your advice as to:

1. The status of the proposed cost allowances and revision of Section XV, Armed Services Procurement Regulations, and

Hon. Perkins McGuire

-2-

February 9, 1959

2. The fact or falsehood of the query put to me, as  
Chairman of this Subcommittee, by our inquirer.

Sincerely yours,

(Signed)

F. E. Robert  
Chairman

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

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



**Part 8—Price Negotiation Policies and Techniques**

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

**3-801 Basic Policy.**

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

**3-801.2 Responsibility of Contracting Officers.**

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

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

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

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

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

### 3-802 Preparation for Negotiation.

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

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

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

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

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

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

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

**3-805 Selection of Offerors for Negotiation and Award.**

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

- (i) where a responsible offeror submits a responsive proposal which, in the contracting officer's opinion, is clearly and substantially more advantageous to the Government than any other proposal, negotiations may be conducted with that offeror only; or
- (ii) where several responsible offerors submit offers which are grouped so that a moderate change in either the price or the technical proposal would make any one of the group the most advantageous offer to the Government, further negotiations should be conducted with all offerors in that group.

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

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

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

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

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

**3-806 Pricing Individual Contracts.**

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

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

**3-807 Cost, Profit, and Price Relationships.**

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

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

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

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

## 3-808 Pricing Techniques.

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

*3-808.2 Price Analysis.*

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

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

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



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

*3-808.3 Cost Analysis.*

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

- (i) effective competition has not been obtained;
- (ii) a valid basis for price comparison has not been established, because of the lack of definite specifications, the novelty of the product, or for other reasons;
- (iii) price comparisons have revealed apparent inconsistencies which cannot be satisfactorily explained or otherwise reasonably accounted for;
- (iv) the prices quoted appear to be excessive on the basis of information available;
- (v) the proposed contract is of a significant amount and is to be awarded to a sole source;
- (vi) the proposed contract will probably represent a substantial percentage of the contractor's total volume of business; or
- (vii) a cost-reimbursement, incentive, price redeterminable, or time and material contract is negotiated.

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

- (i) allowances for contingencies;
- (ii) the necessity for certain costs;
- (iii) the reasonableness of amounts estimated for the necessary costs;
- (iv) the basis used for allocation of overhead costs; and
- (v) the appropriateness of allocations of particular overhead costs to the proposed contract.

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

- (i) actual costs previously incurred by the contractor or offeror; and with its last prior estimate for the same or similar item or with a series of prior estimates;
- (ii) current estimates from other possible sources; and
- (iii) prior estimates or historical costs of other contractors manufacturing the same or related items.

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

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

- (i) direct labor should represent a substantial element of the total price;
- (ii) the contract price should be large enough to warrant the time spent in collecting the statistical data necessary to construct valid curves;
- (iii) the proposed contract should cover production over a relatively long period;
- (iv) a substantial body of historical labor cost data must be available; and
- (v) the product must be a complex, non-standard item requiring a substantial amount of assembly labor (where relatively large amounts of automatic machinery are to be employed, or the product is a relatively standard item, learning curves may be of little value).

## 3-808.4 Profit.

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

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

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

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

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

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

3-808.5 *Subcontracting.*

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

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

- (i) the purchasing practices of the prime contractor;
- (ii) the principal components to be subcontracted and the contemplated subcontractors, including (A) the degree of competition obtained, (B) cost or price analyses or price comparisons accomplished, and (C) the extent of subcontract supervision;
- (iii) the types of subcontracts; i. e., firm fixed-price or other (see ASPR 3-401); and
- (iv) the estimated total extent of subcontracting, including procurement of purchased parts and materials.

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

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

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

- (i) the prime contractor's purchasing policy and system or performance thereunder are considered inadequate;
- (ii) subcontracts are for items for which there is no cost information or for which the proposed prices appear unreasonable, and the amounts involved are substantial;
- (iii) close working arrangements or other business or ownership affiliations exist between the prime and the subcontractor which may preclude the free use of competition or result in higher subcontract prices than would otherwise be obtained;
- (iv) a subcontract is being proposed at a price less favorable than that which has been given by the subcontractor to the Government, all other factors such as manufacturing period and quantity being comparable; or
- (v) a subcontract is to be placed on a price redetermination, fixed-price incentive, time and material, or cost-reimbursement basis.

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

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

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

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

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

(List subcontracts)"

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

**3-809 Audit as a Pricing Aid.**

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

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

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

- (i) the evaluation of contingency allowances, overhead allocations, purchasing management efficiency, and similar cost elements;
- (ii) both the initial and subsequent pricing of contracts containing price revision clauses;
- (iii) establishing limitations on costs and price revision adjustments; and
- (iv) establishing negotiated overhead rates for cost-reimbursement type contracts.

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

- (i) inadequate knowledge concerning the contractor's accounting policies, cost systems, or substantially changed methods or levels of operation;
- (ii) previous unfavorable experience indicating doubtful reliability of the contractor's estimating, accounting, or purchasing methods;
- (iii) procurement of a new product for which cost experience is lacking; and
- (iv) contract performance requiring a substantial period of time.

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

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



COMPARISON OF THE RESEARCH AND DEVELOPMENT PRINCIPLES

Present ASPR	September 10, 1957 Draft	June 19, 1958 Draft	Differences
<p><b>General Research (undefined)</b></p> <p>Unallowable, unless otherwise provided in the contract.</p> <p>Pre-contract costs are not specifically covered.</p>	<p><b>Blue Sky</b></p> <p>Allowable and allocable against production and other research.</p> <p><b>Applied</b></p> <p>Grouped and allowed as allocated to production in the product line.</p> <p><b>Development</b></p> <p>Pre-contract costs are virtually unallowable--this prevents the capitalization and amortization permissible under the 19 June draft.</p> <p><b>August 21, 1958 Draft</b></p> <p>Same as above except that "in cases where a contractor's normal course of business does not involve production work, the costs of independent applied research and development work...are allowable...to the extent that such work is related and allocated as a direct cost to the field of effort of the Government research and development contract."</p>	<p><b>Blue Sky</b></p> <p>Grouped, allowable and allocable against production and research. Blue Sky treatment same as 10 Sept. draft.</p> <p><b>Applied</b></p> <p>Allowed as allocable against any production contract in the same product field. Permits allocation "as incurred" or capitalized upon a contractor selected basis.</p> <p>Except as to the capitalization aspect, development coverage is similar.</p>	<ol style="list-style-type: none"> <li>Under the present ASPR, "Blue Sky" research is allowable only if a specific provision is in the contract. Under the 10 Sept. draft, "Blue Sky" stands alone as allocable against all business, whereas, in the 19 June 1958 draft, applied research has been coupled with "Blue Sky" for allocation against all business.</li> <li>The present ASPR does not specifically cover applied research, simply providing that research and development expenses are allowable as specifically applicable to the supplies in services covered by the contract. Under the 10 Sept. draft "applied research" is coupled with development since both are said to be related to actual hardware and are allowable upon a product line basis, whereas under the 19 June draft, only development expense is so allowed.</li> <li>The effect of the pre-contract coverage in the 10 Sept. draft and the practice under the present ASPR coverage, is virtually to disallow all expense from previous periods which means that it is not possible, as provided in the 10 June draft, to capitalize the expense and amortize it over a reasonable period. The thought behind the 10 Sept. draft and present practice is that over a period of time allowability of the expense on a current basis will achieve equity without the difficulties inherent in the capitalization of past expenses.</li> </ol>



D Allowability

## COMPREHENSIVE CONTRACT COST PRINCIPLES

### Criteria for Allowability

Criteria for determining allowability of individual items of cost includes:

- a. Reasonableness
- b. Allocability
- c. Generally Accepted Accounting Principles
- d. Significant Deviation From Contractor's Established Practices
- e. Limitations Specifically Stated in The Contract Cost Principles

#### Reasonableness

PRUDENCE is the acid test of reasonableness. The NATURE and AMOUNT of the cost to be allowable must be that which would result from the judgment of an ordinarily prudent person in the conduct of COMPETITIVE business.

Additional tests of reasonableness for consideration are:

- a. Generally recognized as ordinary and necessary performance
- b. Arm's length bargaining
- c. Legal restrictions
- d. Specific contract terms

#### Allocability

RELATIONSHIP to the contract is the acid test of allocability. A cost is allocable; hence all costs are allocable, if it is ASSIGNABLE or CHARGEABLE to the work. In other words, allocability means that the cost is "necessary for or incidental to the performance of the contract."

AMOUNTS chargeable, or allocable, must be in fair proportion to the benefit received by the contract from the NATURE of the cost incurred (i.e. a proportionate share of the president's salary).

#### Generally Accepted Accounting Principles

Classification as DIRECT or INDIRECT costs or as credits to a contract may follow any generally accepted accounting principle or practice that is appropriate to particular circumstances.

D 1 Generally Allow-  
able Costs

D 2 Unallowable  
Costs

# COMPREHENSIVE CONTRACT COST PRINCIPLES

## Generally Allowable Costs

<u>Item</u>	<u>Made Allowable by Present ASPH Section IV</u>
Bidding costs	-
Bonding Costs	Yes
Compensation for personal services	Yes
Normal depreciation	Yes
Employee morale, health and welfare costs	-
Food services and dormitory costs	-
Fringe benefits	-
Labor relations costs	-
Insurance	-
Maintenance and repair costs	Yes
Manufacturing and production engineering costs	Yes
Material costs	Yes
Overtime and shift premiums	Yes
Patent costs	Yes
Plant protection	Yes
Precontract costs	-
Professional service costs	-
Recruiting costs	Yes
Rental costs	-
Research and development costs	-
Royalties	Yes
Service and warranty costs	-
Severance pay	-
Special tooling	-
Taxes	Yes
Trade, business, technical and professional activity costs	-
Training and educational costs	-
Transportation costs	-
Travel costs	-



## COMPREHENSIVE CONTRACT COST PRINCIPLES

### Unallowable Costs

<u>Item</u>	<u>Made Unallowable by Present ASPR Section IV</u>
Bad debts	Yes
Stock options	-
Historical contingencies	Yes
Contributions and donations	Yes
Entertainment	Yes
Excess facility costs	-
Interest	Yes
Bond discounts	Yes
Costs of financing and refinancing	Yes
Legal and professional fees paid in preparation of prospectus	Yes
Costs of preparation and issuance of stock rights	Yes
Losses on other contracts	Yes
Organization costs	Yes
Reorganization costs	Yes
Costs of raising capital	Yes
Legal, accounting and consulting services (of certain types)	Yes
Federal income taxes	Yes
Taxes in connection with financing, refinancing or refunding	Yes
Special assessments	-
Losses from sales or exchanges of capital assets	Yes
Contingent fees for securing government orders	Yes

1 December 1958



D 3 Partially Unallowable  
Costs

Issues in Items of Cost  
(in Brief)

Industry Contention

1. Advertising Costs: (i) product advertising creates mass markets, which, in turn, contribute to industry's ability to perform defense work cheaper; (ii) institutional type advertising affects employee and community relations and stimulates interest in employment; and (iii) the requirements of carrying out the contract sometimes require advertising for scarce materials, subcontracting and the like. It is contended that all should be allowed.
2. Bad Debts: Although the Government always pays its bills there are bad debts flowing from Government business which justify allowability of some bad debts.
3. Plant Reconversion Costs. Reconversion from defense work to civilian work may be so costly as to make it inequitable to require such reconversion to be paid for by the new production. It is suggested that allowability should be stated in such a way as to not preclude payment therefor by the Government.
4. Rental Costs. Industry objects to the limitations of costs to "normal costs of ownership" of (i) interplant rentals, and (ii) facilities under sale and lease-back arrangements, contending that the general rule ought to be "open market" rental worth of the property.

Evaluation and Recommendation

Both product and institutional type advertising are designed to influence the general public and should be so allocated. While we should allow the costs of carrying out the contract, we have found no reasonable way of separating this very small item from the above and therefore it is recommended that this expense be absorbed in the fee allowance.

If there are bad debt situations growing out of Government business, they are not significant. Recommendation: Continue to disallow all bad debts.

Make-ready expense ought to be allocated against the ensuing production. Recommendation: That additional reconversion costs be not allowed.

We must remove the incentive for a contractor to increase the cost of the Government by his own action. The limitation of costs to the "normal cost of ownership" accomplishes this purpose. Recommendation: Allow only the "normal cost of ownership" in the two situations described.

5. Research and Development. Allowance of applied research upon a product line basis, and disallowance of such product line research in research contracts, is criticized. The AIA criticizes, as they did in their presentation of 22 January, the requirement for negotiation of the research expense.

6. Training and Educational Costs. Industry objects to (i) the limitation of 2 hours a week for classes during working hours, (ii) allowance of only tuition, etc., (but not salary and subsistence) at post graduate levels and (iii) unallowability of grants.

Applied research has for its purpose the development of improvement of particular hardware. As such, it is appropriate that the cost thereof be borne by the product line involved and since the cost should be absorbed through sales of the product line, it should not be allocated against other research projects specifically awarded to the contractor. Recommend: No change.

The entire program was developed by the procurement, manpower and research interests of OASD and the military departments as a reasonable program under today's conditions. Recommend: No change in the principle.

# COMPREHENSIVE CONTRACT COST PRINCIPLES

## Partially Unallowable Costs

<u>Item</u>	<u>Made Unallowable by Present ASPR Section IV</u>
Advertising costs	Yes
Civil Defense costs	-
Depreciation on idle or excess facilities	-
Use charge in fully depreciated assets	Yes
Fines and penalties	-
Insurance on lives of officers, partners or proprietors	Yes
Patent costs	-
Reconversion costs	-
Costs of special benefits or emoluments offered to new employees	-
Applied research and development costs	-
Accruals for mass or abnormal severance pay	-
Commissions and bonuses	Yes
Unrecovered true depreciation	Yes
Insurance	-
Deferred maintenance	-
Lease-back costs	-

1 December 1954

D 4 Costs Requiring  
Special Tests

# COMPREHENSIVE CONTRACT COST PRINCIPLES

## Cost Requiring Special Tests or Reviews

<u>Item</u>	<u>Made Unallowable by Present ASPR Section XV</u>	<u>Special Consider- ation Required by ASPR Section XV</u>
Bidding costs	-	-
Compensation for personal services	-	Yes
Future contingencies	Yes	-
Emergency depreciation or amortization	-	-
Use charge on fully depreciated assets	-	Yes
Insurance	-	Yes
Costs of materials transferred between plants or affiliates	-	Yes
Overtime, extra-pay shift and multi-shift premiums	-	Yes
Pre-contract costs	-	Yes
Professional services costs	-	Yes
Recruiting costs	-	-
Rental costs	-	-
Research and development costs	Yes	-
Royalties	-	Yes
Selling costs	Yes	-
Severance pay	-	-
Unadjudicated taxes	-	-
Meeting or conference expense	-	-
Travel costs	-	-



E Controversial Issues  
With Industry

## COMPREHENSIVE CONTRACT COST PRINCIPLES

### Controversial Issues With Industry

A. Difference in general concepts between Industry comments and 10 September draft:

#### 1. Applicability of cost principles -

Industry: The use of cost principles in fixed-price contracts must not result in "formula pricing."

DODs: The cost principles will be used as a guide in fixed-price contracts, but will not interfere with overall price negotiation.

#### 2. "All Costs" Concept -

Industry: Government contracts should share in all normal and necessary costs of the contractor's doing business.

DODs: Government business costs are not properly chargeable to Government contracts.

#### 3. "Reasonableness" and "Allocability" of contractor's costs -

Industry: The contractor's normal accounting system should be used in determining reasonableness and allocability of various costs to Government contracts.

DODs: The contractor's accounting system may be adequate for providing profit and loss information, but may not be satisfactory for giving cost data sufficient for individual contract cost reimbursement.

#### 4. Advance agreement on disputed items -

Industry: Some industry groups object to the provision in the cost principles for encouraging advance agreement and providing in the contract for controversial items of cost.

DODs: It is necessary to settle these items in advance and avoid late disputes.

B. Differences in specific items of cost

1. Advertising expense - (allow only advertising in trade journals and "Help Wanted" advertising).

Industry: Institutional and product advertising should be allowed as a cost.

DOD: Institutional and product advertising are not necessary to obtaining or performing Government contracts. Only advertising in technical journals and "Help Wanted" advertising are allowable.

2. Compensation for personal services - ("profit sharing" allowed, stock options not allowed).

Industry: Bonuses, profit sharing plans and stock options to employees should be allowed.

DOD: Bonuses and profit sharing plans are allowed if reasonable, but not stock options.

3. Contributions and donations (disallowed)

Industry: Allow reasonable contributions and donations as costs.

DOD: They are not a cost of performing a Government contract and are not allowed.

4. Interest - (not allowed)

Industry: The cost of borrowing money to perform a contract should be an allowable cost.

DOD: Interest costs should not be allowed since allowance of interest as a cost would provide a preference for one method of obtaining capital requirements over other methods and, therefore, would provide an incentive for borrowing for the performance of our contracts even where our case requirements could be met out of available capital. The extent of capital requirements of our contracts should be considered in the fixing of fees or profits.

B. Difference in specific items of cost - continued.

5. Plant reconversion costs - (not allowed)

Industry: Cost of reconverting a plant from military to civilian production should be allowable.

DOD: Such costs should be charged to future operations.

6. Research and development costs - (allowed, but restricted)

Industry: Desires that product or applied research be charged to all work.

DOD: Allow product or applied research only if the Government is interested in the product being developed.

7. Training and education - (allowed, but restricted)

Industry: The contractor's regular training and educational programs should be reimbursable, plus educational grants.

DOD: The cost principles allow training and educational expenses, but state in detail the limitations. Educational grants are disallowed.



## ISSUES IN ITEMS OF COST

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

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

## 1. Advertising Costs (a)

### Contention

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

### Evaluation

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

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

### Recommendation

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

## 2. Bad Debts.

### Contention

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



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

#### Evaluation

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

#### Recommendation

Continue to disallow all bad debts.

#### 3. Compensation for Personal Services (f)

##### Contention

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

#### Evaluation

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

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

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

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

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

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

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

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

3. are allowable for tax purposes and in renegotiation.

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

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

b. That Stock Options--

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

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

3. are allowable for tax purposes.

#### Recommendation

Allow immediate distribution type compensation plans which may be

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

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

Contention

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

Evaluation

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

Recommendation

We recommend allowance of this element.

5. Interest and Other Financial Costs (q)

Contention

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

### Evaluation

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

### Recommendation

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

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

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

#### Contention

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

### Evaluation

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

### Recommendation

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

While continuing the basic policy against unnecessary overtime:

1. reduce administrative burdens on both Government and industry

2. retain control by the Government of overtime premium and shift premiums at Government expense of an extended nature
3. permit contractors to exercise management judgment with respect to overtime or extra pay shifts which are of a sporadic or emergency nature, or which reduces overall cost
4. apply the tests of "reasonableness" and "allocability" to overtime and shift premiums.

#### 7. Plant Reconversion Costs (cc)

##### Contention

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

##### Evaluation

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

##### Recommendation

Maintain the principle.

#### 8. Rental Costs (hh)

### Contention

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

### Evaluation

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

### Recommendation

Maintain the principle.



## 9. Research and Development Costs (ii).

### Contention

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

### Evaluation

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

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

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

### Recommendation

Maintain the principle.

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

### Contention

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

### Evaluation

The present proposal:

- (i) allows in-training and out-training at vocational and non-college levels.
- (ii) allows part-time technical, engineering and scientific education, including materials, textbooks, fees, tuition, and, if necessary straight time compensation for attendance of classes during working hours for 2 hours a week for the year (1 course).
- (iii) allows post-graduate tuition, fees, materials for fulltime scientific and engineering education (BUT NO SALARY OR SUBSISTENCE), for bona fide employees for one school year for each employee so trained.
- (iv) grants to educational institutions are considered donations and are unallowable by the draft.

The above policy was developed cooperatively by the procurement, manpower and research interests of ASD and the military departments.

During the development every aspect of the problem was reconsidered and the above was adopted as being a reasonable treatment under today's circumstances.

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

## Issues in Basic Concepts

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

### Industry Contention

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

### Evaluation

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

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

## Recommendation

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

## 2. Objective

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

## Industry Contention

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

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

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

#### Evaluation

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

#### Recommendation

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

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

#### Industry Contention

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

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



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

#### Evaluation

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

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

by inference by acceptance of such costs? We believe the answer is clearly and must be specifically stated.

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

#### Recommendation

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

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

#### Industry Contention

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

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

#### Evaluation

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

#### Recommendation

Reject the contention and reevaluate the items as appropriate.

### 3. Application

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

#### Industry Contention

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

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

#### Evaluation

We recognize that our proposed provision [15-101(a)(11)(A)] cannot be strictly enforced upon contractors, particularly in connection with precontract negotiations. However, the statement of fact that contractors are expected to follow these principles as a guide will, we believe, be effective in most cases. However, whether industry accepts or not, we need an objective standard by which to evaluate price proposals and if industry includes unallowable cost elements we need to be able to identify such costs through expanded audit evaluation of proposals.

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

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

### Recommendation

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

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

### Industry Contention

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

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

### Evaluation

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

#### Recommendation

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

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

a. Reasonableness as a standard.

#### Industry Contention

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

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



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

#### Evaluation

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

#### Recommendation

The concept is sound and should be maintained.

b. Allocability as a standard.

#### Industry Contention

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

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

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

#### Evaluation

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

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

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

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

#### Recommendation

That this approach be continued.

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

#### Industry Contention

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

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

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

#### Evaluation

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

#### Recommendation

Maintain the concept at this time.

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

#### Industry Contention

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

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

#### Evaluation

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

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

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

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

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

#### Recommendation

That this general approach be continued.



## ISSUES IN ITEMS OF COST

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

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

### 1. Advertising Costs (a)

#### Contention

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

#### Evaluation

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

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

#### Recommendation

Disallow product and institutional advertising.

#### 2. Bad Debts.

##### Contention

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

##### Evaluation

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

#### Recommendation

Continue to disallow all bad debts.

#### 3. Plant Reconversion Costs (cc)

##### Contention

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

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

#### Evaluation

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

#### Recommendation

Maintain the principle.

#### 4. Rental Costs (hh)

##### Contention

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

#### Evaluation

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

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

#### Recommendation

Maintain the principle.

#### 5. Research and Development Costs (ii)

##### Contention

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

##### Evaluation

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

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

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

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

#### Recommendation

Maintain the principle.

#### 6. Training and Educational Costs (qq).

##### Contention

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

##### Evaluation

The present proposal:

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

- (ii) allows part time technical, engineering and scientific education, including materials, textbooks, fees, tuition and, if necessary straight time compensation for attendance of classes during working hours for 156 hours per year.
- (iii) allows post-graduate tuition, fees, materials for fulltime scientific and engineering education (BUT NO SALARY OR SUBSISTENCE), for bona fide employees for one school year for each employee so trained.
- (iv) grants to educational institutions are considered donations and are unallowable by the draft.

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

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

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

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

#### Recommendation

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





# MACHINERY & Allied Products INSTITUTE

# BULLETIN

REPUBLIC 7-6512

1200 EIGHTEENTH STREET, N.W. • WASHINGTON 6, D.C.

No. 3569

November 17, 1958

## GOVERNMENT CONTRACTS

### CONTRACT COST PRINCIPLES: MAPI Files Statement Supplementing Its Presentation During DOD Hearings on Proposed Set of Comprehensive Contract Cost Principles

As indicated in Bulletin 3560, MAPI participated in a joint government-industry conference at the Department of Defense on October 15, regarding the proposed set of comprehensive contract cost principles. Supplementing our oral presentation a written statement has been submitted to Assistant Secretary of Defense Perkins McGuire, the text of which is reproduced in this bulletin.

The MAPI statement of November 14 stands firm on the proposition advanced and documented by MAPI since 1956, namely, that under no circumstances should contract cost principles of the type embodied in ASPR, Section XV, be applied to fixed-price contracts. This position is spelled out fully in the MAPI statement in terms of current public policy on the subject supporting the MAPI position, pertinent regulations of the Department of Defense which would be in conflict with any single set of cost principles, and the need, in our view, of a complete reappraisal of the concept that a single set of cost principles be uniformly applicable in government prime and subcontracting. The Institute has consistently reasoned and argued that the result of the current DOD proposal would be to convert fixed-price contracting into formula pricing as employed in cost-reimbursement type situations.

Our other specific recommendations are summarized on page 12 of the letter to Secretary McGuire. In addition to the problem of fixed-price contracting the statement recommends that advertised contracts, most subcontracts, and contract terminations be excluded from the applicability of the proposed regulation. Treatment of specific cost disallowances is covered in the December 16, 1957, MAPI statement entitled "Defense Procurement and Contract Costs" which is incorporated as a part of our current presentation.

Comments and further suggestions from interested member companies will be appreciated. May we acknowledge again assistance from the MAPI Accounting Council and the CTA Financial Council in connection with the Institute's work in this area.




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November 14, 1958

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

My dear Mr. McGuire:

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

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

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



MACHINERY & ALLIED PRODUCTS INSTITUTE AND ITS AFFILIATED ORGANIZATION, COUNCIL FOR TECHNOLOGICAL ADVANCEMENT, ARE ENGAGED IN RESEARCH IN THE ECONOMICS OF CAPITAL GOODS (THE FACILITIES OF PRODUCTION, DISTRIBUTION, TRANSPORTATION, COMMUNICATION AND COMMERCE) IN ADVANCING THE TECHNOLOGY AND FURTHERING THE ECONOMIC PROGRESS OF THE UNITED STATES



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

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

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

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

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

In addition to its numerous recommendations for enlargement and improvement of our national defense in terms of military programs and weaponry--with which this statement is not directly concerned--the Johnson Subcommittee recommended in connection with stepping up the tempo of our defense effort a simplification of our military procurement procedures. With this latter recommendation our statement most emphatically is concerned.

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

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

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

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

General Quesada, newly appointed Administrator of The Federal Aviation Agency, bespoke this attitude in a recent speech in which he suggested that industry and government must "start work immediately on working out some new concepts embracing the ways in which we reward industry's efforts for scientific and technological development of advanced weapons." The report of the ad hoc Committee on Research and Development of the U. S. Air Force Scientific Advisory Board--the Stever Report--emphasizes the same point in these words: "Contracting procedures should be changed to give contractors greater incentive to do research development work more effectively." In the legislative area the extension of the Renegotiation Act for a period of only six months--with the proviso that the process be subjected in the meantime to a searching Congressional study--would seem to offer further evidence of a new look by Congress at the whole question of providing incentives and removing disincentives to more efficient production of war materiel.

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

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

### Considerations of Public Policy

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

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

In addition to these express legislative and administrative preferences of procurement policy, ASPR itself contains one further significant statement of general procurement policy that deserves repetition in this connection: "It is the policy of the Department of Defense to procure supplies and services from responsible sources at fair and reasonable prices, calculated to result in the lowest ultimate over-all cost to the government."

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

At the risk of repetition we cannot fail to add that the widespread and continuing suggestions for the enhancement of private incentive in defense

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work--to some of which we have referred briefly above--are not only entirely consistent with these basic policies of military procurement but would lead almost certainly, in our judgment, to improved contract performance, an increased interest in defense production and a very considerable reduction in ultimate over-all cost to the government.

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

We do not believe that it would.

#### The Present Proposal

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

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

The nature of the proposal.--As a part of the colloquy on the subject of applicability at the recent Pentagon conference, the observation was made that industry spokesmen were confusing the applicability of proposed cost principles with their content. We submit that one can no more consider the results of applying this proposal without considering all four corners of the document than one could judge the worth of a horse without examining the beast. What, exactly, is the nature of this proposal?

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



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

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

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

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

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

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

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

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

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

The proposal's use in "cost-related areas".---The case for an across-the-board application of contract cost principles appears to rest finally upon the proposition that such a standard is required for examination of "cost-related areas" under both fixed-price and cost-price contracts. A corollary proposition holds that a cost under a fixed-price contract is no different from a corresponding cost under a cost-type contract and that both should, therefore, be judged by reference to the same standard, i.e., a common or comprehensive set of cost principles.

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

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

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

This contrast goes to the very heart of our case against a comprehensive set of cost principles just as the propositions recited above

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constitute--as we understand it--the core of your staff's case for their adoption. With the issue thus squarely joined let us consider for a moment what this proposal would do to contractor incentive.

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

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

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

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

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

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

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

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

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

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

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

It seems to us that this further evidence of insistence on rigid application of the proposed cost principles in all "cost affected" areas emphasizes once again the spurious logic of applying them to all types of contract price negotiations in the first instance. As we have already suggested

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in our discussion of the essential difference between fixed-price and cost-price contracting situations, we think the logic of a general and unrestricted application of the proposed cost principles is wholly illusory.

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

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

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

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

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

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

"In other than cost-reimbursement contracts, the government audit report is merely advisory and generally the form of the report clearly segregates, in separate columns, those costs which are accepted, those which are questioned, and those which are disallowed--so as to permit proper examination at the contracting officer and



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Board levels in accordance with the cost principles applicable to the particular type of contract involved."  
(Underscoring supplied.)/2

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

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

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

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

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

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

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



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We repeat our suggestions of the past--which are set out in the attachment to this letter--that, with minor exceptions dictated by law and public policy, those portions of all legitimate and reasonable costs of doing business properly allocable to government work should be reimbursed as proper contract costs. We cannot but view with dismay a situation in which this principle is to be all but obliterated in government contract work.

Specific Recommendations as to Applicability of the Present Proposal Summarized

1. That the draft of comprehensive contract cost principles not be published in its proposed form.
2. That if the Department of Defense desires to pursue the goal of a broadly applicable set of cost principles, that it confine the publication of regulations in the area to principles alone, as suggested on pages 11 and 12 of our letter of December 16, 1957, copy attached.
3. That if a set of cost principles in the approximate form of this proposal is to be published, that certain specific exemptions be made to its applicability, as summarized below:
  - (a) That contract cost principles be made specifically inapplicable to (1) advertised contracts, (2) all firm, fixed-price contracts, (3) all subcontracts except those clearly involving privity with the government, and (4) contract terminations. (As a corollary we recommend that cost principles now appearing in Section VIII of ASPR be retained for application to contract termination.)
  - (b) That as to all other types of fixed-price contracts, general principles only (enumerated in Paragraphs 15-100 through 15-203 of the proposed draft) as distinguished from that portion of the draft which is a catalog of allowances and disallowances (15-204 "Application of Principles and Standards") be made applicable to such contracts.

Application of Principles and Standards

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

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

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Honorable Perkins McGuire

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

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

Respectfully yours,

*Charles Stewart*  
P r e s i d e n t

CWS:mo  
Enclosure

F Comptroller General  
Letter

COST PRINCIPLE FOR RESEARCH AND DEVELOPMENT

1. Basic research, for the purpose of this regulation, is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than any practical application thereof. Applied research, for the purpose of this regulation, consists of that type of effort which (1) normally follows basic research, but may not be severable from the related basic research, (2) represents efforts to determine and expand the potentialities of new scientific discoveries, and techniques, and (3) represents efforts to "advance the state of the art." Applied research does not include any such efforts when their principal aim is the design, development, or test of specific articles or services to be offered for sale, which are within the definition of the term development as hereinafter provided.

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

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

4. A contractor's costs of independent research as defined in (1) and (3) above shall be allowable as indirect costs (subject to paragraph (8) below), provided they are allocated to all work of the contractor.

5. Cost of contractor's independent development, as defined in paragraphs (2) and (3) above (subject to paragraph (8) below), are allowable to the extent that such development is related to the product lines for which the government has contracts, provided the costs are reasonable in amount and are allocated as indirect costs to all work of the contractor on such contract product lines. In cases where a contractor's normal course of business does not involve production work, the cost in independent development is allowable to the extent that such development is related and allocated as an indirect cost to the field of effort of government research and development contracts.

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

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

8. The reasonableness of expenditures for independent research and development should be determined in light of all pertinent considerations such as previous contractor research and development activity, cost of past programs and changes in science and technology. Such expenditures should be pursuant to a broad planned program, which is reasonable in scope and well managed. Such expenditures should be scrutinized with great care in connection with contractors whose work is predominantly or substantially with the government. Advance agreements as described in ASPR 15-204.1(b),



are particularly important in this situation. In recognition that cost sharing of the contractor's independent research and development program may provide motivation for more efficient accomplishment of such program, it is desirable in some cases that the government bear less than an allocable share of the total cost of the program. Under these circumstances, the following are among the approaches which may be used as the basis for agreement: (i) review of the contractor's proposed research program and agreement to accept the allocable costs of specific research projects; (ii) agreement on a maximum dollar limitation of costs, an allocable portion of which will be accepted by the Government; and (iii) agreement to accept the allocable share of a percentage of the contractor's planned research program.



*Rec APL #6  
12 Jul 53  
APL #4  
16 June 54*

*Return to  
Proc. Div.*

NUMBER 4105.34  
DATE 1 July 1954

## Department of Defense Instruction

SUBJECT

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

### I. PURPOSE

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

- "6. For the purpose of cost computations in negotiated contract pricing, true depreciation, which includes any extraordinary obsolescence reasonably assignable to the emergency period, is allowable. Any accelerated amortization of depreciation which is in excess of true depreciation, regardless of whether such excess is included in tax amortization certificates, is not allowable as an element of cost in negotiated contract pricing.
- "7. It is recognized that cost determination in negotiated contract pricing is a function of the procurement agency concerned. With respect to facilities to be used in the performance of negotiated contracts for which certificates have been or will be issued, the procurement agencies concerned will, to the extent required for the purpose of cost computations in connection with the negotiation of contract prices, have the responsibility for determining true depreciation. The Office of Defense Mobilization will, on request, furnish the procurement agency concerned with such information as it has or is readily available to it which is pertinent to the determination of true depreciation."

### II. APPLICABILITY

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

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

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

### III. BASIC PRINCIPLES

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

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

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

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

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

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

1. The estimated prospective post-emergency usefulness of the facilities in number of years of useful productive life. Consideration should be given to the post-emergency use (both civilian and military) which it is expected the facilities will have. In this connection, the character of the expected post-emergency use may be different than the emergency-period use.
2. The additional costs of special-construction features of the facilities fairly assignable exclusively to defense requirements.
3. Subject to the application of the principles outlined herein, consideration shall be given to the portion of the cost of emergency facilities certified for amortization plus so-called normal depreciation for tax purposes during the emergency period on the uncertified portion of the cost of such facilities. (See particularly paragraphs F and G of this section.)
4. The normal peacetime life of facilities having a normal peacetime utility. If Bulletin F of the Bureau of Internal Revenue is used in connection herewith, care must be exercised in its use, as its data may not be typical of any specific contractor or industry, especially in the emergency period.

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

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

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

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



#### IV. PROCEDURES

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

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

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

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

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

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

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

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

#### V. CANCELLATION


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

#### VI. IMPLEMENTATION

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

#### VII. EFFECTIVE DATE

This instruction is effective on the day of issuance.



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



OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

Supply and Logistics

September 7, 1960

Dear Admiral Boyle:

31  
Your letter of 8 July asks for our response to nine specific questions relating to the application of ASPR 15-205.35, covering allowability of a contractor's independent research and development costs, in light of the provisions of ASPR 15-107 which provides for an advance understanding on particular cost items (including research and development), and DOD Instruction 4105.52 which provides for uniform negotiation of such costs and establishes an Armed Services Research Specialists Committee to provide scientific and technical advice in connection with the negotiation.

At the outset a brief analysis of the documents cited may facilitate an understanding of the problem.

ASPR 15-205.35 allows a contractor's independent research and development expenses on the basis specifically described. It indicates that advance understandings are particularly important with contractors whose work is predominantly or substantially with the Government. General guidelines as to the reasonableness of this cost item are included and several alternative techniques are provided for use in those situations where it is determined that the cost is unreasonable and, hence, the Government should not bear its full allocable share of the total research program.

DOD Instruction 4105.52 makes provision for the negotiation of contractors' independent research and development costs by a single military department when (i) the research and development costs are substantial, (ii) a substantial portion of the contractor's business is with the Department of Defense, and (iii) the contractor's defense work involves contracts with more than one military department. The Instruction also establishes the Armed Services Research Specialists Committee and assigns to the Committee the mission of providing, when requested, advice to the sponsoring department on the scientific and technical factors which influence the extent to which the independent program should be supported.

Now we will respond to your specific questions.

1. Question 1 presumes that the Armed Services Research Specialists Committee will negotiate advance understandings. As stated above, the negotiations of research costs will be undertaken by the military departments rather than by the Research Specialists Committee. While the recommendations of the ASRSC will necessarily be advisory in nature, they will, nevertheless, be given great weight by the military departments.

The second portion of the question has to do with whether the negotiation procedures are available (a) to any contractor who desires to recover research and development expenses, or (b) who also does business with more than one department. It will not be necessary for all contractors who desire recovery of independent research and development expense to be considered under the procedures established by DOD Instruction 4105.52. Thus, where a small amount of cost is involved, either because of the size of the research and development program or due to the minor amount of defense contracts, or where a contractor is dealing only with one Department, it will usually not be feasible to utilize the centralized negotiation procedure. However, a contractor who is dealing with more than one military department and who particularly desires to negotiate a centralized advance understanding, notwithstanding the amount of cost involved, will be accommodated to the extent that the current workload will permit. A contractor who is dealing with only one department, but with several different activities within the one department, may request a centralized negotiation within the department, the results of which will be used throughout the department.

2. This question asks whether the dollar volume of contracting determines whether a contractor will negotiate centrally and inquires if there are additional factors which suggest the need for such negotiation. The dollar volume of contracting, as such, is not significant; however, the amount of independent research and development expense allocable to defense work is an important criterion. Additional factors are whether a substantial portion of the contractor's business is with the Department of Defense and whether the contractor's defense work involves contracts with more than one military department.

3. This question asks if contractors who will participate in the centralized negotiation of research and development expense will be limited to those who negotiate final overhead rates on a centralized basis. The centralized negotiation of research and development expense will not be restricted to those who centrally negotiate final overhead rates. Advance understandings reached by the research and development negotiators will of course be utilized during the negotiation of final overhead rates.

4. This question asks the role that Government scientific and technical personnel will play in negotiating advance understandings in the research and development area. The Armed Services Research Specialists Committee will review, when requested by the negotiator representing the sponsoring department, the independent research and development programs of defense contractors and will determine whether there has been an adequate segregation between the independent research and the independent development programs. Additionally, the committee will report and make recommendations directly to the sponsoring department on the scientific and technical factors affecting the basis or extent to which a contractor's independent research and development program should be supported. In carrying out its responsibilities, the committee will utilize, where appropriate, the services of other research specialists.

5. This question asks whether the military departments will "control" a contractor's independent research and development program. Our approach is concerned only with the problem of cost allowability and not "control." When the cost of a contractor's independent research and development program is found to be "reasonable", there is no question of "control" involved. Of course, when a determination is made that a contractor's proposed program is not reasonable and, hence, the full allocable portion will not be allowed, there is a measure of control being exercised. This type of control, however, is oriented toward the reimbursement of costs under Defense contracts. Any contractor is obviously free to pursue any type or level of research at his own expense. The provision making independent development costs allowable only on the basis of a showing of relationship of such costs to the product lines for which the Government has contracts might be considered a type of control. However, broad control of the contractor's independent research and development program is not intended.

6. This question asks if a distinction will be made between contractors whose business is primarily commercial as against those whose business is primarily Government. The mix of Government and commercial business is an important consideration in connection with the evaluation of many elements of cost and will be particularly so in connection with research and development costs. We have found it necessary to scrutinize costs with more care in connection with contractors whose work is predominantly or substantially with the Government. However, the same tests of reasonableness will be applied in each instance and the mix of government and commercial business will not, per se, control the final result.

7 and 8. These questions concern themselves with the use of cost sharing formulae and request clarification as to whether cost sharing is appropriate unless there has been a preliminary finding that the over-all cost is unreasonable. It is our view that a preliminary decision of unreasonableness should generally precede the use of cost sharing methods. In the event a contractor's business is substantially commercial, it is expected that the pro rata amount of research and development expense allocated to commercial business will act as a deterrent to the incurring of unreasonable or unnecessary costs. In such instances a cost sharing arrangement will not normally be necessary or desirable. However, in those instances where a contractor's business is primarily with the Government and the contractor's research and development program is so substantial as to appear to be unreasonable in amount, it may be desirable to enter into a cost sharing arrangement in order to provide a motivation for more efficient accomplishment of the program.

9. This question asks whether further guidelines will be issued to contracting officers setting forth tests of reasonableness or other criteria for the recognition of research and development costs. While we do not now

anticipate that further direction will be necessary from this level, experience in operation may dictate otherwise. In addition, the military departments will issue such implementing instructions of a procedural nature as are necessary to operate the system which has been established.

Sincerely yours,

G. C. BANNERMAN

Director for Procurement Policy

Rear Admiral Jas. D. Boyle, USN (Ret)

National Security Industrial Association, Inc.

1107 - 19th Street, N. W.

Washington 6, D. C.

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

Supply and Logistics

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The second portion of the question has to do with whether the negotiation procedures are available (a) to any contractor who desires to recover research and development expenses, or (b) who also does business with more than one department. It will not be necessary for all contractors who desire recovery of independent research and development expense to be considered under the procedures established by DOD Instruction 4105.52. Thus, where a small amount of cost is involved, either because of the size of the research and development program or due to the minor amount of defense contracts, or where a contractor is dealing only with one Department, it will usually not be feasible to utilize the centralized negotiation procedure. However, a contractor who is dealing with more than one military department and who particularly desires to negotiate a centralized advance understanding, notwithstanding the amount of cost involved, will be accommodated to the extent that the current workload will permit. A contractor who is dealing with only one department, but with several different activities within the one department, may request a centralized negotiation within the department, the results of which will be used throughout the department.

2. This question asks whether the dollar volume of contracting determines whether a contractor will negotiate centrally and inquires if there are additional factors which suggest the need for such negotiation. The dollar volume of contracting, as such, is not significant; however, the amount of independent research and development expense allocable to defense work is an important criterion. Additional factors are whether a substantial portion of the contractor's business is with the Department of Defense and whether the contractor's defense work involves contracts with more than one military department.

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4. This question asks the role that Government scientific and technical personnel will play in negotiating advance understandings in the research and development area. The Armed Services Research Specialists Committee will review, when requested by the negotiator representing the sponsoring department, the independent research and development programs of defense contractors and will determine whether there has been an adequate segregation between the independent research and the independent development programs. Additionally, the committee will report and make recommendations directly to the sponsoring department on the scientific and technical factors affecting the basis or extent to which a contractor's independent research and development program should be supported. In carrying out its responsibilities, the committee will utilize, where appropriate, the services of other research specialists.



5. This question asks whether the military departments will "control" a contractor's independent research and development program. Our approach is concerned only with the problem of cost allowability and not "control." When the cost of a contractor's independent research and development program is found to be "reasonable", there is no question of "control" involved. Of course, when a determination is made that a contractor's proposed program is not reasonable and, hence, the full allocable portion will not be allowed, there is a measure of control being exercised. This type of control, however, is oriented toward the reimbursement of costs under Defense contracts. Any contractor is obviously free to pursue any type or level of research at his own expense. The provision making independent development costs allowable only on the basis of a showing of relationship of such costs to the product lines for which the Government has contracts might be considered a type of control. However, broad control of the contractor's independent research and development program is not intended.

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7 and 8. These questions concern themselves with the use of cost sharing formulae and request clarification as to whether cost sharing is appropriate unless there has been a preliminary finding that the over-all cost is unreasonable. It is our view that a preliminary decision of unreasonableness should generally precede the use of cost sharing methods. In the event a contractor's business is substantially commercial, it is expected that the pro rata amount of research and development expense allocated to commercial business will act as a deterrent to the incurring of unreasonable or unnecessary costs. In such instances a cost sharing arrangement will not normally be necessary or desirable. However, in those instances where a contractor's business is primarily with the Government and the contractor's research and development program is so substantial as to appear to be unreasonable in amount, it may be desirable to enter into a cost sharing arrangement in order to provide a motivation for more efficient accomplishment of the program.

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/s/

G. C. BANNERMAN  
Director for Procurement Policy

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Proposed Amendments to Draft Dated 10 September 1957

SECTION XV

CONTRACT COST PRINCIPLES

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

Part 1 - Applicability

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

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

- (1) As a contractual basis, by incorporation by reference in the contract, for determination of:
  - (A) reimbursable costs under cost-reimbursement type contracts including cost-reimbursement type subcontracts thereunder and the cost-reimbursement portion of time and materials contracts;
  - (B) terminations when the amounts thereof are determined unilaterally by the contracting officer;
  - (C) costs of terminated cost-reimbursement contracts.

- (ii) As a basis for:
- (A) the development and submission of cost data and price analyses by contractors and prospective contractors as required in support of negotiated pricing, repricing, negotiated overhead rates, requests for progress payments, and settlement proposals under termination;
  - (B) audit reports prepared by the Audit Agencies in their advisory capacity of providing accounting information respecting negotiated pricing, repricing and termination.
- (iii) By Contracting Officers in the evaluation of cost data, as follows:
- (A) In Retrospective Pricing and Settlements. In negotiating firm fixed prices or settlements for work which has been completed or substantially completed at the time of negotiation (e.g., final negotiations under fixed-price incentive contract, redetermination of price after completion of the work, negotiation of final overhead rates, or negotiation of a settlement agreement under a contract terminated for the convenience of the Government), the treatment of costs is a major factor in arriving at the amount of the price or settlement. Accordingly, ASPR, Section IV, Part 2, shall serve as the basis for evaluation of cost data. However, the finally agreed price or settlement represents something other than the sum total of acceptable costs, since the final price accepted by each party does not necessarily reflect agreement on the

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

- (B) In Forward Pricing. To the extent that costs are a factor in forward pricing, ASFR, Section 17, Part 2, shall serve as a guide in the evaluation of cost data. The extent to which costs influence forward pricing varies greatly from case to case. In negotiations covering future work, actual costs cannot be known and the importance of cost estimates depends on the circumstances. The contracting officer must consider all the factors affecting the reasonableness of the total proposed price, such as the technical, production or financial risk assumed, the complexity of work, the extent of competitive pricing, and the contractor's record for efficiency, economy and ingenuity, as well as available cost estimates. He must be free to bargain for a total price which equitably distributes the risks between the contractor and the Government and provides incentives for efficiency and cost reduction. In negotiating such a price, it is not possible to identify the treatment of specific cost elements since the bargaining is on a total price basis. Thus, while Part 2 will be used to evaluate cost data, it will not control negotiation of prices for work to be performed in the future, e.g., negotiation of a firm fixed-price contract, an intermediate price revision covering, in whole or important part, work which is yet

Draft  
21 August 1958

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

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

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



Negotiation Requirement

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

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

- (i) compensation for personal services (ASPR 15-204.2(f));
- (ii) use charges for fully depreciated assets (ASPR 15-204.2(i)(6));
- (iii) food and dormitory service furnished without cost to employees or involving significant losses (ASPR 15-204.2(n));
- (iv) deferred maintenance costs (ASPR 15-204.2(t)(1)(ii));
- (v) pre-contract costs (ASPR 15-204.2(dd));
- (vi) research and development costs (ASPR 15-204.2(ii)(6));
- (vii) royalties (ASPR 15-204.2(jj));

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- (viii) selling and distribution costs (ASPR 15-204.2(kk)(2)); and
- (ix) travel costs, as related to special or mass personnel movement (ASPR 15-204.2(ss)(5)).

Compensation for Personal Services

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

(f) Compensation for Personal Services.

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

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

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

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

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

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

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

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

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

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

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

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

- (i) valuation placed on the stock transferred shall be the fair market value at the time of transfer, determined upon the most objective basis available; and
- (ii) accruals for the cost of stock prior to the issuance of such stock to the employees shall be subject to adjustment according to the possibilities that the employees will not receive such stock and their interest in the accruals will be forfeited.

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

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

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

*Proposed Amendments to Draft Dated 10 Sept 57*  
*Sec 15 - 204.2(f)(6)(b)*

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

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

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

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

- (i) abnormal forfeitures that are foreseeable and which can be currently evaluated with reasonable accuracy, by actuarial or other sound computation, shall be reflected by an adjustment of current costs otherwise allowable; and
- (ii) abnormal forfeitures, not within (i) above, may be made the subject of agreement between the Government and the contractor either as to an equitable adjustment or a method of determining such adjustment.

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

(7) Fringe Benefits. See (o).

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



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- (9) Training and Education Expenses. See (qq).
- (10) Insurance and Indemnification. See (p).

(11) Research and Development Costs.

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

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

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

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

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

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

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

(7) Overtime, Extra-Pay Shift and Multi-Shift Premiums. Overtime, extra shifts, and multi-shift work is allowable to the extent approved pursuant to contract or other arrangement, subject to the extent that such work is authorized by ASPR 12-102.4, or authorized pursuant to ASPR 12-102.5.

to be related and allocated as an indirect cost to the field of effort of the Government applied research and development contracts.

(8) Independent research and development projects shall absorb

their appropriate share of the indirect costs of the department where the work is performed.

(9) Research and development costs (including amounts capitalized)

regardless of their nature, which were incurred in accounting periods prior to the award of a particular contract, are unallowable.

(10) In addition to the definition of reasonableness provided in

ASPR 12-204.3, the reasonableness of expenditures for independent research

and development should be determined in light of the pattern of the cost of

past programs (particularly those existing prior to the placing of Government

contracts), with due consideration to changes in science and technology. Such

expenditures may be substantiated when made in connection with contracts

whose work is predominantly or substantially with the Government. Where such

expenditures are not subject to the restrictions of commercial product pricing,

there must be assurance that these expenditures are made pursuant to a planned

research program which is reasonable in scope and is well managed. The costs

should not exceed those which would be incurred by an ordinarily prudent

person in the conduct of a competitive business. (See ASPR 12-204.1(d).)

COST PRINCIPLE FOR RESEARCH AND DEVELOPMENT

1. Basic research, for the purpose of this regulation, is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than any practical application thereof. Applied research, for the purpose of this regulation, consists of that type of effort which (1) normally follows basic research, but may not be severable from the related basic research, (2) represents efforts to determine and expand the potentialities of new scientific discoveries, and techniques, and (3) represents efforts to "advance the state of the art." Applied research does not include any such efforts when their principal aim is the design, development, or test of specific articles or services to be offered for sale, which are within the definition of the term development as hereinafter provided.

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

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

4. A contractor's costs of independent research as defined in (1) and (3) above shall be allowable as indirect costs (subject to paragraph (8) below), provided they are allocated to all work of the contractor.

COST PRINCIPLE FOR RESEARCH AND DEVELOPMENT

1. Basic research, for the purpose of this regulation, is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than any practical application thereof. Applied research, for the purpose of this regulation, consists of that type of effort which (1) normally follows basic research, but may not be severable from the related basic research, (2) represents efforts to determine and expand the potentialities of new scientific discoveries, and techniques, and (3) represents efforts to "advance the state of the art." Applied research does not include any such efforts when their principal aim is the design, development, or test of specific articles or services to be offered for sale, which are within the definition of the term development as hereinafter provided.

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

4. A contractor's costs of independent research as defined in (1) and (3) above shall be allowable as indirect costs (subject to paragraph (8) below), provided they are allocated to all work of the contractor.

DRAFT - 18 Feb 1959

## Part 7 - Fixed-Price Type Contracts

15-700 Scope of Part. This Part sets forth the guidelines to be used for the evaluation of costs in negotiated fixed-price type contracts and subcontracts, including terminations thereof, in those instances where such evaluation is required to establish prices for such contracts.

"Fixed-price type" contracts include, for purposes of this Part, the following:

- (i) firm fixed-price contracts (ASPR 3-403.1)
- (ii) fixed-price contracts with escalation (ASPR 3-403.2)
- (iii) fixed-price contracts providing for the redetermination of price (ASPR 3-403.3)
- (iv) fixed-price incentive contracts (ASPR 3-403.4)
- (v) non-cost-reimbursable portion of time and materials contracts (ASPR 3-405.1)

15-701 Basic Considerations. (a) Under fixed-price type contracts, the negotiated price is the basis for payment to a contractor whereas allowable costs are the basis for reimbursement under cost-reimbursement type contracts. Accordingly, the policies and procedures of ASPR Section III, Part 2, are governing and shall be followed in the negotiation of fixed-price type contracts. Cost and accounting data may provide guides for ascertaining fair compensation but are not rigid measures of it. Other types of data, criteria, or standards may furnish equally reliable guides to fair compensation. The ability to apply standards of business judgment as distinct from strict accounting principles is at the heart of a negotiated price or settlement.



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

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

(ii) Forward Pricing. The extent to which costs influence forward pricing varies greatly from case to case. In negotiations covering future work, actual costs cannot be known and the importance of cost estimates depends on the circumstances. The contracting officer must consider all the factors affecting the reasonableness of the total proposed price, such as the technical, production or financial risk assumed, the complexity of work, the

extent of competitive pricing, and the contractor's record for efficiency, economy and ingenuity, as well as available cost estimates. We must be free to bargain for a total price which equitably distributes the risks between the contractor and the Government and provides incentives for efficiency and cost reduction. In negotiating such a price, it is not possible to identify the treatment of specific cost elements since the bargaining is on a total price basis. Thus, while cost data is often a valuable aid, it will not control negotiation of prices for work to be performed in the future, e.g., negotiation of a firm fixed-price contract, an intermediate price covering, in whole or important part, work which is yet performed, or a target price under an incentive contract.

15-702 Cost Principles and Their Use. When pursuant to ASPR 15-701, costs are to be considered in the negotiation of fixed-price type contract, Section IV, Part 2, shall be used as a guide in the evaluation of cost data required to establish a fair and reasonable price in conjunction with other pertinent considerations set forth more fully in ASPR Section III, Part 6.

(b) Whenever an occasion arises in which acceptability of a specific item of cost becomes an issue, Section IV, Part 2, will serve as a guide for the resolution of the issue.

(c) In applying Part 2 of this Section IV to fixed-price contracts, contracting officers will: (i) not be required to negotiate agreement on each

individual element of cost; and (ii) be expected to use their judgment as to the degree of detail in which they consider the individual elements of cost in arriving at their evaluation of total cost, where such evaluation is appropriate. However, the negotiation record should fully substantiate and justify the reasoning leading to any negotiated price.

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15 Dec 58/JMM

### COMPENSATION

- A. To take care of the gigantic problem incident to an examination of ALL compensation plans, change paragraph (b) as follows:

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

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

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

## Part 7 - Fixed-Price Type Contracts

15-700 Scope of Part. This Part sets forth the guidelines to be used for the evaluation of costs in negotiated fixed-price type contracts, including terminations thereof, in those instances where such evaluation is required to establish prices for such contracts. "Fixed-price type" contracts include, for purposes of this Part, the following:

- (i) firm fixed-price contracts (ASPR 3-403.1)
- (ii) fixed-price contracts with escalation (ASPR 3-403.2)
- (iii) fixed-price contracts providing for the redetermination of price (ASPR 3-403.3)
- (iv) fixed-price incentive contracts (ASPR 3-403.4)
- (v) non-cost-reimbursable portion of time and materials contracts (ASPR 3-405.1)

15-701 Basic Considerations. (a) Under fixed-price type contracts, prices, not separate elements of cost plus profit, are to be negotiated. A negotiated price is the basis for payment to a contractor under fixed-price type contracts; allowable costs are the basis for reimbursement under cost-reimbursement type contracts. Accordingly, the policies and procedures of ASPR Section III, Part 8, are governing and shall be followed in the negotiation of fixed-price type contracts.

(b) As recognized in ASPR Section III, Part 8, there are within the fixed-price type category of contracts certain situations, e.g., incentive and redeterminable contracts, in which costs are a significant factor in the negotiation of prices. In such situations, costs must be submitted by contractors, evaluated by the Government, and used as



appropriate in negotiating fair and reasonable prices. However, since the basic objective, even in these situations, is the negotiation of a price rather than the determination of allowable and unallowable costs, the use of cost principles must be flexible.

15-702 Cost Principles and Their Use. (a) When, pursuant to ASFR 15-701, costs are to be considered in fixed-price type contracts, Section IV, Part 2, shall be used to provide general guidance in the consideration of cost data in conjunction with other pertinent considerations as set forth more fully in ASFR Section III, Part 8, required to establish a fair and reasonable price.

(b) In using Part 2 of this Section IV for general guidance, contracting officers are not necessarily required to evaluate specifically each individual item of cost (as is required for cost-reimbursement type contracts) in establishing a price; nor shall they be required, in substantiating or justifying a negotiated price, to explain the treatment accorded each such item of cost. Notwithstanding the above, contracting officers are required to fully substantiate and justify any negotiated price. (See ASFR 1-811).

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COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON 25

B-124125

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

Dear Mr. McGuire:

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

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

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

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

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

- (i) the determination of historical costs
- (ii) the preparation and presentation of cost estimates by contractors and subcontractors, and
- (iii) the review, audit and evaluation of cost data; in the negotiation and administration of Government contracts and subcontracts thereunder

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Sincerely yours,

Comptroller General  
of the United States

## **COST PRINCIPLES**

### **APPLICABILITY**

**Draft as of 21 August 1958**

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

**a. Cost-Reimbursement Type Contracts**

As a contractual basis for termination of costs.

**b. Fixed-Price Type Contracts**

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

**c. Audit Reports**

As a basis for the preparation of advisory audit reports.

**d. Contract Terminations**

Unilateral determinations in contract terminations.

### **Industry**

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

### **Special Working Group Recommendation**

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

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

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

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

Recommended Army Position

Concur in the Special Working Group recommendation.

## **COST PRINCIPLES**

### **COMPENSATION**

**Draft as of 21 August 1958**

Compensation is reasonable to the extent that the total amount paid or accrued is commensurate with compensation paid under the contractor's established policy and conforms generally to compensation paid by other contractors of the same size, in the same industry, or in the same geographic area, for similar services.

#### **Special Working Group Recommendation**

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

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

#### **Recommended Army Position**

Concur in the Special Working Group recommendation.



12/3/58

COMPENSATION

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

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

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

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

## **COST PRINCIPLES**

### **RENTAL COSTS**

**Draft as of 21 August 1958**

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

#### **Industry**

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

#### **Special Working Group Recommendation**

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

#### **Recommended Army Position**

Concur in the recommendation of the Special Working Group.

12/3/58

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

Revise paragraph (1) of the principle to read as follows:

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

**COST PRINCIPLES**

**DIRECT COSTING**

**Draft as of 21 August 1958**

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

**Special Working Group Recommendation**

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

**Recommended Army Position**

Concur in the Special Working Group recommendation.

12/3/58

DIRECT COSTING

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

15-202(a) Add:

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

## **COST PRINCIPLES**

### **PLANT RECONVERSION COSTS**

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

Draft as of 21 August 1958

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

#### **Industry**

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

#### **Special Working Group Recommendation**

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

#### **Recommended Army Position**

Concur in the recommendation of the Special Working Group.

## CONTRACT COST PRINCIPLES

### ARMY POSITIONS

The new proposals made by the Special Working Group and submitted to the Materiel Secretaries, by memorandum from the Assistant Secretary of Defense (Supply and Logistics) dated 31 December 1958, have been coordinated within the Army and the recommended Army positions are set forth in Tabs C 1 through C 10 as follows:

- C 1 - Title
- C 2 - Advance Understandings
- C 3 - Direct Costing
- C 4 - Advertising
- C 5 - Contributions
- C 6 - Interest
- C 7 - Plant Reconversion
- C 8 - Rentals
- C 9 - Compensation
- C 10 - Applicability



CONTRACT COST PRICES

Title  
ARMY PUBLICATION

The new proposals made by the Special Working Group and submitted to the National Security Agency (NSA) dated 11 December 1950, have been coordinated with the Army and the recommended Army positions are set forth in Table 1 through 10 as follows:

- 01 - Title
- 02 - Advance Understanding
- 03 - Direct Control
- 04 - Administration
- 05 - Confidentiality
- 06 - Interviews
- 07 - Plans Development
- 08 - Materials
- 09 - Communications
- 10 - Application

## COST PRINCIPLES

### TITLE

Draft as of 21 August 1958

Contract Cost Principles. This is the title which has been used for Section XV of the ASPR since 1949.

### Industry

Industry claims that the proposed Section XV goes far beyond "principles" in that we have included procedural and instructional material.

### Special Working Group Recommendation

Contract Cost Principles and Procedures.

### Recommended Army Position

Concur in Special Working Group recommendation.

12/3/58

ADVANCE UNDERSTANDINGS

Modify 15-204.1(b) of the 21 August draft to read as follows:

"... Such agreement may be initiated by contracting officers individually or jointly for all defense work of the contractor, as may be appropriate. Any such agreement should be incorporated in cost-reimbursement type contracts or made a part of the contract file in the case of negotiated fixed-price type contracts, and should govern the cost determinations covered thereby throughout the performance of the related contract. The absence of such an advance agreement on any element of cost will not, in itself, serve to make that element either allowable or unallowable. However, the nature of certain costs is such that advance agreements are normally essential. These are:

- (i) pre-contract costs (ASPR 15-204.2(dd));
- (ii) royalties (ASPR 15-204.2(jj));
- (iii) travel costs, as related to special or mass personnel movement (ASPR 15-204.2(ss)(5));

Examples of others for which such agreements are normally appropriate, though not essential, are:

- (iv) use charges for fully depreciated assets (ASPR 15-204.2 (1)(6));
- (v) compensation for personal services (ASPR 15-204.2 (f));
- (vi) deferred maintenance costs (ASPR 15-204.2 (t)(1)(11));
- (vii) research and development costs (ASPR 15-204.2 (11)(6)); and
- (viii) selling and distribution costs (ASPR 15-204.2 (kk)(2))."

## **COST PRINCIPLES**

### **ADVANCE UNDERSTANDINGS**

**Draft as of 21 August 1958**

Encourages contractors and contracting officers to agree in advance on items of cost which frequently result in disagreements, such as compensation for personal services, deferred maintenance costs, precontract costs, research and development costs, royalties and selling costs.

#### **Industry**

Some industry groups object to this provision since many of the items might be controversial and actual costs cannot be known prior to the placement of contracts.

#### **Special Working Group Recommendation**

Change this principle to clearly indicate that "the absence of such an agreement on any element of cost will not, in itself, serve to make that element either allowable or unallowable." In addition segregate the items for which advance understandings are "normally essential" from those where agreements are "normally appropriate, though not essential."

#### **Recommended Army Position**

Concur with the Special Working Group recommendation.

12/3/58

**15-204.2 Listing of Costs.**

**(a) Advertising Costs.**

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

(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; and

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

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

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

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

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

## **COST PRINCIPLES**

### **ADVERTISING**

**Draft as of 21 August 1958**

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

#### **Industry**

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

#### **Special Working Group Recommendation**

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

#### **Recommended Army Position**

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

12/3/56

CONTRIBUTIONS AND DONATIONS

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

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

o/b matches  
from joint  
from corporate  
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educational  
& scientific  
foundation

A-11

costs

costs

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What about double payment?



## **COST PRINCIPLES**

### **CONTRIBUTIONS AND DONATIONS**

**Draft as of 21 August 1958**

**Unallowable.**

#### **Industry**

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

#### **Special Working Group Recommendation**

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

#### **Recommended Army Position**

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

*Speculation  
in further  
to central*

12/3/58

INTEREST ON BORROWINGS

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

"d. Extent of the Contractor's Investment.

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

## **COST PRINCIPLES**

### **INTEREST**

**Draft as of 21 August 1958**

**Unallowable (however represented).**

#### **Industry**

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

#### **Special Working Group Recommendation**

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

#### **Recommended Army Position**

**Concur in the recommendation of the Special Working Group.**

12/3/58

PLANT RECONVERSION COSTS

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

Binder #5

Misc. Papers and  
Correspondence

1960-1961

November 1959

A G I D A

Meeting with Industry Representatives  
Contract Cost Principles

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

October 15, 1958

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

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



CR

NOV 10 1958

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SAL)

SUBJECT: Status Report on Contract Cost Principles

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

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

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

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

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

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

Inclsures

10 November 1958

NOV 10 1958

MEMORANDUM FOR MR. McNEIL

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

Inclosures

*C. A. Malloy*



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

SUPPLY AND LOGISTICS

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AsatSecDef(S&L) has seen

NOV 10 1958

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

SUBJECT: Status Report on Contract Cost Principles

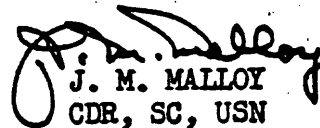
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administrative review of compensation, we can only hope to focus on the out-of-line or unreasonable situation. Since this is true, he suggests that we try to inject some flavor of this approach into our cost principle to relieve our people of a difficult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

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J. M. MALLOY  
CDR, SC, USN

Staff Director, ASFR Division  
Office of Procurement Policy

Inclosures



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

SUPPLY AND LOGISTICS

CR

2 December 1958

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

SUBJECT: Status Report on Contract Cost Principles

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

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

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

Subj: Status Report on Contract Cost Principles

2 December 1958

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

*J. M. Malloy*

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

1 Incl  
Draft dtd 1 Dec 58



CR

12 December 1958

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

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

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

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

*J. M. Malloy*

DEC 12 1953

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

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

You have asked for a statement of Department of Defense policy with respect to compensation for personal services in connection with the pricing of Department of Defense contracts. It is considered that the compensation of individuals for personal services includes all remuneration in whatever form for services rendered during the period of contract performance. It includes incentive compensation for management employees as described and limited in the 21 August 1953 draft of the Contract Cost Principles.

The cost of such compensation should be favorably considered in contract pricing to the extent that total compensation of individual employees is reasonable for the service rendered. While the amount of compensation in individual instances is a difficult matter to evaluate, the tests of reasonableness set forth in the 21 August 1953 draft of the Contract Cost Principles are considered adequate for this purpose. It is my understanding that the Air Force has established administrative controls which are designed to preclude the inclusion of unreasonable compensation costs in contract pricing.

*Perkins W. Quinn*

Assistant Secretary of Defense  
(Supply and Logistics)

Prepared by:  
CR - Cdr JG Mallory/rba/12 Dec 72026  
39774

Coordinated with:  
J. J. Phelan, Jr., \_\_\_\_\_

Mr. Golden (AF) \_\_\_\_\_

CG:  
ASD (Comp)

001  
Cdr Mallory

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

I believe that industry recognized the validity of this conclusion.

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

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

I believe that our contingency cost principle, together with the consideration of this factor in profits (covered by ASPR 3-806.4 (b)) contains proper policy consideration of this element—not differences in cost treatment.



price of his product. And to argue from this truism that both costs should, or must be judged by reference to the same standard seems eminently proper as a matter of pure theory." "We are not, however, dealing with a theoretical exercise but a practical procurement situation. In the paragraphs which follow, Mr. Stewart isolates 'risk' as the point of difference between the several types of contract."

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

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

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

"WE AGREE THAT A COST IS A COST WHEREVER INCURRED. BECAUSE THE PROPOSED REGULATIONS ARBITRARILY EXCLUDE CERTAIN NORMAL OR LEGITIMATE COSTS FROM CONSIDERATION, THE GOVERNMENT'S PROPOSALS OF AREAS OF APPLICABILITY BECOME IMPRACTICAL AND PATENTLY UNJUST.

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

"Despite the sincere instructions in this draft that costs shall be only one factor of pricing, the draft actually requires that MANY COSTS CALLED 'UNALLOWABLE' BE ELIMINATED from the submission from the outset. Thus, such costs will never be considered in negotiation, and will never become a factor in pricing. To this degree, formula pricing has already occurred.

"...we strongly urge, at the very least, that this regulation not apply to fixed price negotiations, or to the preparation of cost estimates or price analyses in negotiated procurements or terminations, and that its use in such circumstances be specifically negated...

"If, however, the regulations are redrafted on the principle of recognizing ALL NORMAL AND LEGITIMATE COSTS, reasonable in amount and fairly allocated, THEN THEIR APPLICABILITY COULD BE EXPANDED. We oppose in principle, however, ANY use of cost data as a formula basis for negotiating prospective firm fixed prices."

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

"...we should point out once more that we do not regard ASFA cost principles--IN EITHER THEIR PRESENT OR PROPOSED FORM--as desirable or proper standards even for cost-reimbursement type contracts."

He explains that:

"the extent of allowability or unallowability of any item of contract expense identified in these 'principles' would almost certainly be the same under either a cost-reimbursement or a fixed-price type contract."

He observes:

"We think no one would argue seriously that there is any essential difference between an item of expense under a fixed-price contract and a similar expense under a cost-type agreement, nor that the manufacturer incurring either cost must recover it in the selling



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

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

Although speaking to the problem of the "applicability" of the principles,

Mr. Marshalk spoke in favor of the "ALL COSTS" concept, when he said:

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

B. Mr. Stewart, MAPI, paid particular attention to the applicability.

He said:

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

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

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

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

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

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

Applicability of Cost Principles

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

1. In termination and in reimbursement of costs under cost-type contracts;
2. In the establishment of reasonable redetermined pricing under price-redetermination and incentive-type contracts;
3. In the establishment of reasonable prices and targets in the negotiation of fixed-price contracts when other pricing aids are insufficient to establish reasonableness of prices;
4. By auditors in the provision of cost data to support a factual basis for a proper reimbursement and for the establishment of reasonable prices;
5. By the Board of Contract Appeals, the Courts, and elsewhere in the final resolution of questions of cost.

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

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



Memo for Cdr J. M. Malloy, OASD (S&L), Subject: Comprehensive Cost Principles, dtd 4 Dec 58 (Cont'd)

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

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

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

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

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

*G. J. Vecchiatti*  
G. J. VECCHIETTI

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

Memo for Cdr J. M. Malloy, OASD(S&L), Subject: Comprehensive Cost Principles, dtd 4 Dec 58 (Cont'd)

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

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

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

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

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

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

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

Memo for Cdr J. M. Malloy, OASD (S&L), Subject: Comprehensive Cost Principles, dtd 4 Dec 58 (Cont'd)

effectiveness of the methods of price analysis outlined in ASPR 3-808.2, the amount of the proposed contract, and the cost and time needed to accumulate the information necessary for analysis. When cost analysis is undertaken, the contracting officer must exercise judgment in determining the extent of the analysis." (The balance in 3-808.3 is too lengthy to incorporate herein. It is however, highly significant in considering the problem at hand, setting forth as it does comprehensive treatment on the use of cost analysis.)

3-808.6 "When purchases of standard commercial or modified standard commercial items are to be made from sole source suppliers, use of the techniques of price and cost analysis may not always be possible. In such instances....the contractor's price lists.....should be examined....and negotiations conducted on the basis of the "best user," "most favored customer" or similar practice customarily followed by the contractor."

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

3-808.1 "Under fixed-price type contracts, including redeterminable types, prices are to be negotiated, not separate elements of cost plus profit. In many cases, a breakdown of price into cost and profit elements will be useful in the process of analysis, evaluation, and negotiation of proposed prices. A negotiated price is the basis for payment to a contractor under fixed-price type contracts; allowable costs are the basis for reimbursement under cost-reimbursement contracts."

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

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

Memo for Cdr J. M. Malloy, OASD (S&L), Subject: Comprehensive Cost Principles, dtd 4 Dec 58 (Cont'd)

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

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

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

3-807(a) "When products are sold in the open market, costs are not necessarily the controlling factor in establishing a particular seller's price. Similarly, where competition may be ineffective or lacking, estimated costs plus estimated profit are not the only pricing criteria..... The objective of the contracting officer shall be to negotiate fair and reasonable prices in which due weight is given to all relevant factors, including those in ASPR 3-101."

3-807(b) "While the public interest requires that excessive profits be avoided, the contracting officer should not become so pre-occupied with particular elements of a contractor's estimate of cost and profits that the most important consideration, the total price itself, is distorted or diminished in its significance."

3-807(c) "A fair and reasonable profit cannot be made by simply applying a certain predetermined percentage to the cost estimate or selling price of a product."

3-808.2(c) "Rough yardsticks may be developed.... to point up apparent gross inconsistencies which should be subjected to additional pricing techniques, including cost analysis. Such yardsticks should be considered as an indispensable adjunct to cost analysis, since a study of a single offeror's estimated costs in sole source situations will not indicate whether the proposed price is fair and reasonable in comparison with other products of the same kind."

3-808.3(a) "The need for cost analysis depends on the



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

AFMPP-PH

4 December 1958

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

SUBJECT: Comprehensive Cost Principles

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

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

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

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

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

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

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





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

SUPPLY AND LOGISTICS

10 November 1958

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

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

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

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

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

*J. M. Malloy*  
J. M. MALLOY  
Cdr., SC, USN

Staff Director, ASPR Division  
Office of Procurement Policy



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

SUPPLY AND LOGISTICS

CR

29 December 1958

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

SUBJECT: Contract Cost Principles

1. At your direction, I have held numerous meetings with representatives of the Military Departments and the Assistant Secretary of Defense (Comptroller) to consider the contract cost principles in the light of the strong protests which have been received from industry. Our objective has been to take a fresh look at the entire philosophy underlying our past efforts to develop a so-called comprehensive set of cost principles. Additionally, we have reviewed the individual items of costs and our recommendations in this regard are set forth herein.

2. Separate meetings were held on the research and development principle with additional representatives of the Military Departments and this office who are concerned directly with the Department of Defense research program. We have agreed on a substantial revision of our previous draft of this principle and this new draft has been sent to the various Assistant Secretaries for an expression of their views.

3. There is attached, as Tab A, a revision of certain portions of the cost principles. These changes are summarized as follows:

A. Title. Changed to "Contract Cost Principles and Procedures". This change is made to counter the industry claim that we have included procedural and instructional type material in addition to "principles". We feel that the detail which is included is the minimum necessary for proper administration.

B. Advance Understandings. This principle has been changed to clearly indicate that "The absence of such an advance agreement on any element of cost will not, in itself, serve to make that element either allowable or unallowable". Additionally, we have segregated the items for which advance understandings are "normally essential" from those where agreements are "normally appropriate".



- C. Direct Costing. We recommend certain technical changes in this principle to take care of a concept which was inadvertently omitted and to avoid duplication of charges under certain circumstances.
- D. Advertising. This principle has been liberalized somewhat to include the cost of exhibits sponsored by the Government as well as advertising for scarce materials or disposing of scrap or surplus materials.
- E. Contributions and Donations. We have made a substantive change in this principle to allow the costs of reasonable contributions to established nonprofit charitable organizations. It is our feeling that industry fully substantiated this type of cost as an unavoidable expense. We do not believe that we have opened "Pandora's box" and, further, we feel that no insurmountable problems of administration will be encountered.

The Air Force representative does not concur in the above recommendation feeling that, as proposed, this principle would open the door to further demands by industry, as well as lead to abuses and complex administrative problems.

- F. Interest. While we recommend that interest costs remain unallowable, we propose an addition to ASPR 3-808.4 to indicate that the extent of a contractor's total investment in the performance of the contract will be taken into consideration in the fixing of the amount of the fee or profit.
- G. Plant Reconversion Costs. This principle has been liberalized to allow additional costs by mutual agreement where equity so dictates in special circumstances.
- H. Rental Costs. This principle has been liberalized to include "market conditions in the area" as a test of reasonableness of rental costs.

4. I am attaching as Tab B, a suggested revision of the compensation principle. The objective of this revision is to recognize that in the determination of the reasonableness of total compensation, contracting officers, as a practical matter, can only cope with the unreasonable or out of line situation. Since this is true, it is felt that we should inject some flavor of this approach into our cost principle to assist contracting officers in an extremely difficult area of contract administration. The substance of this revision is currently contained in paragraph 54-905 (a) of the Air Force Procurement Instructions.

5. We have spent most of our time in reviewing our previous position with respect to the Applicability section of the principles since it is the most controversial area both within the Department of Defense and with industry. In our review of industry comments, we have taken particular note of the strong protests lodged against the application of detailed cost principles to contracts of the fixed-price type. While we never intended to utilize the cost principles as a detailed blueprint for the establishment of prices in the fixed-price area, we feel that industry is justified in their objections to our previous drafts in this regard. In addition to the industry protests, the Military Departments have expressed a strong desire that our regulations specifically recognize the pricing principles incorporated in ASPR Section III, Part 8, as the basic guidelines for the determination of fair and reasonable prices for fixed-price type contracts. This approach is in contradistinction to our previous draft which, however artfully worded, gives the unmistakable flavor of pricing by formula. Procurement personnel of all of the Departments are apprehensive lest contracting officers use the cost principles as a crutch to avoid criticism, to the detriment of our generally accepted pricing philosophy. They have maintained, as did industry, that this will be the inevitable result of our previous approach regardless of our intent to the contrary.

Our overall analysis of the specific items of cost as now recommended is that they are fair and equitable for strict application to cost type contracts. In reviewing any of the specific items of cost, we are necessarily primarily concerned with respect to their allowability in the riskless cost type contract. We feel that we should be more conservative, more detailed, and more specific in this type of contract than in those of the fixed-price type.

The need for cost analysis with respect to fixed-price type contracts varies in a broad spectrum. In the final pricing of incentive contracts, major reliance must be placed on costs. In redeterminable type contracts, we are generally looking ahead and, while cost analysis is an important factor in establishing fair and reasonable prices, it must be used judiciously and not slavishly. In firm fixed-price contracts, the use of cost analysis and the detail of its use varies on a broad scale. As we endeavor to fit a given set of cost principles, tailored as they must necessarily be to the cost-type contract, to these many and varied pricing situations, we run the great danger of so inhibiting our contracting personnel that the inherent advantages of fixed-price contracts and our pricing techniques will be lost.

We have previously been guided and influenced by the truism that "a cost is a cost regardless of the type of contract". We do not take issue with this generality; however, to give effect to this principle tends to result in a detailed evaluation of costs in most instances. This motivation for specificity in the evaluation of a price will inevitably lead to formula pricing. There are many situations in which we need be concerned only with the general level of estimated costs and secondarily with the types of costs included in the estimate.

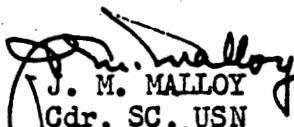
We have stated repeatedly in ASFR that the negotiation of a fair and reasonable price requires the exercise of good business judgment. The exercise of this judgment requires flexibility in the negotiation process to concentrate on the major elements of a price. Negotiation implies and demands a give and take approach so as to arrive at a mutually acceptable fair and reasonable price. In this atmosphere of give and take (not adamant dictation by one party to the negotiation) it is essential that the Government negotiator be provided with the flexibility to recognize the validity of a contractor's requests with respect to any element of cost in return for a more advantageous concession by the contractor with respect to another element of the price. 2

The observations set forth above are not new. They are the basic and inherent problems which have prevented an easy resolution to this question over the past few years. If the principles are issued with their applicability as set forth in the 21 August 1958 draft, we can look forward to continued and violent disagreement with industry. We can foresee future misunderstanding on the part of contracting officers as they endeavor to reconcile the applicability of the cost principles with the pricing techniques of ASFR Section III, Part 8. We can expect pressure toward formula pricing emanating from reviewing authorities such as the General Accounting Office.

In many respects, we find ourselves on the horns of a dilemma. Some members of the working group strongly advocated a complete separation of all fixed-price type contracts from any tie-in with the cost principles. They would create a separate part in Section XV to cover fixed-price type contracts in which the principles would not be used as a "guide" since previous experience in using the present Section XV, Part 2, as a guide in pricing fixed-price contracts had resulted in formula pricing. The majority, however, while concurring in the concept of a separate part for fixed-price contracts, believes that since cost analysis is an important factor in pricing many fixed-price contracts, we need to state that the cost principles will be used "to provide general guidance" in the pricing of such contracts. While recognizing that even this latter tie-in to the principles runs the danger of some formula pricing, it is recommended here as a middle ground which offers the best accommodation of the many conflicting points of view which are involved.

While we have redrafted the Applicability Section many times, we are not able to present a fully coordinated new draft at the present time. Tab C, attached, appears to offer the most practical solution. It is furnished herewith to serve as the basis for future discussions of the basic policy questions underlying the resolution of this difficult problem.

The representative of the Assistant Secretary of Defense (Comptroller) does not concur with the views expressed herein. It is his view that to the extent costs are a factor in pricing, they should be evaluated on a uniform basis regardless of the type of contract involved. He believes that the present proposal is inconsistent with the policy previously established after thorough consideration at the highest levels within the Department, and that the Applicability section contained in the 21 August 1958 draft, with certain minor revisions, should be retained.

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

3 Incls

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

TITLE OF SECTION

In order to avoid the charge that ASPR Sec. XV is not "Cost Principles" as the present title would indicate, we recommend that the title be changed to "Contract Cost Principles and Procedures."

ADVANCE UNDERSTANDINGS

Modify 15-204.1(b) of the 21 August draft to read as follows:

"...Such agreement may be initiated by contracting officers individually or jointly for all defense work of the contractor, as may be appropriate. Any such agreement should be incorporated in cost-reimbursement type contracts or made a part of the contract file in the case of negotiated fixed-price type contracts, and should govern the cost determinations covered thereby throughout the performance of the related contract. The absence of such an advance agreement on any element of cost will not, in itself, serve to make that element either allowable or unallowable. However, the nature of certain costs is such that advance agreements are normally essential. These are:

- (i) pre-contract costs (ASPR 15-204.2 (dd));
- (ii) royalties (ASPR 15-204.2 (jj));
- (iii) travel costs, as related to special or mass personnel movement (ASPR 15-204.2 (ss)(5));

Examples of others for which such agreements are normally appropriate, though not essential, are:

- (iv) use charges for fully depreciated assets (ASPR 15-204.2 (i)(6));
- (v) compensation for personal services (ASPR 15-204.2 (f));
- (vi) deferred maintenance costs (ASPR 15-204.2 (t)(1)(ii));
- (vii) research and development costs (ASPR 15-204.2 (ii)(6)); and
- (viii) selling and distribution costs (ASPR 15-204.2 (kk)(2))."

DIRECT COSTING

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

15-202(a) Add:

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

ADVERTISING15-204.2 Listing of Costs.(a) Advertising Costs.

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

- (i) Advertising in trade and technical journals, provided such advertising does not offer specific products or services for sale but is placed in journals which are valuable for the dissemination of technical information within the contractor's industry; and
- (ii) help wanted advertising, as set forth in (gg) below, when considered in conjunction with all other recruitment costs.
- (iii) costs of participation in exhibits sponsored by the Government for the purpose of developing military applications of products.
- (iv) advertising relating to accomplishment of the contract mission for the purpose of obtaining scarce materials or equipment, or disposing of scrap or surplus materials.

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

CONTRIBUTIONS AND DONATIONS

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

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

INTEREST ON BORROWINGS

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

"d. Extent of the Contractor's Investment.

*(both equity and borrowed capital)*

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

PLANT RECONVERSION COSTS

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

RENTAL COSTS

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

Revise paragraph (1) of the principle to read as follows:

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



COMPENSATION

- A. To take care of the gigantic problem incident to an examination of ALL compensation plans, change paragraph (b) as follows:

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

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

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

## Part 7 - Fixed-Price Type Contracts

15-700 Scope of Part. This Part sets forth the guidelines to be used for the evaluation of costs in negotiated fixed-price type contracts, including terminations thereof, in those instances where such evaluation is required to establish prices for such contracts. "Fixed-price type" contracts include, for purposes of this Part, the following:

- (i) firm fixed-price contracts (ASPR 3-403.1)
- (ii) fixed-price contracts with escalation (ASPR 3-403.2)
- (iii) fixed-price contracts providing for the redetermination of price (ASPR 3-403.3)
- (iv) fixed-price incentive contracts (ASPR 3-403.4)
- (v) non-cost-reimbursable portion of time and materials contracts (ASPR 3-405.1)

15-701 Basic Considerations. (a) Under fixed-price type contracts, prices, not separate elements of cost plus profit, are to be negotiated. A negotiated price is the basis for payment to a contractor under fixed-price type contracts; allowable costs are the basis for reimbursement under cost-reimbursement type contracts. Accordingly, the policies and procedures of ASPR Section III, Part 8, are governing and shall be followed in the negotiation of fixed-price type contracts.

(b) As recognized in ASPR Section III, Part 8, there are within the fixed-price type category of contracts certain situations, e.g., incentive and redeterminable contracts, in which costs are a significant factor in the negotiation of prices. In such situations, costs must be submitted by contractors, evaluated by the Government, and used as

appropriate in negotiating fair and reasonable prices. However, since the basic objective, even in these situations, is the negotiation of a price rather than the determination of allowable and unallowable costs, the use of cost principles must be flexible.

15-702 Cost Principles and Their Use. (a) When, pursuant to ASPR 15-701, costs are to be considered in fixed-price type contracts, Section XV, Part 2, shall be used to provide general guidance in the consideration of cost data in conjunction with other pertinent considerations as set forth more fully in ASPR Section III, Part 8, required to establish a fair and reasonable price.

(b) In using Part 2 of this Section XV for general guidance, contracting officers are not necessarily required to evaluate specifically each individual item of cost (as is required for cost-reimbursement type contracts) in establishing a price; nor shall they be required, in substantiating or justifying a negotiated price, to explain the treatment accorded each such item of cost. Notwithstanding the above, contracting officers are required to fully substantiate and justify any negotiated price. (See ASPR 3-811.)

ASSISTANT SECRETARY OF DEFENSE  
Washington 25, D.C.

DepAsstSecDef(S&L) has seen

Supply and Logistics

CR

DEC 31 1958

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

SUBJECT: Contract Cost Principles

As you are aware, our staffs have been re-evaluating our previous draft of the contract cost principles in the light of the strong protests lodged by industry at the 15 October 1958 meeting and in subsequent correspondence. The attached memorandum contains the results of this staff analysis and contains much food for thought as to our final resolution of this matter. While I am not necessarily in agreement with all of the recommendations contained in this report, I think that it provides a basis for our further discussions. I would like to meet with you upon my return to Washington in early February for the purpose of formulating a recommendation to the Secretary of Defense.

(signed)

PERKINS McGUIRE  
Assistant Secretary of Defense  
(Supply and Logistics)

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

445  
2/14/59

C O P Y

December 15, 1959

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

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

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

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

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

Attachment

C O P Y

C O P Y

CR

December 10, 1959

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

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

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

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

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

C O P Y

C O P Y

December 15, 1959

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

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

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

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

/Signed/

FRANKLIN B. LINCOLN, JR.  
ASSISTANT SECRETARY OF DEFENSE

Attachment

Prep: JLucas/ak/12/11/59  
OASD(CMPT)AUDIT POLICY DIV 3B352 76321

C O P Y



ASSISTANT SECRETARY OF DEFENSE  
Washington 25, D. C.

CR

Supply and Logistics

February 10, 1960

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

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

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

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

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

(a) Existing Cost-Reimbursement Type Contracts.

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

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

- (i) anticipated increased or decreased costs, if any;
- (ii) administrative savings expected to be gained by costing cost-reimbursement prime contracts with a given contractor on the basis of one set of cost principles;
- (iii) the effect on subcontracts under the prime contract (see ASPR 15-204(b));
- (iv) absence or existence of specific contractual provisions or other arrangements affecting the treatment of certain costs, such as those for research;
- (v) in consideration of (iv) above, the appropriate use of advance understandings (ASPR 15-107) as for example, where it may not be appropriate to allow independent research costs under the revised cost principles in instances where such costs have not been allowed heretofore under the existing contracts;
- (vi) other advantages or disadvantages to the Government.

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

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

**(b) New Cost-Reimbursement Type Contracts.**

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

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

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

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

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

**USE OF REVISED CONTRACT COST PRINCIPLES**

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

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

## USE OF REVISED CONTRACT COST PRINCIPLES

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

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

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

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

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

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

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

\_\_\_\_\_  
/s/

PERKINS McGUIRE  
Assistant Secretary of Defense  
(Supply and Logistics)



ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON 25, D. C.

FEB 24 1959

COMPTROLLER

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

SUBJECT: Contract Cost Principles

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

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

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

*W. J. McNeil*

W. J. McNeil

Inclosure  
Comments on  
applicability.

*PS. I wonder how soon some very sincere people in the business will recognize that - whether we like it or not - the more of the contract dollar volume is based on cost regardless of the label on the contract.*

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

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



CR

19 February 1959

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

SUBJECT: Contract Cost Principles

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

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

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

cc: Cdr. Malloy

CR

23 March 1959

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

SUBJECT: Contract Cost Principles

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

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

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

12 February 1959

CONTRACT COST PRINCIPLES  
APPLICABILITY TO FIXED PRICE CONTRACTS

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

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

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

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

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

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

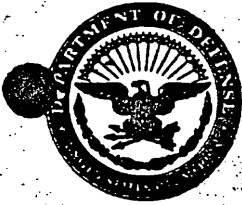
3. Who will be governed by the principles? -- Almost from the inception of this project, there was basic agreement on the important concept that all three of the parties involved in procurement cost matters -- the contracting officer, the contractor, and the auditor -- would be guided by the principles.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

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

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

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

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



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

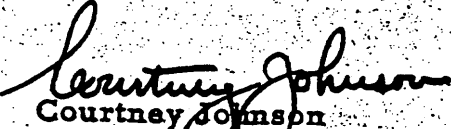
IN REPLY REFER TO:

JUN 5 1959

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (S&L)

SUBJECT: Contract Cost Principles

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

  
Courtney Johnson  
Assistant Secretary of the Army  
(Logistics)

0720 (275F)

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RECEIVED



DEPARTMENT OF THE NAVY  
OFFICE OF THE SECRETARY  
WASHINGTON

29 MAY 1959

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

Subj: The Contract Cost Principles and Procedures, comment on

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

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

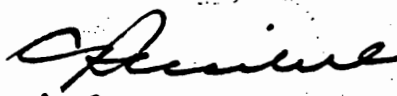
a. Page 4, line 19, after "will not," insert "with the exception of the limitations on rentals paid under sale and leaseback agreements. (See ASPR 15-205.34 (c))." Also include on page 5, as one of the examples of costs for which advance agreements may be particularly important, "(ix) Sales and leaseback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

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

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

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

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

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



DEPARTMENT OF THE AIR FORCE  
WASHINGTON

OFFICE OF THE ASSISTANT SECRETARY

JUN 11 1959

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)  
SUBJECT: Contract Cost Principles

1. Reference is made to your memorandum dated 19 May 1959 on the above subject. We have reviewed the latest draft attached to your memorandum and recognize the compromises that have been made in several items to accommodate divergent views among the Departments as well as with industry. Accordingly, we think it should be clearly understood that if actual experience under the proposed principles reveals any deficiencies, we will seek reconsideration of the matters involved. Since the proposal seems to offer an acceptable basis for early adoption, we concur subject to the comments noted below.

2. We note the deletion in paragraph 13-207.22(a) of the prohibition relating to "write down" or "write up" of material values which had appeared in earlier drafts and which now appears in part in current ASPR 17-207.1. We understand that discussions on this point have taken place between the top Comptroller people in the Air Force and the Department of Defense. We also understand that agreement in principle has been reached to the effect that it is our common understanding that Department of Defense policy generally is not to accept such costs. Apparently this understanding is to be made a matter of record so that, should the problem arise, such an understanding could be relied upon to give a common answer. As you know, such an understanding cannot form the basis of a contractual obligation. Accordingly, we would urge for consideration the inclusion in the Cost Principles of appropriate language covering the point.



P. B. TAYLOR  
Assistant Secretary of the Air Force

C-1211 (SF)

RECEIVED

4 May 1959

**MEMORANDUM**

**From:** N302A  
**To:** N03A

**Subj:** Conformance of ASPR Section VIII with Section IV Cost Principles

**Encl:** (1) Proposed Revision of ASPR Section VIII

1. It is recommended that ASPR Section VIII be revised as indicated by enclosure (1). While Section VIII, Part 2 contains principles applicable to both fixed-price and cost-reimbursement type contracts, this part in ASPR 8-213 also deals with the settlement of certain research and development contracts under fixed-price or cost-reimbursement type no-profit or no-fee with educational or other non-profit institutions. For such cost-reimbursement contracts with non-profit institutions the principles in Section IV, Part 3 should be used in effecting a termination settlement, while the fixed-price types should be settled under Section IV, Part 3 and the principles recommended for insertion in Section VIII, Part 3.
2. The cost principles in ASPR Section IV, Part 2 are considered to be sufficient for the settlement of cost-reimbursement type contracts with other than non-profit institutions. For the settlement of terminated fixed-price contracts, however, the cost principles in Section IV, Part 2, should be supplemented by the additional cost principles recommended for insertion in Section VIII, Part 3.
3. It is also recommended that the language originally submitted under Case #1-74 for ASPR 8-301 and 8-301.1 which was approved by the ASPR Committee be restored when the comprehensive set of principles are published.

C. E. CLARK

### Part 3

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

Pages 823 - 831 - Delete present AFPM 8-306, 8-301, and 8-302 and insert the following:

##### 8-301 Principles for Establishing the Settlement Amount.

8-301.I General. (a) A settlement should compensate the contractor fairly for the work done and the preparations made for the terminated portion of the contract, including an allowance for profit thereon which is reasonable under the circumstances. The primary objective is to negotiate a settlement by agreement; however, the total amount payable to the contractor, whether through negotiation or by determination, before deducting disposal or other credits and exclusive of settlement costs, shall not exceed the contract price less payments otherwise made or to be made under the contract. Fair compensation is a matter of judgment and cannot be measured exactly. In a given case, various methods may be equally appropriate for arriving at fair compensation. The application of standards of business judgment, as distinguished from strict accounting principles, is the heart of a settlement. The parties may agree upon a total amount to be paid the contractor without agreeing on or segregating the particular elements of costs or profit comprising this amount. Cost and accounting data may provide guides, but are not rigid measures, for ascertaining fair compensation. In appropriate cases, costs may be estimated, differences compromised, and doubtful questions settled by agreement. Other types of data, criteria, or standards may furnish equally reliable guides to fair compensation. The amount of record keeping, reporting, and accounting, in connection



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

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

#### 8-302 Additional Cost Principles

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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



**8-303 Allowance for Profit.**

(Use printed ASPR 8-303)

**8-304 Adjustment for Loss.**

(Use printed ASPR 8-304)

**8-305 Deductions**

(Use printed ASPR 8-305)

**8-306 Completed End Items.**

(Use printed ASPR 8-306)

**8-307 Settlement Proposals**

(Use printed ASPR 8-307)

**Reference changes:**

**Page 831 8-303(a) - Line 4 - change parenthetical reference**

**8-302(b)(27) to 8-302(6)**

**Page 832 8-304(b)(11)-Line 3 - change parenthetical reference**

**8-302(b)(13) to 8-302(3)**

**Page 841 8-503.5 - Line 5 - change parenthetical reference**

**8-302a(1)(a)(11) to 8-302(1)**

**Page 862 - 872 Clauses 701 and 703, para (f) change references to**

**include applicable principles in Section XV and those**

**in Section VIII, Part 3**



Part 2

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

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

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

Binder #5

Misc. Papers and  
Correspondence

1960-1961

November 1959

A G I D A

Meeting with Industry Representatives  
Contract Cost Principles

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

October 15, 1958

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

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

CR

NOV 10 1958

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SAL)

SUBJECT: Status Report on Contract Cost Principles

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

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

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



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

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

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

Inclsures

10 November 1958

NOV 10 1958

MEMORANDUM FOR MR. McNEIL

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

Inclosures

*C. D. Malloy*



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

SUPPLY AND LOGISTICS

CR

AsstSecDef(S&L) has seen

NOV 10 1958

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

SUBJECT: Status Report on Contract Cost Principles

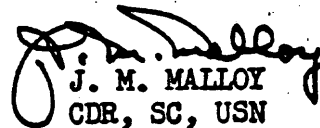
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J. M. MALLOY  
CDR, SC, USN

Staff Director, ASFR Division  
Office of Procurement Policy

Inclosures



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

SUPPLY AND LOGISTICS

CR

2 December 1958

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

SUBJECT: Status Report on Contract Cost Principles

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

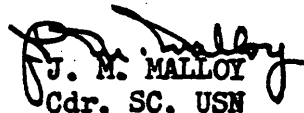
We have finished our review of the industry comments with respect to particular items of cost. We will recommend a change in the title of the section (to Contract Cost Principles and Procedures). Additionally, we have agreed on a revision of the treatment of advanced understandings, rentals and plant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

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

Subj: Status Report on Contract Cost Principles

2 December 1958

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

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

1 Incl  
Draft dtd 1 Dec 58



CR

12 December 1958

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

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

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

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

*J. M. Malloy*



DEC 12 1953

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

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

You have asked for a statement of Department of Defense policy with respect to compensation for personal services in connection with the pricing of Department of Defense contracts. It is considered that the compensation of individuals for personal services includes all remuneration in whatever form for services rendered during the period of contract performance. It includes incentive compensation for management employees as described and limited in the 21 August 1953 draft of the Contract Cost Principles.

The cost of such compensation should be favorably considered in contract pricing to the extent that total compensation of individual employees is reasonable for the service rendered. While the amount of compensation in individual instances is a difficult matter to evaluate, the tests of reasonableness set forth in the 21 August 1953 draft of the Contract Cost Principles are considered adequate for this purpose. It is my understanding that the Air Force has established administrative controls which are designed to preclude the inclusion of unreasonable compensation costs in contract pricing.

*Perkins W. Quinn*

Assistant Secretary of Defense  
(Supply and Logistics)

Prepared by:  
CR - Cdr JG Mallory/rba/12 Dec 72026  
39774

Coordinated with:  
J. J. Phelan, Jr., \_\_\_\_\_

Mr. Golden (AF) \_\_\_\_\_

CG:  
ASD (Comp)

001  
Cdr Mallory

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

I believe that industry recognized the validity of this conclusion.

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

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

I believe that our contingency cost principle, together with the consideration of this factor in profits (covered by ASPR 3-806.4 (b)) contains proper policy consideration of this element—not differences in cost treatment.



price of his product. And to argue from this truism that both costs should, or must be judged by reference to the same standard seems eminently proper as a matter of pure theory." "We are not, however, dealing with a theoretical exercise but a practical procurement situation. In the paragraphs which follow, Mr. Stewart isolates 'risk' as the point of difference between the several types of contract."

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

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

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

"WE AGREE THAT A COST IS A COST WHEREVER INCURRED. BECAUSE THE PROPOSED REGULATIONS ARBITRARILY EXCLUDE CERTAIN NORMAL OR LEGITIMATE COSTS FROM CONSIDERATION, THE GOVERNMENT'S PROPOSALS OF AREAS OF APPLICABILITY BECOME IMPRACTICAL AND PATENTLY UNJUST.

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

"Despite the sincere instructions in this draft that costs shall be only one factor of pricing, the draft actually requires that MANY COSTS CALLED 'UNALLOWABLE' BE ELIMINATED from the submission from the outset. Thus, such costs will never be considered in negotiation, and will never become a factor in pricing. To this degree, formula pricing has already occurred.

"...we strongly urge, at the very least, that this regulation not apply to fixed price negotiations, or to the preparation of cost estimates or price analyses in negotiated procurements or terminations, and that its use in such circumstances be specifically negated...

"If, however, the regulations are redrafted on the principle of recognizing ALL NORMAL AND LEGITIMATE COSTS, reasonable in amount and fairly allocated, THEN THEIR APPLICABILITY COULD BE EXPANDED. We oppose in principle, however, ANY use of cost data as a formula basis for negotiating prospective firm fixed prices."

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

"...we should point out once more that we do not regard ASFA cost principles--IN EITHER THEIR PRESENT OR PROPOSED FORM--as desirable or proper standards even for cost-reimbursement type contracts."

He explains that:

"the extent of allowability or unallowability of any item of contract expense identified in these 'principles' would almost certainly be the same under either a cost-reimbursement or a fixed-price type contract."

He observes:

"We think no one would argue seriously that there is any essential difference between an item of expense under a fixed-price contract and a similar expense under a cost-type agreement, nor that the manufacturer incurring either cost must recover it in the selling



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

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

Although speaking to the problem of the "applicability" of the principles,

Mr. Marshalk spoke in favor of the "ALL COSTS" concept, when he said:

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

B. Mr. Stewart, MAPI, paid particular attention to the applicability.

He said:

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

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

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

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

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

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

Applicability of Cost Principles

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

1. In termination and in reimbursement of costs under cost-type contracts;
2. In the establishment of reasonable redetermined pricing under price-redetermination and incentive-type contracts;
3. In the establishment of reasonable prices and targets in the negotiation of fixed-price contracts when other pricing aids are insufficient to establish reasonableness of prices;
4. By auditors in the provision of cost data to support a factual basis for a proper reimbursement and for the establishment of reasonable prices;
5. By the Board of Contract Appeals, the Courts, and elsewhere in the final resolution of questions of cost.

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

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

Memo for Cdr J. M. Malloy, OASD (S&L), Subject: Comprehensive Cost Principles, dtd 4 Dec 58 (Cont'd)

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

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

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

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

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

*G. J. Vecchiatti*  
G. J. VECCHIETTI

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



Memo for Cdr J. M. Malloy, OASD(S&L), Subject: Comprehensive Cost Principles, dtd 4 Dec 58 (Cont'd)

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

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

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

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

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

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

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

Memo for Cdr J. M. Malloy, OASD (S&L), Subject: Comprehensive Cost Principles, dtd 4 Dec 58 (Cont'd)

effectiveness of the methods of price analysis outlined in ASPR 3-808.2, the amount of the proposed contract, and the cost and time needed to accumulate the information necessary for analysis. When cost analysis is undertaken, the contracting officer must exercise judgment in determining the extent of the analysis." (The balance in 3-808.3 is too lengthy to incorporate herein. It is however, highly significant in considering the problem at hand, setting forth as it does comprehensive treatment on the use of cost analysis.)

3-808.6 "When purchases of standard commercial or modified standard commercial items are to be made from sole source suppliers, use of the techniques of price and cost analysis may not always be possible. In such instances....the contractor's price lists.....should be examined....and negotiations conducted on the basis of the "best user," "most favored customer" or similar practice customarily followed by the contractor."

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

3-808.1 "Under fixed-price type contracts, including redeterminable types, prices are to be negotiated, not separate elements of cost plus profit. In many cases, a breakdown of price into cost and profit elements will be useful in the process of analysis, evaluation, and negotiation of proposed prices. A negotiated price is the basis for payment to a contractor under fixed-price type contracts; allowable costs are the basis for reimbursement under cost-reimbursement contracts."

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

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

Memo for Cdr J. M. Malloy, OASD (S&L), Subject: Comprehensive Cost Principles, dtd 4 Dec 58 (Cont'd)

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

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

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

3-807(a) "When products are sold in the open market, costs are not necessarily the controlling factor in establishing a particular seller's price. Similarly, where competition may be ineffective or lacking, estimated costs plus estimated profit are not the only pricing criteria..... The objective of the contracting officer shall be to negotiate fair and reasonable prices in which due weight is given to all relevant factors, including those in ASPR 3-101."

3-807(b) "While the public interest requires that excessive profits be avoided, the contracting officer should not become so pre-occupied with particular elements of a contractor's estimate of cost and profits that the most important consideration, the total price itself, is distorted or diminished in its significance."

3-807(c) "A fair and reasonable profit cannot be made by simply applying a certain predetermined percentage to the cost estimate or selling price of a product."

3-808.2(c) "Rough yardsticks may be developed.... to point up apparent gross inconsistencies which should be subjected to additional pricing techniques, including cost analysis. Such yardsticks should be considered as an indispensable adjunct to cost analysis, since a study of a single offeror's estimated costs in sole source situations will not indicate whether the proposed price is fair and reasonable in comparison with other products of the same kind."

3-808.3(a) "The need for cost analysis depends on the



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

AFMPP-PH

4 December 1958

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

SUBJECT: Comprehensive Cost Principles

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

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

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

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

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

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

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



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

SUPPLY AND LOGISTICS

10 November 1958

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

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

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

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

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

*J. M. Malloy*  
J. M. MALLOY  
Cdr., SC, USN

Staff Director, ASPR Division  
Office of Procurement Policy





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

SUPPLY AND LOGISTICS

CR

29 December 1958

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

SUBJECT: Contract Cost Principles

1. At your direction, I have held numerous meetings with representatives of the Military Departments and the Assistant Secretary of Defense (Comptroller) to consider the contract cost principles in the light of the strong protests which have been received from industry. Our objective has been to take a fresh look at the entire philosophy underlying our past efforts to develop a so-called comprehensive set of cost principles. Additionally, we have reviewed the individual items of costs and our recommendations in this regard are set forth herein.

2. Separate meetings were held on the research and development principle with additional representatives of the Military Departments and this office who are concerned directly with the Department of Defense research program. We have agreed on a substantial revision of our previous draft of this principle and this new draft has been sent to the various Assistant Secretaries for an expression of their views.

3. There is attached, as Tab A, a revision of certain portions of the cost principles. These changes are summarized as follows:

A. Title. Changed to "Contract Cost Principles and Procedures". This change is made to counter the industry claim that we have included procedural and instructional type material in addition to "principles". We feel that the detail which is included is the minimum necessary for proper administration.

B. Advance Understandings. This principle has been changed to clearly indicate that "The absence of such an advance agreement on any element of cost will not, in itself, serve to make that element either allowable or unallowable". Additionally, we have segregated the items for which advance understandings are "normally essential" from those where agreements are "normally appropriate".



- C. Direct Costing. We recommend certain technical changes in this principle to take care of a concept which was inadvertently omitted and to avoid duplication of charges under certain circumstances.
- D. Advertising. This principle has been liberalized somewhat to include the cost of exhibits sponsored by the Government as well as advertising for scarce materials or disposing of scrap or surplus materials.
- E. Contributions and Donations. We have made a substantive change in this principle to allow the costs of reasonable contributions to established nonprofit charitable organizations. It is our feeling that industry fully substantiated this type of cost as an unavoidable expense. We do not believe that we have opened "Pandora's box" and, further, we feel that no insurmountable problems of administration will be encountered.

The Air Force representative does not concur in the above recommendation feeling that, as proposed, this principle would open the door to further demands by industry, as well as lead to abuses and complex administrative problems.

- F. Interest. While we recommend that interest costs remain unallowable, we propose an addition to ASPR 3-808.4 to indicate that the extent of a contractor's total investment in the performance of the contract will be taken into consideration in the fixing of the amount of the fee or profit.
- G. Plant Reconversion Costs. This principle has been liberalized to allow additional costs by mutual agreement where equity so dictates in special circumstances.
- H. Rental Costs. This principle has been liberalized to include "market conditions in the area" as a test of reasonableness of rental costs.

4. I am attaching as Tab B, a suggested revision of the compensation principle. The objective of this revision is to recognize that in the determination of the reasonableness of total compensation, contracting officers, as a practical matter, can only cope with the unreasonable or out of line situation. Since this is true, it is felt that we should inject some flavor of this approach into our cost principle to assist contracting officers in an extremely difficult area of contract administration. The substance of this revision is currently contained in paragraph 54-905 (a) of the Air Force Procurement Instructions.



5. We have spent most of our time in reviewing our previous position with respect to the Applicability section of the principles since it is the most controversial area both within the Department of Defense and with industry. In our review of industry comments, we have taken particular note of the strong protests lodged against the application of detailed cost principles to contracts of the fixed-price type. While we never intended to utilize the cost principles as a detailed blueprint for the establishment of prices in the fixed-price area, we feel that industry is justified in their objections to our previous drafts in this regard. In addition to the industry protests, the Military Departments have expressed a strong desire that our regulations specifically recognize the pricing principles incorporated in ASPR Section III, Part 8, as the basic guidelines for the determination of fair and reasonable prices for fixed-price type contracts. This approach is in contradistinction to our previous draft which, however artfully worded, gives the unmistakable flavor of pricing by formula. Procurement personnel of all of the Departments are apprehensive lest contracting officers use the cost principles as a crutch to avoid criticism, to the detriment of our generally accepted pricing philosophy. They have maintained, as did industry, that this will be the inevitable result of our previous approach regardless of our intent to the contrary.

Our overall analysis of the specific items of cost as now recommended is that they are fair and equitable for strict application to cost type contracts. In reviewing any of the specific items of cost, we are necessarily primarily concerned with respect to their allowability in the riskless cost type contract. We feel that we should be more conservative, more detailed, and more specific in this type of contract than in those of the fixed-price type.

The need for cost analysis with respect to fixed-price type contracts varies in a broad spectrum. In the final pricing of incentive contracts, major reliance must be placed on costs. In redeterminable type contracts, we are generally looking ahead and, while cost analysis is an important factor in establishing fair and reasonable prices, it must be used judiciously and not slavishly. In firm fixed-price contracts, the use of cost analysis and the detail of its use varies on a broad scale. As we endeavor to fit a given set of cost principles, tailored as they must necessarily be to the cost-type contract, to these many and varied pricing situations, we run the great danger of so inhibiting our contracting personnel that the inherent advantages of fixed-price contracts and our pricing techniques will be lost.

We have previously been guided and influenced by the truism that "a cost is a cost regardless of the type of contract". We do not take issue with this generality; however, to give effect to this principle tends to result in a detailed evaluation of costs in most instances. This motivation for specificity in the evaluation of a price will inevitably lead to formula pricing. There are many situations in which we need be concerned only with the general level of estimated costs and secondarily with the types of costs included in the estimate.

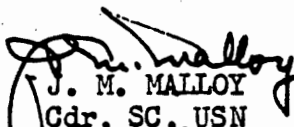
We have stated repeatedly in ASFR that the negotiation of a fair and reasonable price requires the exercise of good business judgment. The exercise of this judgment requires flexibility in the negotiation process to concentrate on the major elements of a price. Negotiation implies and demands a give and take approach so as to arrive at a mutually acceptable fair and reasonable price. In this atmosphere of give and take (not adamant dictation by one party to the negotiation) it is essential that the Government negotiator be provided with the flexibility to recognize the validity of a contractor's requests with respect to any element of cost in return for a more advantageous concession by the contractor with respect to another element of the price. 2

The observations set forth above are not new. They are the basic and inherent problems which have prevented an easy resolution to this question over the past few years. If the principles are issued with their applicability as set forth in the 21 August 1958 draft, we can look forward to continued and violent disagreement with industry. We can foresee future misunderstanding on the part of contracting officers as they endeavor to reconcile the applicability of the cost principles with the pricing techniques of ASFR Section III, Part 8. We can expect pressure toward formula pricing emanating from reviewing authorities such as the General Accounting Office.

In many respects, we find ourselves on the horns of a dilemma. Some members of the working group strongly advocated a complete separation of all fixed-price type contracts from any tie-in with the cost principles. They would create a separate part in Section XV to cover fixed-price type contracts in which the principles would not be used as a "guide" since previous experience in using the present Section XV, Part 2, as a guide in pricing fixed-price contracts had resulted in formula pricing. The majority, however, while concurring in the concept of a separate part for fixed-price contracts, believes that since cost analysis is an important factor in pricing many fixed-price contracts, we need to state that the cost principles will be used "to provide general guidance" in the pricing of such contracts. While recognizing that even this latter tie-in to the principles runs the danger of some formula pricing, it is recommended here as a middle ground which offers the best accommodation of the many conflicting points of view which are involved.

While we have redrafted the Applicability Section many times, we are not able to present a fully coordinated new draft at the present time. Tab C, attached, appears to offer the most practical solution. It is furnished herewith to serve as the basis for future discussions of the basic policy questions underlying the resolution of this difficult problem.

The representative of the Assistant Secretary of Defense (Comptroller) does not concur with the views expressed herein. It is his view that to the extent costs are a factor in pricing, they should be evaluated on a uniform basis regardless of the type of contract involved. He believes that the present proposal is inconsistent with the policy previously established after thorough consideration at the highest levels within the Department, and that the Applicability section contained in the 21 August 1958 draft, with certain minor revisions, should be retained.

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

3 Incls

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

### TITLE OF SECTION

In order to avoid the charge that ASPR Sec. XV is not "Cost Principles" as the present title would indicate, we recommend that the title be changed to "Contract Cost Principles and Procedures."

### ADVANCE UNDERSTANDINGS

Modify 15-204.1(b) of the 21 August draft to read as follows:

"...Such agreement may be initiated by contracting officers individually or jointly for all defense work of the contractor, as may be appropriate. Any such agreement should be incorporated in cost-reimbursement type contracts or made a part of the contract file in the case of negotiated fixed-price type contracts, and should govern the cost determinations covered thereby throughout the performance of the related contract. The absence of such an advance agreement on any element of cost will not, in itself, serve to make that element either allowable or unallowable. However, the nature of certain costs is such that advance agreements are normally essential. These are:

- (i) pre-contract costs (ASPR 15-204.2 (dd));
- (ii) royalties (ASPR 15-204.2 (jj));
- (iii) travel costs, as related to special or mass personnel movement (ASPR 15-204.2 (ss)(5));

Examples of others for which such agreements are normally appropriate, though not essential, are:

- (iv) use charges for fully depreciated assets (ASPR 15-204.2 (i)(6));
- (v) compensation for personal services (ASPR 15-204.2 (f));
- (vi) deferred maintenance costs (ASPR 15-204.2 (t)(1)(ii));
- (vii) research and development costs (ASPR 15-204.2 (ii)(6)); and
- (viii) selling and distribution costs (ASPR 15-204.2 (kk)(2))."

### DIRECT COSTING

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

15-202(a) Add:

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



ADVERTISING15-204.2 Listing of Costs.(a) Advertising Costs.

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

- (i) Advertising in trade and technical journals, provided such advertising does not offer specific products or services for sale but is placed in journals which are valuable for the dissemination of technical information within the contractor's industry; and
- (ii) help wanted advertising, as set forth in (gg) below, when considered in conjunction with all other recruitment costs.
- (iii) costs of participation in exhibits sponsored by the Government for the purpose of developing military applications of products.
- (iv) advertising relating to accomplishment of the contract mission for the purpose of obtaining scarce materials or equipment, or disposing of scrap or surplus materials.

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

CONTRIBUTIONS AND DONATIONS

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

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

INTEREST ON BORROWINGS

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

"d. Extent of the Contractor's Investment.

*(both equity and borrowed capital)*

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

PLANT RECONVERSION COSTS

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

RENTAL COSTS

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

Revise paragraph (1) of the principle to read as follows:

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

COMPENSATION

- A. To take care of the gigantic problem incident to an examination of ALL compensation plans, change paragraph (b) as follows:

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

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

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

## Part 7 - Fixed-Price Type Contracts

15-700 Scope of Part. This Part sets forth the guidelines to be used for the evaluation of costs in negotiated fixed-price type contracts, including terminations thereof, in those instances where such evaluation is required to establish prices for such contracts. "Fixed-price type" contracts include, for purposes of this Part, the following:

- (i) firm fixed-price contracts (ASPR 3-403.1)
- (ii) fixed-price contracts with escalation (ASPR 3-403.2)
- (iii) fixed-price contracts providing for the redetermination of price (ASPR 3-403.3)
- (iv) fixed-price incentive contracts (ASPR 3-403.4)
- (v) non-cost-reimbursable portion of time and materials contracts (ASPR 3-405.1)

15-701 Basic Considerations. (a) Under fixed-price type contracts, prices, not separate elements of cost plus profit, are to be negotiated. A negotiated price is the basis for payment to a contractor under fixed-price type contracts; allowable costs are the basis for reimbursement under cost-reimbursement type contracts. Accordingly, the policies and procedures of ASPR Section III, Part 8, are governing and shall be followed in the negotiation of fixed-price type contracts.

(b) As recognized in ASPR Section III, Part 8, there are within the fixed-price type category of contracts certain situations, e.g., incentive and redeterminable contracts, in which costs are a significant factor in the negotiation of prices. In such situations, costs must be submitted by contractors, evaluated by the Government, and used as

appropriate in negotiating fair and reasonable prices. However, since the basic objective, even in these situations, is the negotiation of a price rather than the determination of allowable and unallowable costs, the use of cost principles must be flexible.

15-702 Cost Principles and Their Use. (a) When, pursuant to ASPR 15-701, costs are to be considered in fixed-price type contracts, Section XV, Part 2, shall be used to provide general guidance in the consideration of cost data in conjunction with other pertinent considerations as set forth more fully in ASPR Section III, Part 8, required to establish a fair and reasonable price.

(b) In using Part 2 of this Section XV for general guidance, contracting officers are not necessarily required to evaluate specifically each individual item of cost (as is required for cost-reimbursement type contracts) in establishing a price; nor shall they be required, in substantiating or justifying a negotiated price, to explain the treatment accorded each such item of cost. Notwithstanding the above, contracting officers are required to fully substantiate and justify any negotiated price. (See ASPR 3-811.)

ASSISTANT SECRETARY OF DEFENSE  
Washington 25, D.C.

DepAsstSecDef(S&L) has seen

Supply and Logistics

CR

DEC 31 1958

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

SUBJECT: Contract Cost Principles

As you are aware, our staffs have been re-evaluating our previous draft of the contract cost principles in the light of the strong protests lodged by industry at the 15 October 1958 meeting and in subsequent correspondence. The attached memorandum contains the results of this staff analysis and contains much food for thought as to our final resolution of this matter. While I am not necessarily in agreement with all of the recommendations contained in this report, I think that it provides a basis for our further discussions. I would like to meet with you upon my return to Washington in early February for the purpose of formulating a recommendation to the Secretary of Defense.

(signed)

PERKINS McGUIRE  
Assistant Secretary of Defense  
(Supply and Logistics)

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

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2/14/59



C O P Y

December 15, 1959

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

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

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

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

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

Attachment

C O P Y

C O P Y

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December 10, 1959

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

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

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

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

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

C O P Y

C O P Y

December 15, 1959

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

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

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

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/Signed/

FRANKLIN B. LINCOLN, JR.  
ASSISTANT SECRETARY OF DEFENSE

Attachment

Prep: JLucas/ak/12/11/59  
OASD(CMPT)AUDIT POLICY DIV 3B352 76321

C O P Y

ASSISTANT SECRETARY OF DEFENSE  
Washington 25, D. C.

CR  
Supply and Logistics

February 10, 1960

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

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

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

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

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

(a) Existing Cost-Reimbursement Type Contracts.

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

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

- (i) anticipated increased or decreased costs, if any;
- (ii) administrative savings expected to be gained by costing cost-reimbursement prime contracts with a given contractor on the basis of one set of cost principles;
- (iii) the effect on subcontracts under the prime contract (see ASPR 15-204(b));
- (iv) absence or existence of specific contractual provisions or other arrangements affecting the treatment of certain costs, such as those for research;
- (v) in consideration of (iv) above, the appropriate use of advance understandings (ASPR 15-107) as for example, where it may not be appropriate to allow independent research costs under the revised cost principles in instances where such costs have not been allowed heretofore under the existing contracts;
- (vi) other advantages or disadvantages to the Government.

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

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

**(b) New Cost-Reimbursement Type Contracts.**

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

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

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

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

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

**USE OF REVISED CONTRACT COST PRINCIPLES**

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

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

## USE OF REVISED CONTRACT COST PRINCIPLES

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

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

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

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

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

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



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

\_\_\_\_\_  
/s/

PERKINS McGUIRE  
Assistant Secretary of Defense  
(Supply and Logistics)



ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON 25, D. C.

FEB 24 1959

COMPTROLLER

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

SUBJECT: Contract Cost Principles

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

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

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

*W. J. McNeil*

W. J. McNeil

Inclosure  
Comments on  
applicability.

*PS. I wonder how soon some very sincere people in the business will recognize that - whether we like it or not - the more of the contract dollar volume is based on cost regardless of the label on the contract.*

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

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

CR

19 February 1959

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

SUBJECT: Contract Cost Principles

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

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

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

cc: Cdr. Malloy

CR

23 March 1959

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

SUBJECT: Contract Cost Principles

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

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

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

12 February 1959

CONTRACT COST PRINCIPLES  
APPLICABILITY TO FIXED PRICE CONTRACTS

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

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

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

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

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



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

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

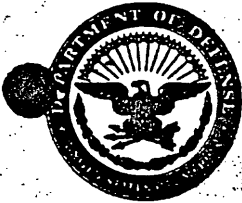
4. Effect of risk on application of cost principles -- In justifying the proposed new applicability Part, there appears to be some confusion with respect to risk in two respects. The first relates to the reference to "the riskless cost type contract." This seems to say that there is no risk in cost type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

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



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

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



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

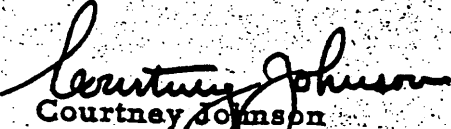
IN REPLY REFER TO:

JUN 5 1959

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (S&L)

SUBJECT: Contract Cost Principles

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

  
Courtney Johnson  
Assistant Secretary of the Army  
(Logistics)

0720 (2751)

100 001 2 134 11

RECEIVED

DEPARTMENT OF THE NAVY  
OFFICE OF THE SECRETARY  
WASHINGTON

29 MAY 1959

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

Subj: The Contract Cost Principles and Procedures, comment on

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

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

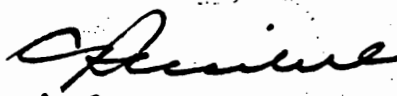
a. Page 4, line 19, after "will not," insert "with the exception of the limitations on rentals paid under sale and leaseback agreements. (See ASPR 15-205.34 (c))." Also include on page 5, as one of the examples of costs for which advance agreements may be particularly important, "(ix) Sales and leaseback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

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

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

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

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

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

DEPARTMENT OF THE AIR FORCE  
WASHINGTON

OFFICE OF THE ASSISTANT SECRETARY

JUN 11 1959

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)  
SUBJECT: Contract Cost Principles

1. Reference is made to your memorandum dated 19 May 1959 on the above subject. We have reviewed the latest draft attached to your memorandum and recognize the compromises that have been made in several items to accommodate divergent views among the Departments as well as with industry. Accordingly, we think it should be clearly understood that if actual experience under the proposed principles reveals any deficiencies, we will seek reconsideration of the matters involved. Since the proposal seems to offer an acceptable basis for early adoption, we concur subject to the comments noted below.

2. We note the deletion in paragraph 13-207.22(a) of the prohibition relating to "write down" or "write up" of material values which had appeared in earlier drafts and which now appears in part in current ASPR 17-207.1. We understand that discussions on this point have taken place between the top Comptroller people in the Air Force and the Department of Defense. We also understand that agreement in principle has been reached to the effect that it is our common understanding that Department of Defense policy generally is not to accept such costs. Apparently this understanding is to be made a matter of record so that, should the problem arise, such an understanding could be relied upon to give a common answer. As you know, such an understanding cannot form the basis of a contractual obligation. Accordingly, we would urge for consideration the inclusion in the Cost Principles of appropriate language covering the point.



P. B. TAYLOR

Assistant Secretary of the Air Force

C-1211 (SF)

RECEIVED

4 May 1959

**MEMORANDUM**

**From:** N302A  
**To:** N03A

**Subj:** Conformance of ASPR Section VIII with Section IV Cost Principles

**Encl:** (1) Proposed Revision of ASPR Section VIII

1. It is recommended that ASPR Section VIII be revised as indicated by enclosure (1). While Section VIII, Part 2 contains principles applicable to both fixed-price and cost-reimbursement type contracts, this part in ASPR 8-213 also deals with the settlement of certain research and development contracts under fixed-price or cost-reimbursement type no-profit or no-fee with educational or other non-profit institutions. For such cost-reimbursement contracts with non-profit institutions the principles in Section IV, Part 3 should be used in effecting a termination settlement, while the fixed-price types should be settled under Section IV, Part 3 and the principles recommended for insertion in Section VIII, Part 3.
2. The cost principles in ASPR Section IV, Part 2 are considered to be sufficient for the settlement of cost-reimbursement type contracts with other than non-profit institutions. For the settlement of terminated fixed-price contracts, however, the cost principles in Section IV, Part 2, should be supplemented by the additional cost principles recommended for insertion in Section VIII, Part 3.
3. It is also recommended that the language originally submitted under Case #1-74 for ASPR 8-301 and 8-301.1 which was approved by the ASPR Committee be restored when the comprehensive set of principles are published.

C. M. CLARK



### Part 3

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

Pages 823 - 831 - Delete present AFPM 8-306, 8-301, and 8-302 and insert the following:

##### 8-301 Principles for Establishing the Settlement Amount.

8-301.I General. (a) A settlement should compensate the contractor fairly for the work done and the preparations made for the terminated portion of the contract, including an allowance for profit thereon which is reasonable under the circumstances. The primary objective is to negotiate a settlement by agreement; however, the total amount payable to the contractor, whether through negotiation or by determination, before deducting disposal or other credits and exclusive of settlement costs, shall not exceed the contract price less payments otherwise made or to be made under the contract. Fair compensation is a matter of judgment and cannot be measured exactly. In a given case, various methods may be equally appropriate for arriving at fair compensation. The application of standards of business judgment, as distinguished from strict accounting principles, is the heart of a settlement. The parties may agree upon a total amount to be paid the contractor without agreeing on or segregating the particular elements of costs or profit comprising this amount. Cost and accounting data may provide guides, but are not rigid measures, for ascertaining fair compensation. In appropriate cases, costs may be estimated, differences compromised, and doubtful questions settled by agreement. Other types of data, criteria, or standards may furnish equally reliable guides to fair compensation. The amount of record keeping, reporting, and accounting, in connection

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

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

#### 8-302 Additional Cost Principles

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

**8-303 Allowance for Profit.**

(Use printed ASPR 8-303)

**8-304 Adjustment for Loss.**

(Use printed ASPR 8-304)

**8-305 Deductions**

(Use printed ASPR 8-305)

**8-306 Completed End Items.**

(Use printed ASPR 8-306)

**8-307 Settlement Proposals**

(Use printed ASPR 8-307)

**Reference changes:**

**Page 831 8-303(a) - Line 4 - change parenthetical reference**

**8-302(b)(27) to 8-302(6)**

**Page 832 8-304(b)(11)-Line 3 - change parenthetical reference**

**8-302(b)(13) to 8-302(3)**

**Page 841 8-503.5 - Line 5 - change parenthetical reference**

**8-302a(1)(a)(11) to 8-302(1)**

**Page 862 - 872 Clauses 701 and 703, para (f) change references to**

**include applicable principles in Section XV and those**

**in Section VIII, Part 3**



Part 2

Pages 820 - 821 - Delete present ASPR 8-213 and insert the following:

8-213 Cost Principles Applicable to the Settlement of Certain Terminated Research and Development Contracts.

In considering cost data as a guide for negotiation or determination of settlements under fixed-price or cost-reimbursement type no-profit or no-fee contracts for experimental, developmental, or research work with educational or other nonprofit institutions, which contain the termination clause set forth in ASPR 8-704, the items of cost set forth in ASPR Section XV, Part 3 and ASPR 8-302 shall be considered subject to the general policies set forth in ASPR 8-301.1.





DEPARTMENT OF THE AIR FORCE  
WASHINGTON

OFFICE OF THE ASSISTANT SECRETARY

JUN 11 1959

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)

SUBJECT: Contract Cost Principles

1. Reference is made to your memorandum dated 15 May 1959 on the above subject. We have reviewed the latest draft attached to your memorandum and recognize the compromises that have been made in several items to accommodate divergent views among the Departments as well as with industry. Accordingly, we think it should be clearly understood that if actual experience under the proposed principles reveals any deficiencies, we will seek reconsideration of the matters involved. Since the proposed principles seem to offer an acceptable basis for comments on the subject to the

2. We prohibition values which in part, in on this point in the Air stand that a that it is a policy general understanding the problem to give a cannot form t we would urge Principles of

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TOMORROW

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05.22(c) of the "ups" of material which now appears, and that discussions comptroller people. We also understood to the effect of Defense apparently this that, should be relied upon understanding. Accordingly, the Cost point.

P. B. LARSON  
Assistant Secretary of the Air Force



DEPARTMENT OF THE AIR FORCE  
WASHINGTON

OFFICE OF THE ASSISTANT SECRETARY

JUN 11 1959

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)

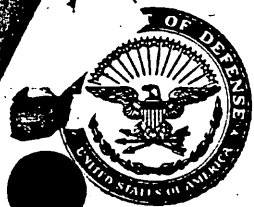
SUBJECT: Contract Cost Principles

1. Reference is made to your memorandum dated 15 May 1959 on the above subject. We have reviewed the latest draft attached to your memorandum and recognize the compromises that have been made in several items to accommodate divergent views among the Departments as well as with industry. Accordingly, we think it should be clearly understood that if actual experience under the proposed principles reveals any deficiencies, we will seek reconsideration of the matters involved. Since the proposal seems to offer an acceptable basis for early adoption, we concur subject to the comments noted below.

2. We note the deletion in paragraph 15-205.22(c) of the prohibition relating to "write downs" or "write ups" of material values which had appeared in earlier drafts and which now appears, in part, in current ASPS 15-202.1. We understand that discussions on this point have taken place between the top Comptroller people in the Air Force and the Department of Defense. We also understand that agreement in principle has been reached to the effect that it is our common understanding that Department of Defense policy generally is not to accept such costs. Apparently this understanding is to be made a matter of record so that, should the problem arise, such an understanding could be relied upon to give a common answer. As you know, such an understanding cannot form the basis of a contractual obligation. Accordingly, we would urge for consideration the inclusion in the Cost Principles of appropriate language covering the point.

P. B. LARSON  
Assistant Secretary of the Air Force

ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON 25, D. C.



COMPTROLLER

MAY 26 1959

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (S&L)

SUBJECT: Contract Cost Principles and Procedures

By memorandum of May 15, 1959, you requested my approval of the May 12th draft of cost principles. In consideration of the many divergent viewpoints which had to be accommodated therein and the urgent need for principles in the negotiated fixed-price area, I give my approval.

A handwritten signature in cursive script, reading "W. J. McNeil", is written above the printed name.

W. J. McNeil





OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON 25, D. C.

CR

SUPPLY AND LOGISTICS

13 May 1959

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)  
Through: Director for Procurement Policy *MS*

SUBJECT: Contract Cost Principles

Mr. Kilgore and I have met with representatives of the Military Departments to consider the changes which were made in the Contract Cost Principles as a result of the meetings we held with Industry representatives on 1-3 April 1959. I am inclosing as Tab A a new draft of the Cost Principles which we recommend for your approval. This draft has been concurred in by all members of the special working group.

While we made numerous changes in the previous draft as a result of the Industry meeting and our further consideration of the Cost Principles, a great majority of the changes were of a clarifying nature. Several revisions of a technical nature, such as the definitions of direct and indirect costs, were made at the suggestion of the Industry representatives. No change has been made in the research and development principle as a result of our latest reviews. We have made certain editorial rearrangements of the material which we feel has improved the overall content of the regulation. For example, we have included the section on Advance Understandings in Part 1 of the regulation in lieu of having it an integral part of the cost principles themselves which are set forth in Part 2 of the regulation.

Your particular attention is invited to the following changes which we recommend for your approval, but which go beyond the type of clarifying and technical changes mentioned above:

1. Advertising Costs.

The Industry representatives argued strongly and rather persuasively that our proposed coverage of the cost of exhibits was much too narrow. The previous draft contained the following:

"(iii) costs of participation in exhibits upon invitation of the Government:"

Our recommended revision is as follows:

"(iii) costs of participation in exhibits—

(A) upon invitation of the Government, or

(B) which exhibits are valuable for the purpose of disseminating technical informa-



tion within the contractor's industry; however, such costs are not allowable under this subparagraph (B) if the exhibit offers specific products or services for sale;"

It is our feeling that the principle as revised does not open the door too far with respect to costs of exhibits. We allow costs of advertising in trade and technical journals which do not offer specific products for sale but are placed in journals which are valuable for the dissemination for technical information within the contractors' industry. It seems logical to us to allow the cost of exhibits under the same circumstances.

## 2. Training and Educational Costs.

We have revised that portion of this principle which deals with costs of part-time education at an under-graduate or post-graduate college level by deleting the restriction to "technical, engineering, and scientific." Our discussion, even within Defense, indicated that the term "technical" was subject to varying interpretations. In its narrowest sense, it could be considered to exclude certain training which we considered acceptable such as training of contract administration personnel and the training of certain technical personnel in sound business and cost control techniques. The other controls and restrictions which we have as a part of this particular cost principle seem to us sufficient to prevent any abuse.

## 3. 16-603. Cost Principles and Their Use.

The previous draft of a portion of this paragraph was as follows:

"(b) Whenever an occasion arises in which acceptability of a specific item of cost becomes an issue, Section XV, Part 2, will serve as a guide for the resolution of the issue."

We have revised the above as follows:

(b) "In retrospective pricing, whenever an occasion arises in which the acceptability of a specific item of cost becomes an issue, the appropriate part of this Section XV will serve as a guide for the contracting officer in his conduct of negotiations."

The Industry representatives were particularly vocal with respect to our previous draft. While they would have much preferred to see this paragraph eliminated entirely, we were able to work out an acceptable compromise which serves to eliminate the impression which could be read into the previous draft that we would resolve conflicts on specific items of cost by dictation or slavish application of accounting rules.

Many of the suggestions offered by Industry were not acceptable to our working group and have not now been incorporated in the revised draft. Some of these suggestions concern themselves with costs connected with patents, taxes and insurance. The Industry representatives felt quite strongly that we should change our principle on bad debts to restrict the unallowability of such a cost to "commercial" bad debts on the theory that there are numerous instances within the Defense industries wherein bad debt expense is encountered in connection with government contracts, without the fault or negligence of the contractor. While some of us felt that the Industry point here was well taken, the departmental representatives did not consider such a revision appropriate and hence it has not been made in the attached draft.

It is my hope that we can expedite the remaining clearances necessary in connection with these cost principles to the end that they can be sent to the printer during the month of June. In this way, they could be mandatorily effective on 1 January 1960, although they would be available for use upon publication. The following specific actions seem necessary prior to the releasing of this regulation for printing:

1. The attached draft should be specifically approved by the Materiel Secretaries of the Departments and Mr. McNeil as soon as possible. This could be accomplished by memorandum, by discussion at the Materiel Secretaries weekly meeting on 21 May 1959, or in a special meeting called for this purpose.
2. The question as to the necessity of obtaining the specific approval of the Secretary of Defense should be decided.
3. The method by which we deal with the General Accounting Office should be determined and the program of action in this regard should be initiated.
4. We have a commitment to discuss the cost principles prior to publication with Dr. Saulnier and the Committee on Government Activities Affecting Costs and Prices.

  
J. M. MALLOY

Cdr, SC, USN  
Staff Director, ASPR Division  
Office of Procurement Policy

1 Incl.  
Tab A



15 May 59

MEMORANDUM FOR THE DIRECTOR OF DEFENSE RESEARCH AND ENGINEERING  
THE ASSISTANT SECRETARY OF DEFENSE (COMPTROLLER)  
THE ASSISTANT SECRETARY OF THE ARMY (LOGISTICS)  
THE ASSISTANT SECRETARY OF THE NAVY (MATERIAL)  
THE ASSISTANT SECRETARY OF THE AIR FORCE (MATERIAL)

SUBJECT: Contract Cost Principles.

I am enclosing for your consideration a revised draft, dated 12 May 1959, of the contract cost principles. While this revision does not contain major changes from the draft which we recently discussed, it does represent a refinement of language as a result of the meetings with certain industry representatives on 1-3 April 1959.

I am hopeful that no further revisions need be made in the cost principles and that we can move quickly to accomplish the remaining clearances necessary prior to publication. I am encouraged in this belief by the fact that the attached draft has been recommended for my approval by an interdepartmental working group made up of your designated representatives.

In view of the urgency of this matter, I would appreciate an indication of your approval of the attached draft at your earliest convenience. Should you care to suggest changes of a substantive nature, I suggest that you advise me at the earliest possible time.

*Perkins McGuire*

PERKINS MCGUIRE  
Assistant Secretary of Defense  
(Supply and Logistics)

1 Incl.  
Rev. Draft 214  
12 May 59

Prepared by: JMMalloy/rbs/14May59  
3D774 72026

Coordinated by:  
G.C. Bannerman

*Reverts*

15 May 1959

TO: Mr. Ernest Brackett  
NASA

FROM: Cdr. J. M. Malloy

SUBJECT: Contract Cost Principles

As promised in my letter of 12 May 1959, I am attaching a copy of the latest draft of the Contract Cost Principles. This draft has not been released as yet, and hence I would request that you refrain from making any distribution beyond your office. I will keep you posted as to the status of approval of this draft within the Department of Defense.

(signed)

J. M. MALLOY  
Cdr, SC, USN  
Staff Director, ASPR Division  
Office of Procurement Policy

## THE CONTRACT COST PRINCIPLES DILEMMA

Remarks by Commander John M. Malley, SC, USN, at the Joint  
NSA-Strategic Industries Association Symposium, Miramar  
Hotel, Los Angeles, California, 20 May 1959.

I suppose there is no more controversial or talked about subject in procurement circles today than the proposed revision of Section IV of the Armed Services Procurement Regulation dealing with contract cost principles.

You are aware, no doubt, that we have had cost principles for cost-type contracts for many years. The latest major revision of these particular principles occurred in 1949. There is no dispute with respect to the need for rather precise cost principles applicable to cost-type contracts, although reasonable men may disagree rather violently on the particular treatment accorded specific elements of cost. About 5 years ago, we undertook to revise and up-date our principles for cost-type contracts and, at the same time, extend the use of cost principles in some way to other types of contracts where costs are a factor in pricing.

We are, I think, approaching the end of this effort. We have received voluminous comments from almost all segments of American industry on the various drafts of this revision. Last October, we conducted a rather unique meeting with industry which involved an all-day discussion by key Government and industry spokesmen on the principal issues which have been raised with respect to the proposed revision of the Regulation.



The verbatim transcript of this meeting provides an interesting and, I think, enlightening discussion. I believe that a few copies of this transcript are still available.

Subsequent to this meeting, we, in the Department of Defense, have been conducting a thorough re-appraisal of this project so as to have a workable and, as nearly as is possible, a mutually acceptable regulation which will be of maximum assistance to all parties at interest.

I would like to outline for you today some of the basic problems involved in this effort. I think it only fair to ask the question - What are we really trying to do by this revision? What are the reasons why the project seems to have taken so long to get off dead center? We are trying basically to develop a common set of guidelines applicable to the determination of costs in all types of contracts in which costs are a factor in pricing. No one will seriously argue that a particular item of cost, say advertising or contributions or entertainment, is different, per se, under differing contractual situations. When these elements of cost are being considered, why should they be treated differently in different types of contracts? What we are really saying is that no one form of contract should be more attractive than another solely because of the cost treatment accorded it.

Further, we feel that we have a responsibility to establish some uniformity of treatment of the various cost elements and, hence, some type of cost principle application would appear to be necessary to accomplish this purpose. I recently discussed the



subject of cost principles with a very knowledgeable Congressman whose reaction was fast and definite on this question of uniformity. He used as his example, the case where one of the Services had established a flat prohibition against allowing incentive compensation based upon profit-sharing plans, when the other two Services were allowing such costs to the extent that the overall compensation received by an individual was determined to be reasonable. Obviously, such differing approaches should be resolved and made uniform.

Additionally, as you can appreciate, in carrying out a 22 billion dollar annual procurement program, we have many thousands of contracting officers, negotiators and auditors who, as a practical matter, need to be informed of at least the generality of the Department of Defense position with respect to certain cost items. Many of you are also familiar with the problems which continually arise in dispute cases being heard by the Armed Services Board of Contract Appeals. You are aware, for example, that the Board on several occasions has, in effect, created its own policies with respect to particular cost items in the fixed-price area, since no policy had been promulgated through administrative channels.

Now you might say that all this seems quite reasonable and logical. What then is the problem? What creates the dilemma? The objections to the use of cost principles on a broad scale are many. For example, there is the fear that there will be such attention paid to costs that our entire philosophy of pricing will be in danger. It is contended that this attention to specific

elements of cost may well drive the contracting officer to rely on cost principles so completely as a basis for pricing in order to avoid criticism, that our generally accepted pricing policies will be negated. It is contended that this situation will lead to formula pricing; that is, totaling up the adding machine tape of costs, to which a standardized profit is added. The effect of such pricing may well destroy the inherent advantages of our family of fixed-price type contracts.

There is another practical problem worthy of note. I think it is true that in developing the specific treatment to be accorded a particular item of cost, we tend to be primarily concerned with its reasonableness and allocability under the relatively riskless cost type contract. I have heard even the so-called liberals in this area say many times that we should be more conservative, more detailed in this kind of contracting atmosphere. The resulting set of principles then, and this can be said, I think, of any particular set which has been developed, is on the conservative side. Many claim that, for this reason alone, it can't, in equity, be considered in any area except the one which primarily reflects its contents; namely, the cost-reimbursement type contract.

We have stated repeatedly in our procurement regulation that the negotiation of a fair and reasonable price requires the exercise of good business judgment. The exercise of this

judgment requires flexibility in the negotiation process to concentrate on the major elements of a price. Negotiation implies and demands a give and take approach, so as to arrive at a mutually acceptable fair and reasonable price. In this atmosphere of give and take (not adamant dictation by one party to the negotiation) it is essential that the Government negotiator be provided with the flexibility to recognize the validity of any contractor request in return for a more advantageous concession by the contractor.

I have sketched for you some of the pros and cons of this argument. Now let's look at something more basic. I have mentioned pricing philosophy several times and have pointed out that comprehensive cost principles should not destroy this pricing concept. Now then, what is this pricing technique? Why not look at individual costs in each instance and tack on a profit?

Some people feel that a "fair and reasonable price" is one in which the contractor recovers all of his costs and gets a profit appropriate to his effort. This approach, however, ignores a basic business and pricing truth. Within reasonable limits, you can, through your method of contracting, control profits or you can control costs. You can't, within any reasonable degree of preciseness, control both. Through cost-reimbursement type contracts, you can control profit. You can assure that the contractor doesn't get rich, but you cannot, with any substantial



degree of effectiveness, assure that he is using his engineers, labor, and materials with reasonable effectiveness, that he is planning the work for efficient performance, that his designs are capable of low-cost manufacture, that his facilities are most effectively arranged or that any of a number of other factors seriously affecting his costs are being well performed. The Department of Defense does not have the talent, the experience, or the number of people required to undertake the management of American industry. If we do not perform this function, we cannot control costs in the only way they can be controlled under cost-reimbursement contracts. Since costs represent 85 percent or more of the prices we pay, it follows that uncontrolled costs are much more important to the prices we are required to pay than uncontrolled profits. Accordingly, we would prefer to create contractual situations where the contractor's management will bend every effort to keep costs down. Under these circumstances, we are willing to assume risks with respect to the extent of profits. This is the function of fixed-price contracts and of those incentive or redeterminable contracts which are targeted early. In setting firm fixed prices, final prices in redeterminable contracts or targets in incentive contracts, the great effort should be to arrive at a price which is sufficiently low to require the contractor's own management to do its utmost to use his engineers, labor, and materials effectively, to plan his work for efficient performance, to design his product for low-cost manufacture, to arrange his facilities in the best manner and to

to all other things appropriate to reducing his cost. If this is done, we shouldn't worry too much if he makes a higher-than-normal profit. He has earned it, and we have gained by it in most instances.

Fixed-price contracts provide a maximum amount of price control, whereas cost reimbursement type contracts provide for the maximum profit control. I want to emphasize this feature since it is very important. Recognition of this concept is the basis of our pricing philosophy. We might ask the question at this time, can we have both price control and profit control? If not, where should we place the emphasis?

I have spent considerable time on this basic pricing principle because, in my mind, it is at the crux of the dilemma which confronts us in prescribing cost principles to other than cost type contracts. We have the clear responsibility to provide guidelines for the handling of specific costs in any given situation while, on the other hand, we dare not destroy the very incentives for cost reduction which we feel are an inherent part of fixed-price contracts. Within the Department of Defense, I think it is safe to say we are all in agreement on these basic objectives. As you can imagine, however, there is plenty of room for reasonable men to disagree on how to accommodate these objectives.

I wish that I could give you a scoop today on the present status of this project within our office. However, I must content myself by telling you we have been spending a great deal of time re-appraising

our previous position with respect to the applicability of the principles.

We have leaned over backwards to obtain and fully consider the views of industry in our work on the cost principles. In this connection, we recently spent three full days with four industry experts who were asked by Secretary McNamara to assist us in a page by page review of the actual language which we are proposing. The revised cost principles are now in the process of final approval at the Secretarial level. We are undertaking discussions with certain agencies outside of the Department who have an interest in this project. My personal hope and expectation is that we will be able to send our new regulation to the printer in June. We contemplate that the new principles will present some rather substantial administrative problems in their early application and, hence, we are now thinking of a mandatory effective date of 1 January 1963 thereby providing a five months lead time. They would, of course, be available for use upon publication and, in any event, they would only apply to new contracts unless current contracts are amended by mutual consent.

In summary, I have endeavored to describe for you the horns of the cost principle dilemma-- the need for guidelines for use



internally and to provide for some uniformity in treatment of costs when costs are a factor in pricing. On the other hand, if this desirable objective could be obtained only at the expense of formula pricing, and at the cost of loss of incentives for price reduction in the fixed-price area, it might well be best to retain the status quo. It is my view that both objectives can be accommodated, and I am convinced that our current efforts will provide this result.

DEPARTMENT OF THE NAVY  
OFFICE OF THE SECRETARY  
WASHINGTON

29 May 1959

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)

SUBJ: The Contract Cost Principles and Procedures, comment on

Ref: (a) Memorandum from ASTSECDEF(S&L) of 15 May 1959 re Contract Cost Principles and Procedures revised draft of 12 May 1959.

1. Reference (a) has been reviewed by my staff and with the exception of the following comments, I approve its issuance:

a. Page 4, line 19, after "will not," insert "with the exception of the limitations on rentals paid under sale and leaseback agreements. (See ASPR 15-205.34 (c))." Also include on page 5, as one of the examples of costs for which advance agreements may be particularly important, "(ix) Sales and leaseback agreements." This is considered necessary in view of the specific limitation on such rentals in ASPR 15-205.34 (c).

b. Page 31, line 4, change (i) to read "the item is regularly manufactured and sold by the contractor through commercial channels for commercial end use." (Underscoring supplied). Change (ii) to (iii) and add a new (ii) as follows: "the charges for the item(s) are nominal in amount." These revisions are considered essential to avoid a situation where the "commercial" customer of the vendor is a prime or subcontractor to the Government and the prices of the items have not been established in the non-governmental market. Also, if the total volume of such items is substantial, it seems only equitable that they should be charged to the Government contracts on a cost basis (rather than at a price which includes a profit element) in order to avoid the payment of what may be hidden profits.

c. Page 45, top line: the word "allowable" should be changed to "unallowable."

d. Page 47 - Either add (i) after "instances" in the fourth line or delete (ii) in the fifth line.

2. As you know, industry has been primarily concerned with the applicability of the cost principles to other than CPFF contracts. The recent letter from MAPI to many of us is a strong reiteration of this position. Although I do not agree that issuance of the principles should be delayed to accommodate a further discussion of this subject, I recommend that in the practical implementation of the principles, the services be cautioned to avoid the "formula" pricing which industry fears. Should evidence of such pricing exist after a reasonable period of implementation of the principles, I strongly recommend further consideration on this matter at that time.

(signed) C. P. Milne

C. P. MILNE  
Assistant Secretary

30 August 1960

**SUGGESTED QUESTIONS ON COST PRINCIPLES FOR USE  
AT THE FEDERAL R&D ASSOCIATION MEETING ON  
6 OCTOBER 1960.**

1. What is the attitude of the Congress and the General Accounting Office toward cost principles in general and the new Department of Defense cost principles in particular?
2. Will the new Defense cost principles eventually be used throughout the Federal Government; specifically, will they be used by the Atomic Energy Commission and the National Aeronautics and Space Administration?
3. Industry has argued that all normal and necessary costs of doing business should be allowed under defense contracts. The new cost principles are not in accord with this principle. Why?
4. Were the new cost principles coordinated with industry? If so, how? Will future revisions of the cost principles be coordinated with industry?
5. In view of the obvious need to increase our research effort, why does the Department of Defense restrict the allowability of contractors' independent research and development expenses?
6. The expense of recruiting personnel, particularly technical personnel, has been increasing steadily. This often results in excessive competition, with the Government paying most of the cost. How can excesses in this area be isolated and stopped?
7. Bidding costs are allowable. Would it not, however, be a good idea to allow bidding costs only in those cases where the Government has solicited bids? This would prevent abuses in this area and would cut down on a lot of wasted effort.
8. Should not the cost principles be more specific with respect to travel, per diem, and moving expenses? If not, how can contractors be afforded uniform treatment in this area?
9. What is the role of Government auditors in connection with the use of cost principles; specifically, can a contracting officer overrule the recommendation of an auditor?
10. Does the Department of Defense plan to issue cost interpretations as the need may develop?
11. Cost principles should remain static to the maximum practicable extent to obviate administrative difficulties. Does the Department of Defense have any plan for the issuance of future changes, particularly as to the timing of these changes?

24. Can you segregate the major unallowable items into categories and indicate why they are not allowed?

25. Is it possible to negotiate an advance understanding which would provide for the allowability of an item listed as unallowable in the cost principles?

26. In connection with independent development expense, what is meant by the term "product line?"

27. May a prime contractor insert the new cost principles in subcontracts entered into under prime contracts which contain the old principles?

28. When a contractor and the Department of Defense cannot agree on an advance understanding for independent research and development costs (or any other cost) -

(a) Will the Department of Defense make a unilateral determination at that time? or

(b) Will the matter be left open for negotiation after the fact?

29. What will be the attitude of the ASBIA toward use of the cost principles - - basis?, guide?, or not at all, particularly in connection with fixed price contracts?

30. In applying the test of "reasonableness," from whose standpoint will it be considered? For example, from a contractor's standpoint it might be reasonable to spend large sums on research and development over a short period in order to establish himself at the forefront in a new area of technology. At the same time, however, allocation of such costs to an end product for which the Government is contracting might appear to make the cost of that product unreasonable.



12. The cost principles provide that rental costs specified in sale and leaseback agreements are allowable only to the extent that any such rentals do not exceed the amount which the contractor would have received had he retained legal title to the facilities. How does this affect a bona fide sale and leaseback arrangement established prior to the publication of the new cost principles?

13. How much of the total Department of Defense contract dollar will be affected by the new cost principles?

14. The new cost principles provide a big stick to those elements who believe in formula pricing. How does the Department of Defense plan to prevent formula pricing?

15. What type of internal controls does the Department of Defense have to prevent each Military Department from issuing multitudinous and conflicting implementations of the new cost principles?

16. Does the Department of Defense have any changes to the cost principles under active consideration now?

17. What has been the general reaction of industry to the new cost principles?

18. How does the Department of Defense insure that the cost principles are administered in accordance with the philosophy and intent of the drafters of the principles? It is a long way from policy to execution.

19. Why did the Department of Defense find it necessary to come out with so many unallowable items of expense and so many other restrictions on allowability?

20. Why is it not sufficient to establish cost rules of a general nature and trust that a fair and equitable result will flow from the exercise of good judgment on the part of both Government and contractor representatives?

21. In connection with the research and development cost principles, is cost-sharing appropriate unless there has been a preliminary finding that the overall research cost is unreasonable?

22. Does the Department of Defense make any distinction between contractors whose business is primarily governmental and those whose business is primarily commercial?

23. Do contractors have to submit price proposals (including cost breakdowns) in accordance with the new cost principles?

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

Supply and Logistics

September 7, 1960

Dear Admiral Boyle:

Your letter of 8 July asks for our response to nine specific questions relating to the application of ASPR 15-205.35, covering allowability of a contractor's independent research and development costs, in light of the provisions of ASPR 15-107 which provides for an advance understanding on particular cost items (including research and development), and DOD Instruction 4105.52 which provides for uniform negotiation of such costs and establishes an Armed Services Research Specialists Committee to provide scientific and technical advice in connection with the negotiation.

At the outset a brief analysis of the documents cited may facilitate an understanding of the problem.

ASPR 15-205.35 allows a contractor's independent research and development expenses on the basis specifically described. It indicates that advance understandings are particularly important with contractors whose work is predominantly or substantially with the Government. General guidelines as to the reasonableness of this cost item are included and several alternative techniques are provided for use in those situations where it is determined that the cost is unreasonable and, hence, the Government should not bear its full allocable share of the total research program.

DOD Instruction 4105.52 makes provision for the negotiation of contractors' independent research and development costs by a single military department when (i) the research and development costs are substantial, (ii) a substantial portion of the contractor's business is with the Department of Defense, and (iii) the contractor's defense work involves contracts with more than one military department. The Instruction also establishes the Armed Services Research Specialists Committee and assigns to the Committee the mission of providing, when requested, advice to the sponsoring department on the scientific and technical factors which influence the extent to which the independent program should be supported.

Now we will respond to your specific questions.

1. Question 1 presumes that the Armed Services Research Specialists Committee will negotiate advance understandings. As stated above, the negotiations of research costs will be undertaken by the military departments rather than by the Research Specialists Committee. While the recommendations of the ASRSC will necessarily be advisory in nature, they will, nevertheless, be given great weight by the military departments.



The second portion of the question has to do with whether the negotiation procedures are available (a) to any contractor who desires to recover research and development expenses, or (b) who also does business with more than one department. It will not be necessary for all contractors who desire recovery of independent research and development expense to be considered under the procedures established by DOD Instruction 4105.52. Thus, where a small amount of cost is involved, either because of the size of the research and development program or due to the minor amount of defense contracts, or where a contractor is dealing only with one Department, it will usually not be feasible to utilize the centralized negotiation procedure. However, a contractor who is dealing with more than one military department and who particularly desires to negotiate a centralized advance understanding, notwithstanding the amount of cost involved, will be accommodated to the extent that the current workload will permit. A contractor who is dealing with only one department, but with several different activities within the one department, may request a centralized negotiation within the department, the results of which will be used throughout the department.

2. This question asks whether the dollar volume of contracting determines whether a contractor will negotiate centrally and inquires if there are additional factors which suggest the need for such negotiation. The dollar volume of contracting, as such, is not significant; however, the amount of independent research and development expense allocable to defense work is an important criterion. Additional factors are whether a substantial portion of the contractor's business is with the Department of Defense and whether the contractor's defense work involves contracts with more than one military department.

3. This question asks if contractors who will participate in the centralized negotiation of research and development expense will be limited to those who negotiate final overhead rates on a centralized basis. The centralized negotiation of research and development expense will not be restricted to those who centrally negotiate final overhead rates. Advance understandings reached by the research and development negotiators will of course be utilized during the negotiation of final overhead rates.

4. This question asks the role that Government scientific and technical personnel will play in negotiating advance understandings in the research and development area. The Armed Services Research Specialists Committee will review, when requested by the negotiator representing the sponsoring department, the independent research and development programs of defense contractors and will determine whether there has been an adequate segregation between the independent research and the independent development programs. Additionally, the committee will report and make recommendations directly to the sponsoring department on the scientific and technical factors affecting the basis or extent to which a contractor's independent research and development program should be supported. In carrying out its responsibilities, the committee will utilize, where appropriate, the services of other research specialists.

5. This question asks whether the military departments will "control" a contractor's independent research and development program. Our approach is concerned only with the problem of cost allowability and not "control." When the cost of a contractor's independent research and development program is found to be "reasonable", there is no question of "control" involved. Of course, when a determination is made that a contractor's proposed program is not reasonable and, hence, the full allocable portion will not be allowed, there is a measure of control being exercised. This type of control, however, is oriented toward the reimbursement of costs under Defense contracts. Any contractor is obviously free to pursue any type or level of research at his own expense. The provision making independent development costs allowable only on the basis of a showing of relationship of such costs to the product lines for which the Government has contracts might be considered a type of control. However, broad control of the contractor's independent research and development program is not intended.

6. This question asks if a distinction will be made between contractors whose business is primarily commercial as against those whose business is primarily Government. The mix of Government and commercial business is an important consideration in connection with the evaluation of many elements of cost and will be particularly so in connection with research and development costs. We have found it necessary to scrutinize costs with more care in connection with contractors whose work is predominantly or substantially with the Government. However, the same tests of reasonableness will be applied in each instance and the mix of government and commercial business will not, per se, control the final result.

7 and 8. These questions concern themselves with the use of cost sharing formulae and request clarification as to whether cost sharing is appropriate unless there has been a preliminary finding that the over-all cost is unreasonable. It is our view that a preliminary decision of unreasonableness should generally precede the use of cost sharing methods. In the event a contractor's business is substantially commercial, it is expected that the pro rata amount of research and development expense allocated to commercial business will act as a deterrent to the incurring of unreasonable or unnecessary costs. In such instances a cost sharing arrangement will not normally be necessary or desirable. However, in those instances where a contractor's business is primarily with the Government and the contractor's research and development program is so substantial as to appear to be unreasonable in amount, it may be desirable to enter into a cost sharing arrangement in order to provide a motivation for more efficient accomplishment of the program.

9. This question asks whether further guidelines will be issued to contracting officers setting forth tests of reasonableness or other criteria for the recognition of research and development costs. While we do not now

anticipate that further direction will be necessary from this level, experience in operation may dictate otherwise. In addition, the military departments will issue such implementing instructions of a procedural nature as are necessary to operate the system which has been established.

Sincerely yours,

/s/

G. C. BANNERMAN  
Director for Procurement Policy

Rear Admiral Jas. D. Boyle, USN (Ret)  
National Security Industrial Association, Inc.  
1107 - 19th Street, N. W.  
Washington 6, D. C.

THE CHAIRMAN OF THE  
COUNCIL OF ECONOMIC ADVISERS  
WASHINGTON

February 24, 1959

MEMORANDUM FOR: Mr. Perkins McGuire  
Assistant Secretary of Defense

It has come to my attention that certain revisions in the cost principles of ASPR are under consideration in the Department of Defense, that such revisions are about to be made, and that they are likely to have a significant effect on costs under cost-reimbursement type contracts.

I would appreciate an opportunity to have this matter discussed before the Committee on Government Activities Affecting Costs and Prices, naturally, in advance of the issuance of such revisions. Would you be good enough to suggest an appropriate date for such a discussion? I would appreciate it if you would notify John Hamlin, Executive Secretary of the Committee, of the date you would find agreeable.

(signed)  
Raymond J. Saulnier

COPY

Tab C

CE

27 April 1959

MEMORANDUM FOR LT. COL. WILLIAM E. THURCHY  
MR. E. E. JONES  
MR. GEORGE VECCHIETTI  
MR. HERBERT KILGORE

SUBJECT: Contract Cost Principles, Review of 27 April 1959 Draft

At the 16 April 1959 meeting of the Material Secretaries, it was decided that the further review of the Contract Cost Principles would be accomplished by the new group which worked with me on the revision occasioned by the 15 October 1958 meeting with Industry. Accordingly, I am scheduling two meetings to consider the 27 April 1959 draft at 10 A.M. in Room 3C-483 on 5 May and 7 May 1959. For this purpose, I am enclosing 6 copies of the 27 April 1959 draft. A limited number of additional copies are available.

In this latest draft, we have incorporated certain changes for the following reasons:

1. Changes suggested by Industry representatives during meetings held on 1-3 April 59.
2. Certain editorial rearrangement of the material in previous drafts.
3. Certain changes in AFPM so that the cost principles applicable to Terminations are set forth.
4. A rearrangement of the Cost Principles applicable to Construction Contracts.

While all of the editorial changes are not pointed out here, they will be specifically pointed out during our meetings. The following specific changes are highlighted for your particular attention:

1. The draft of Part I - Applicability.
2. The additional coverage with respect to Exhibits under "Advertising Costs" --- page 12.
3. A change in the Red Book Principle --- page 12.

Cdr Mallon



4. A change under "Hotel Costs" - - - page 34.

5. A change under "Training and Education Costs" in subparagraph (a) - - - page 44.

6. 2 changes in Paragraph 15-623 on page 50. These changes are in subparagraph (b) and subparagraph (4).

There is attached as TAB B a series of suggestions designed to conform AFM Section VIII to AFM Section IV.

We have tried here to provide a working draft of the changes in Section VIII which seem appropriate. This Tab B may require additional changes of a perfecting nature.

There is attached as TAB C a revision of Part 4 - Construction Contracts, of present AFM. It is our feeling that we cannot at this time do the complete job of bringing the cost principles for Construction Contracts up-to-date. In lieu thereof, we have merely rearranged the material in present AFM so as to incorporate all of it in Part 4. We feel that the complete revision of Contract Cost Principles for Construction Contracts should be undertaken in an orderly fashion subsequent to the publication of the revised Part 2. For the same reason, we have reserved a section on cost principles for Facilities Contracts to be developed at a later date.

Our meetings will be most fruitful if we confine ourselves to a consideration of the changes which have been made since the cost principles were last approved by the Material Secretaries. It should be pointed out that no approval has as yet been given to the changes which have been incorporated in the 27 April 1959 draft.

Signed

J. M. NELSON  
Chf, IC, WEM  
Staff Director, AFM Division  
Office of Procurement Policy

Inst.  
On 27 Apr 59 draft  
(2 wps)



APR. 1 1959

### Contract Cost Principles

The staffs of the military departments and of ASD(S&I) and ASD(Comp) have utilized the time since the industry meeting of 15 October last, and the receipt of the industry comment a month later, to reappraise fully the contract cost principles problem.

On completion of the first review, ASD(S&I) called upon four industry consultants who were in attendance at the 15 October meeting, to review with our staffs the new draft. The group consisted of:

#### Industry

Mr. McNair - Ernst & Ernst  
Mr. Haynes - Boeing  
Mr. Bellows - Maxson Corp  
Mr. Marschall - Strategic Industries  
Assn.

#### Government

Col. Malloy - ASD(S&I)  
Mr. E. E. Kilgore - ASD(Comp)  
Mr. E. Cook - Navy(Comp)  
Mr. L. Cox - AF(Counsel)  
member, ASFR  
Hitting Submits.

Every paragraph of the draft was again reviewed and an effort was made to find mutually acceptable provisions.

On the basis of this conference another draft has been prepared which is being utilized as the basis for final intra-departmental coordination and certain other inter-agency coordination preparatory to publication.

There is provided on the next two pages a discussion of:

- a. Applicability
- b. R&D Coverage

Enclosure 1.

## Applicability of Contract Cost Principles

In the latest recasting of the Contract Cost Principles, a physical separation has been made between the cost-type use and the fixed price type use. This has been done by specifying the use of Part 2 (which includes the principles themselves) only to:

- a. The DETERMINATION of reimbursable costs;
- b. the negotiation of overhead rates;
- c. the DETERMINATION of costs of terminated cost type contracts when the contractor elects to "voucher out" the cost.

Part 6 provides "guidance" for use in fixed-price type contracts. While this is physically separated from Part 2, it is to be noted that the verbs utilized are not different from those objected to at the industry-government meeting. It specifies that Part 2 shall be used "AS A GUIDE," within the framework of some included formula-preventing policy, "in the evaluation of cost data required to establish a fair and reasonable price. . ."

The previous use of the principles in the settlement of issues has been watered down to say that:

"In retrospective pricing" when "the acceptability of a specific item of cost becomes an issue" Part 2 "will serve as a guide FOR THE CONTRACTING OFFICER IN HIS CONDUCT OF NEGOTIATIONS."

## Research and Development Contract Cost Principles

### RESEARCH

Contractor's independent research is allowable as indirect costs, provided they are allocated to all work of the contractor.

In providing a definition of "research," it is stated that it includes "basic research" together with that portion of applied research which represents efforts to advance the state of the art, but which do not relate to a product to be offered for sale. The latter represents a concession to industry.

### DEVELOPMENT

Independent development is allowable as "related to the product lines for which the Government has contracts," to the extent such costs are reasonable and are "allocated to all work of the contractor on such product line."

### REASONABLENESS OF RESEARCH AND DEVELOPMENT EXPENSES

Reasonableness of this item of expense is subject to "negotiation," and advance agreement is rather strongly suggested "with contractors whose work is predominantly or substantially with the Government."

TOPICAL INDEX

T O

PRINCIPLES

GOVERNING THE DETERMINATION OF ALLOWABLE COSTS

UNDER

DEFENSE DEPARTMENT

RESEARCH AGREEMENTS

WITH EDUCATIONAL INSTITUTIONS

---

ISSUED BY THE OFFICE OF NAVAL MATERIAL

AUGUST 1960

Compiled by  
Lewis Lever, C.P.A.  
Pittsburgh, Pennsylvania

---

CROSS REFERENCE TABLE OF SELECTED COSTS IN NEW AND OLD  
SECTION XV, ASPR

<u>Cost Item</u>	<u>New Section XV Paragraph</u>	<u>Old Section XV Paragraph</u>
Fringe Benefits	15-205.15	-
Insurance and Indemnification	15-205.16	15-204(b) 15-205(p) 15-502(d) 15-502(f)
Interest and Other Financial Costs	15-205.17	15-205(k)(r)
Labor Relations Costs	15-205.18	-
Losses on Other Contracts	15-205.19	15-205(n)
Maintenance and Repair Costs	15-205.20	15-204(q) 15-205(o)
Manufacturing and Production Engineering Costs	15-205.21	15-204(j)
Material Costs	15-205.22	15-202.1 15-204(k)(u) 15-502(e)
Material Handling	-	15-204(f)
Miscellaneous Office and Administrative Services and Supplies, Including Communication Expenses	-	15-204(m)
Organization Costs	15-205.23	15-205(l)
Other Business Expenses	15-205.24	15-204(e)
Overtime, Extra-Pay Shift and Multi-Shift Premiums	15-205.25	15-204(n) 15-502(h)
Patent Costs	15-205.26	15-204(o) 15-502(i)



DEPARTMENT OF THE NAVY  
OFFICE OF THE GENERAL COUNSEL  
WASHINGTON 25, D. C.

OGC/MHS:ag  
3 June 1959

MEMORANDUM FOR COMMANDER JOHN M. MALLOY

Subj: Treatment of Taxes in the Revised Draft of ASPR  
Section XV

1. I understand that the latest draft of ASPR Section XV has been sent to the Materiel Secretaries for review. I have two comments on the treatment of taxes in ASPR 15-205(41). I believe that both of these comments can be accommodated at this time without anyone being accused of "major surgery."

2. ASPR 15-205(41)(a)(iii) speaks only of exemptions available to the contractor directly or available to the contractor based on an exemption afforded the Government. Exemptions are also available to subcontractors for various reasons. In order to include certain of these exemptions, I recommend that ASPR 15-205(41)(a)(iii) be revised to read as follows:

"(iii) taxes from which exemptions are available to the contractor or cost-reimbursement type subcontractors directly, or available to the contractor or such subcontractors based on an exemption afforded the Government . . . ."

*See P 11 -  
also - don't  
want to  
bring  
CPFF  
subs.*

3. The language of ASPR 15-205(41)(b)(i) is not clear as to who makes the determination as to the existence of a claim of illegality or erroneous assessment. It could be the contractor, the Government, or a third party. Taken alone, this ambiguity is not harmful. In fact, insofar as it tends to increase the number of instances in which the Government is notified of a tax problem, it is beneficial. However, the effect of this ambiguity on (41)(b)(ii) may be troublesome. It could be argued that the contractor and the contractor alone is to determine whether a legal problem exists, and only when he so determines that a problem exists must he request in-



## FOREWORD

This index has been compiled to facilitate reference to the principles for the determination of cost currently incorporated in Department of Defense research agreements with educational institutions. These principles are indexed as of the text current on the bases indicated:

Section XV, Part 3 - Revised

Armed Services Procurement Regulation,  
Change No. 50, dated 2 November 1959

Department of the Army, Department of  
the Navy and Department of the Air  
Force Joint Letter No. 41

Dated 26 August 1959

Section XV, Part 3 (and applicable  
portions of Parts 5 and 6) -  
Original

Appendix H, Department of Defense Contract  
Audit Manual, Change 2, dated 7 May 1956

Blue Book

Explanation of Principles for Determination  
of costs under Government Research and  
Development Contracts with Educational  
Institutions War Department - Navy  
Department August 1947

When this topical index was originally contemplated, there was some doubt concerning the value of indexing the latter two documents. However, it now appears that many research agreements may continue to completion utilizing these documents as the basis for the determination of allowable costs. Accordingly, it is not unlikely that institutions may be performing research agreements under the original and revised principles simultaneously. It is hoped that the index as prepared will prove useful to both Government and institution personnel confronted with this situation.

The indexing process disclosed certain variations in terminology among the several documents. The following are some of the more important differences:

<u>Section XV, Part 3 - Revised and Joint Letter No. 41</u>	<u>Section XV, Part 3 - Original</u>	<u>Blue Book</u>
Allowable costs	Allowable costs	Admissible costs
General administration and general expenses	General administration General expense	General administration General expense
Indirect costs	Indirect costs	Indirect expense
Material costs	Materials Materials and supplies	Materials and supplies
Operation and maintenance expenses	Operation and maintenance of physical plant	Operation and maintenance of physical plant
Other institutional activities	Noneducational activities	Non-educational activities
Research agreements	Contracts	Contracts
Unallowable costs	Unallowable costs	Inadmissible costs
Use allowance	Use charge in lieu of depreciation	Use charge

For purposes of uniformity, the main captions utilized coincide with the terminology in the revised principles. For example, all references in the original principles to the subject "Contracts" are indexed under "Research agreements." Similarly, references to "Indirect expense" in the Blue Book will be found in the index under "Indirect costs." In order to avoid any confusion, the index has been completely cross-referenced to show the captions superseded.

A

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## ACCIDENT INSURANCE

- . allowability of cost
- . see also Staff benefits

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## ACCOUNTING FEES

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  - . classified as general administration and general expenses

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36(a)

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- . see Allowable costs

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- . see also Help wanted advertising

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QUESTIONS PRESENTED AT MONTEREY, CALIFORNIA - 10/6/60

1. Today's practice for auditor and analyst recommendations and contracting officers' decisions is to treat cost as the sole basis for pricing fixed price business and to apply it by formula. Is this the intent of the regulations? If not, what steps do you suggest for both government and contractors to make practice conform to intent?
2. You say that if a procurement is competitive, that you don't give a "hoot and a damn" what costs make up the low bidder's price. Maybe you don't, but negotiators do. This is an obsession with most negotiators. If your statement is the Government's philosophy, why isn't this philosophy passed on to the negotiator's level, and to those who review his negotiations before the contract can be approved?
3. Contractor's Resident Auditor always comments on what he thinks the contractor's profit ought to be on an audit report of a fixed price or redeterminable proposal. Isn't it the function of the Audit agency to audit costs, period?
4. Audit Agency insists that audits of fixed price on redeterminable proposals must be performed according to CPFF principles and reports to Government negotiators are prepared on this basis, regardless of the ASPR language regarding the use of CPFF principles as a guide. Contractor is advised that reinstatement of disallowed overhead items must be made by negotiator or contracting officer. Negotiators take the position that they must accept auditors' reports as submitted and that they cannot allow an item in overhead which the auditor has disallowed. Contractor is told to "go home and work out your problems with your auditor." What can the contractor do? (Aside from giving up and going broke)
5. When will the DOD recognize that interest is a normal cost of doing business and recognize it as such in definitions of allowable costs? Or, will DOD ever concede allowability of interest when necessary to perform on a specific contract? This latter situation can easily develop where a major contract is awarded to a company which contract is large relative to the company's other normal business.
6. Allowability of interplant, division and affiliate charges - Ref. - ASPR - 15-205.22(e) Material Costs. Heretofore charges by one plant or division against another have been generally acceptable to the Services if on a cost basis (excluding any question of profit). Under the latest cost principles apparently these costs must also be in line with competitive or current market prices to be acceptable. Is this correct? If so, does this same interpretation apply to affiliates (organizations under common control, i.e. subsidiaries, i.e. separate corporate entities, etc.? Of one type or another - minority interest but controlling, etc.).

7. Could you briefly state the cost problem areas in which Advance Understanding Agreements have been negotiated to date under the new ASPR-15?

8. Contracting Officers often require the application of learning curves in arriving at prices before beginning production of a follow on contract, and in other situations. Why are they reluctant (or refuse) to permit the application of these same learning curve computations in arriving at the starting costs of a terminated contract for termination settlement purposes? Why aren't auditors for the government more familiar with learning curve computations and agreeable to covering these problems in all audits, i.e. for procurement and terminations alike?

9. Is an Advance Understanding - as contemplated by ASPR Committee -  
(a) to be covered by special language, on a contract by contract basis?

(b) "res judicata," in later contracts -

(i) in some service

(ii) let by other military services

(c) to be negotiated on a single-service basis (like overhead rates)

10. Advance Understandings -

1. Is it not the general intent of "Advance Understandings" to bind both the contractor and all DOD procurement agencies with which the contractor does business?

2. What is the feeling of the ASPR Committee as to the incorporation of "Advance Understandings" into contracts by amendment?

11. In the case of a contractor which received its first government contract between Nov 1959 and June 30, 1960, what is the operating policy of the Defense Department in amending CPFF contracts to incorporate the new cost principles? Is an amendment of this type wholly at the discretion of the contracting officer? Does the letter issued by the Department of Defense in Feb 1960 mean there is an obligation on the part of the contracting officer, whether it benefits the Government or not, to amend contracts let after Nov. 2, 1959, where the contractor received his first contract of a CPFF nature?

12. Capt. Malloy, in view of the fact that you are Chairman of the ASPR Committee, could it be possible to get a ruling on this condition? For example: A corporation who has a large diversification of products has a division holding a prime contract. This prime division (A) has requested competitive fixed price bids on a piece of hardware to all companies willing to bid. This corporation has another division (B) that has the capabilities to produce this piece of hardware and enters into this competition and wins the award. Would the Government allow the division (A) to include in its cost the price that the division (B) won the award on and take a profit on this price?



13. 1-309 Solicitations for Informational or Planning Purposes. It is the general policy of the Department of Defense to solicit bids, proposals or quotations only where there is a definite intention to award a contract or purchase order. However, in some cases solicitation for informational or planning purposes may be justified. Invitations for bids and requests for proposals will not be used for this purpose. Requests for quotations may be issued for informational or planning purposes only with prior approval of an individual at a level higher than the Contracting Officer. In such cases, the request for quotation shall clearly state its purpose and, in addition, the following statement in capital letters shall be placed on the face of the request: "THE GOVERNMENT DOES NOT INTEND TO AWARD A CONTRACT ON THE BASIS OF THIS REQUEST FOR QUOTATION, OR OTHERWISE PAY FOR THE INFORMATION SOLICITED."

Question - Will this Regulation be revised to clearly state that costs generated by these requests will be allowed in burden?

ASPR - 1 July 1960 - Will ASPR ever eliminate other instructions that are issued by other Services, such as AFPI by the Air Force and NPD by the Navy?

PRICE WATERHOUSE & CO.

SEVENTEEN TEN H STREET, N. W.

WASHINGTON 6, D. C.

September 23, 1960

Mr. John Marschalk  
2850 Belden Drive  
Hollywood 28, California

Dear John:

Your list of ten questions, and Captain Malloy's list of thirty, seem to me to provide the basis for a thorough and constructive panel discussion. I have no further questions to propose.

If it fits in with your idea of the discussion, I would like to direct my remarks on these various questions primarily toward the manner in which the trend of events is being influenced by accounting and auditing considerations, and toward what seem to me to be probable consequences of the trend of events. Major consequences, of course, include those which have their impact on profit. I think I can give the discussion this kind of a twist without invading the areas reserved for the 10:30 session on the Theory and Practice of Profit and the other sessions which deal with auditing and cost accounting. As a matter of fact I feel that, ours being the lead-off session, we have some obligation to lay the groundwork for developing the relationship between the Procurement Regulation and the various other subject matters which will be dealt with in other meetings.

As you may know, it is my feeling that the position the Government has taken in the development of the cost principles is one which does some degree of violence to the basic conception of cost and it therefore does violence also to the basic conception of profit, neither being very meaningful in the business world without the other. You probably will recall also that I see a chain of inter-connected concepts with cost definition at the front-end and severely detailed regulation of business activity at the tail-end. Whoever defines costs has thereby defined profit, and whoever has the custodianship of the measurement of profit reasonableness holds also the power of affecting economic life and death. These may sound like abstractions but I think I can give them a practical turn in the panel meeting as the various individual questions come up for consideration.

Mr. John Marschalk

- 2 -

September 23, 1960

A particular aspect of these things which has interested me lately has been the development of governmental controls over subcontractors and their exercise through prime contractors. In the final analysis there is not much difference between a subcontractor and any other supplier, and accordingly, the development of this trend, under pressure from the Government's auditors, is a matter which should be examined very closely by many more businesses than simply those engaged directly in Government contracting at the present time. I think this aspect of the general question of subcontractors' affairs should be brought out into the open for consideration. It may very well be that this is an avenue through which the general business community will ultimately be affected by the things we will be talking about with the thought that they are now the special problems of a special group.

I realize that we are very close to our deadline date and that I have not given you much time to respond to these general ideas. However, I have confidence in your moderating ability and in my willingness to be moderated.

See you in Monterey.

*Ted Herz*

cc: Captain J. M. Malloy, Staff Director ✓  
ASPR Division, Office of Procurement Policy  
Assistant Secretary of Defense (S&L)  
Washington 25, D. C.

32776

Questions Presented at Monterey, California.

1. Mr. Charnak says that production engineering is separate from R&D. Defined as costs "related to a product being produced." Does this mean that production engineering must be so immediately related that it becomes a direct cost of a particular contract or order? Can production engineering be just related in a general sense and a proper overhead expense? If so, what is the distinction between production engineering (presumably allowable) and development (requiring advance understanding).
2. If all "basic" research has been approved as an overhead cost for prior years without getting prior approval, isn't the contractor gambling on possible disallowance of part of future "basic" research by trying to get an advance understanding and approval. Isn't it wiser to wait until a disallowance occurs? Has the Navy changed its attitude on "basic" research with new regulations and now requires advance understandings?
3. What is safest method of establishing allowability of questionnaire items? (1) Advance understanding with contracting officer on each contract or (2) Advance understanding with resident audit on accounting system and allowability of items desired in overhead.
4. If the Navy will accept development costs as an overhead item without burden where the contractor has followed this practice for years, why have the Navy auditors begun this year to disallow burden on disallowed development costs, thus forcing contractors to appeal (and incur the expense of so doing)?
5. Assuming a company has entered into an "advanced understanding" re independent research, must each contract nevertheless contain a clause re allowability before obtaining reimbursement? (Or is ASPR itself adequate without having individual clauses in contracts?)
6. Would you please expand on the idea of "burdening the R&D cost center"? Are you suggesting that both the direct and indirect costs incurred in the R&D cost center may be allocated to cost type contracts?

7. Has Mr. Chermak's interpretation that basic research means increasing the particular investigator's knowledge rather than increasing knowledge in general (and the similar interpretation with respect to advances in the state of the art) been communicated to the technical people reviewing contractors' R&D programs and to the other Govt. representatives negotiating R&D cost allowances? This question is asked because recent negotiations have indicated that the opposite interpretations are being used.

8. A recent Air Force policy letter issued by Gen. Davis directs that contractor costs in excess of the amount reimbursable under study contracts are to be disallowed. Do you consider such directive to be consistent with the intent of the revised cost principles?

9. Mr. Chermak says preferred treatment is to burden R&D labor. Yet talks about R&D as overhead. Isn't it a well established accounting principle that you do not apply burden to burden?

10. Should a prime contractor on a CPFF prime contract agree to special provisions governing overhead in its CPFF subcontracts in view of the fact that the prime contractor generally has no voice in the negotiation of subcontractor overhead rates?

11. Are the following likely to be considered as research expense (subject to sharing) by Govt. auditors? (1) Technical effort necessary to submission of unsolicited proposals. (2) Non-contract technical studies conducted at Govt. request or suggestion.

12. Does negotiation with the Christenat Committee and reaching of an agreement with them constitute an advance understanding on research & development which will insure recovery of a proportionate amount of the agreed upon costs against all contracts or do we also need an advance understanding & contract clause with each contracting officer?

13. How do you feel about disallowing all R&D cost. Of course the contractor would have to have additional profit to subsidize this.

14. Would you comment on allowability of R&D costs based on a reasonable fixed percentage of sales. Would you say that applied research or product development of products whose basic research was done under a CPFF contract is allowable if the products are improved by this applied research and are being sold for Government contracts to other prime contractors.



15. Has the Navy actually completed negotiation of advanced research & development rates with any contractor? (pursuant to ASPR 15) (1) If so what form are the agreements taking? (i.e., dollar maximum, overall % or % by program), (2) if so, what % of support is generally given by the Govt. (i.e., 30%, 40%, 80% of contractors total independent R&D costs, etc.)?
16. Please discuss the possibility of achieving a uniform set of cost principles ASPR US AEC.
17. What is the "generally accepted accounting procedure & practice" for allocation of G&A for a multi-plant corporation?
18. Is it fair to require one contractor to burden his research costs while on the other hand you permit his competitor to continue not burdening it.
19. As a former AF contracting officer I know a feeling exists in the Govt regarding advance understanding for R&D. These people (at the working level) feel they are sinning if they allow R&D. How can we expect to get ahead if this philosophy exists. Further, MCPC in the AF as well as the ARDC review Committee balks at any advanced understanding re Jack Pauls lecture.
20. Is an "advance understanding" agreement limited to question of reasonableness and allocability or may it also cover questions of allowability?
21. Assume that a contractor is performing under contracts with both the USAF and the AEC and that it accumulates bidding costs into an overhead account, applied to direct labor. Since the AEC will not allow such costs, may the contractor accumulate bidding costs to the USAF separately from those incurred in bidding to the AEC, recovering such USAF bidding costs as an overhead item applied to USAF direct labor only. (This question addressed to Mr. Wesselink.)
22. What are "burden centers," "burden rates" and their relationship to overhead?
23. Has the Navy any procedure for getting, in a timely manner, advance understandings affecting contracts of more than one Bureau. If so, what is it?



24. Please explore a little more the distinction between research and development-- a specific case: A company has developed a proprietary product (built one hand made prototype). It then plans to make a pilot run of a few more units \*under the supervision of the engineer (and in his lab) who developed the product. After completion of the run, production drawings will be released since they can't be completed before. What category do the original costs fall into and what category do those connected with the pilot run fall into? What about allowance of these costs in overhead? The units to be made in the pilot run will be used for evaluation and not sold.

25. (a) You made a careful distinction between basic research, applied research and development engineering. Question: How do these distinctions affect the means by which these costs may be recovered. (b) You recommended that contractors reach an advance understanding as to the percent of total research & development dollars may be recovered. I read the ASPR to mean that such cost sharing may be "desirable" but not essential. Any comment?

26. In the absence of an advanced understanding are R&D expenses unallowable if not specifically authorized in cost type contracts? I read nothing in new ASPR that says that either advance understandings or specific contractual authority are mandatory for R&D expenses to be allowable.

27. Re applied research under old ASPR 15. It is my understanding that the Controller of the Navy has issued to his field auditors an interpretation that states in part "applied research related to product lines for which the contractor has CPFF rates on the premise that this applied research is general research and as such is specifically unallowable by ASPR. Question: 1) Is that interpretation not inconsistent with the current definition of applied research? 2) Why is this interpretation not readily available to contractors?

(a)

28. / Under Navy contracts, should advance agreements per Sec. XV be made with the Auditor or the contracting officer. (2) On a FFR or FFR contract, some contracting officers will not recognize the cost sharing of research, can this unrecognized share be re-allocated to call the CPFF contracts.



## RAYTHEON COMPANY

WALTHAM 54, MASSACHUSETTS

TWINBROOK 9-8400

Malloy

12 January 1961

Mr. Kenneth K. Kilgore  
Director, Audit Policy Division  
Office of the Assistant Secretary of Defense  
Washington 25, D. C.

Dear Mr. Kilgore:

The following are a group of questions which occurred to me after reading your letter which might be worth discussing in the NSIA Cost Principles Symposium Panel:

1. What is the proper base for the distribution of the Contractor's Independent Development costs? There are apparently two different points of view in the Department of Defense: (1) That it can be distributed only to the overhead bases applicable to production contracts, (2) That it may be distributed to all of the costs of a given product line, including product line oriented-sponsored Research and Development contracts.
2. I have heard some interpretations to the effect that that portion of a Contractor's Independent Research and Development which is not shared by the Government should become part of the cost base for the distribution of the Government's share of Research and Development as well as other G & A costs.
3. Machinery exists for the negotiation of Advanced Understanding in the areas of Research and Development. Certain other costs mentioned in 15-107 should be negotiated on a contract-by-contract basis with individual contracting officers, e.g. pre-contract costs, royalties, and possibly travel costs as related to special or mass personnel movement. Would it be appropriate for ASPR to establish machinery for the negotiation of Advanced Understanding on other areas relating purely to general and indirect costs?

Excellence in Electronics

4. What is meant by the phrase "Product Advertising"?  
Is an institutional advertisement displaying a Missile System in a trade or technical journal properly considered product advertising?
5. In order to avoid formula-pricing on negotiated fixed-price contracts, would it be appropriate to expand Part 6 to include a complete listing of all the considerations other than cost which should govern the pricing of a fixed-price contract?
6. Is an amendment to Section XV required to recognize the cost of excess facilities and personnel resulting from "stop work orders"?
7. Section XV -205.26 makes the statement that patent costs in connection with the filing of a patent application where title is conveyed to the Government are allowable. Is it the intent of this section to consider all filing costs where the Contractor retains title but gives the Government a non-exclusive royalty fee license, unallowable?
8. Why is a modest subsistence stipend for full time graduate trainees considered unallowable especially when in most cases this stipend constitutes the trainees only means of support for himself and his family?
9. Is this a correct interpretation of Section XV 205.22 (e):

That a Contractor who chooses, because of the need for close Engineering liaison, better delivery, quality, and reliability, to buy an item from a division within his Company cannot charge the Government his cost if a similar item is available on the outside at a lower price?

10. Since Independent Research is distributed to approximately the same base (i.e. cost of sales, or cost of manufacturing) as G & A expenses, is it practical to apply G & A to Independent Research?
11. 15-205.35 recognizes Independent Research and Development to be an allowable cost for which an advance understanding is recommended but not required. Why is the Government unwilling in many cases to bear its full allocable share of these programs in the light of the following premises:


- (1) that the same competitive restraints exist in the prices of government contracts as on most commercial products.

- (2) satisfactory criteria for the reasonableness of Research and Development expenditures exist or can be established
- (3) a contractor who is forced to share the cost of his Research and Development is at a competitive disadvantage on his Commercial products which must absorb the unrecovered costs allocable to Government Contracts on his commercial products.
- (4) A contractor who chose the disputes route can probably recover 100% of his Research & Development on after-the-fact pricing actions.

I am not sure that these questions are actually pertinent to the panel discussion to which we have been assigned, nor would I object violently if you eliminate most or all of them. I am sending you sufficient copies to distribute these questions to Colonel Blattau and Mr. Jones, if you should choose to do so. I am also sending Mr. Beall a copy directly. I would appreciate receiving the questions suggested by the other members of the panel and I would also appreciate further opportunity to raise additional questions as they occur to me.

I am attaching to this letter, a copy of the brief biographical sketch which I mailed to Mr. Youngblood of NSIA. I look forward to meeting you and the other members of the panel at the end of Tuesday's session.

Very truly yours,

  
Charles A. Dana, Manager  
Government Accounting Controls

1/4/61

15-205.22 e

"Recognizing that it is the Contractor's long established practice to price interorganization transfers at other than cost for commercial work, in connection with the work under this contract, the Contractor shall be free, but not obligated, to use any article or service customarily produced, assembled, or provided by the Contractor in the regular course of its business, provided such articles or services are billed at the lowest commercial prices charged to an outside user purchasing in similar quantities."

GE proposal to Navy

QUESTIONS PRESENTED AT NSIA COST PRINCIPLES SEMINAR  
24 and 25 January 1961

1. Although you have said that it may be necessary for the Services to issue implementing instructions - why does the Department of Defense permit conflicting instructions to be issued on interpretations of the ASPR?

2. Why doesn't the Department of Defense require that all implementing instructions by the three Services be cleared by the Department of Defense to assure that the instructions are in compliance with ASPR?

3. Why is it that one branch of the Government (Internal Revenue Service) allows a contractor's expense and another branch of the Government (DOD) does not?

Examples: Advertising  
Interest

4. Entrance into an advance understanding on independent R&D expense must be done with full knowledge of all the particulars involved. If patent rights to independent R & D inventions are not requested at the time of the advance understanding but are requested during the negotiation of individual contracts subject to the advance understanding, a contractor does not know the full cost of the advance understanding entered into.

What is the Government's intent on requesting patent rights to independent R&D inventions and when will it request such rights?

5. In quoting on Fixed-Price contracts, why is it necessary to prepare cost breakdowns, bills of materials, tabling lists, etc. when the contracting agency admits frankly it is only interested in the low bid? This adds considerable costs to our operations when the information is not used unless one is low.

6. Is the Statement of Cost Principles the only published or unpublished statement of policy (or interpretation of policy) on "Pre-Contract Costs?"

7. Use of contingencies in contract pricing. Why should contingencies, properly used, be frowned upon and cost questioned by auditors and negotiators? Contingencies can be effectively used to both increase or decrease a basic price proposal, or any element thereof.

8. In the implementation of Section IV of the ASPR, many people expect contracting officers to use sound business judgment in determining reasonableness, yet every day most of the problems result from a difference of opinion on reasonableness. What is being done to insure C. O. development in this sound business judgment?



9. On the question of mortgage interest - Should steps be taken to distinguish this cost from other kinds of interest thereby removing the present penalty of realty ownership?

10. Let's face the fact that all DOD procurement is running from difficulties with GAO and Congress. Why, as you lay awake nights worrying about new ways to squeeze the contractor, do you not also seek ways to pay for fair costs incurred? Money which you are, in effect, borrowing from the contractor - not even GAO could argue that this is a fair cost.

11. With the development of different approaches to cost recovery as implied by the issue of separate set of cost principles by AEC, what efforts are being exerted to achieve a common set of cost principles for all Government agencies?

12. Has Bureau of Budget authority to dictate changes in ASPR cost principles? If so, on what authority - statute, executive order, or what?

13. Re ASPR-15-205.44(b). Costs of part-time education relative to job requirements of bona fide employees. The words "related to job requirements" are subject to different interpretations. Could you discuss the intent of the paragraph, ASPR 15-205.44(b)?

14. Location Allowances at Field Test Sites. Expense allowances and/or bonuses for living at field test sites must be considered along with total salary in determining reasonableness of over-all compensation to personnel. How does DOD propose to control (through ASPR Cost Principles) the payment of expense allowances or site bonuses without also controlling over-all salary? Is it proper for the DOD to attempt control of salaries? (I think not). How do contractors meet competition in payments to employees when controls on method of payments are imposed?  
I would like to have some discussion on this subject.

15. Lawyers and the problem of "consideration" are blamed for the DOD refusal to permit wholesale substitution of the new principles for the old. Couldn't this be done under Title II residuary authority - "without consideration" - on the Secretary's finding that it would facilitate the national defense (in administering controls)?

16. The 10 February 1960 memo of the Assistant Secretary of Defense to the Assistant Secretaries of the Army, Navy and Air Force relative to uniform procedures for the implementation of the revised cost principles provided that contracts entered into after the effective date for the "new" cost principles (1 July 1960) could provide for the extension of the applicability of the "old" principles through the end of the contractor's current fiscal year. Where the extension has been granted, do the "new" cost principles automatically come into effect at the close of the contractor's fiscal year or does it remain as a requirement that the shift from the "old" to the "new" cost principles may be allowed only if there is no disadvantage to the Government?

17. In the absence of an amendment to an "old" contract to provide for the application of the "new" cost principles, is it proper for contracting officers to seek the incorporation of the "new" cost principles to amendments or supplemental agreements to such contracts where the scope of the work or procurement is significantly increased?

18. What is the real intent of the new Sale and Leaseback Provision? Is Mr. Landesco's interpretation correct?

19. Re: Sale and leasebacks:

- 1) Is rule different when lease used as a means of original financing - (i.e., where contractor never had title) - as opposed to when contractor had title, then calls a lease-back?
- 2) Is contractor prohibited from realizing legitimate product so long as rental fixed is fair, reasonable and competitive?

20. Why should any costs be disallowed?

Why not allow all costs to be spread proportionately over all types of business, and apply the rule of reasonableness, plus acceptability of the contractor's accounting system?

21. ASPR III, Part 9, apparently intends that (a) contractor's Purchasing Systems and (b) Major Individual Subcontracts will be reviewed and approved on basis of new ASPR XV (i.e., in pricing and cost analysis) among other bases.

a. What is the ASPR Committee planning to do regarding some of the "cost audit and transfer" (from subs to primes) problems mentioned by Mr. Cook of Westinghouse?

b. In the meantime, what can procuring activities do to meet such problems?

19 January 1961

Mr. Aaron Racusin  
6512 Kenhove Drive  
Bethesda, Maryland

Dear Aaron:

1. Be sorry that we were delayed in furnishing you the answers to questions which may come up during the panel discussions at the NSIA Seminar. The following comments are based on our evaluation and feel for these questions and are as follows:

Question No. 1

Can consistency of implementation and interpretation ever be achieved by all Services? What steps are being taken to attain this goal?

Answer

Several years ago, the Air Force decentralized to Administrative Contracting Officers at Air Force Plant Representative Offices and Procurement Districts the responsibility for negotiating overheads with contractors who are on negotiated rather than on actual overhead rate basis. Our experience under this arrangement indicated that there were more problems with respect to lack of consistency in implementation and interpretation even within the Air Force. Consequently, steps were taken in 1957 to recentralize this responsibility. At the present time a small group of negotiators, headed by Mr. Dale Babione of my office, is charged with the responsibility for either negotiating or delegating negotiation responsibility for all contractors on negotiated overhead rates. As a practical matter with respect to large divisionalized multi-plant contractors, the negotiation is conducted by one of the people here at HQ. This practice, plus the fact that close coordination is maintained between Mr. Dale Babione and Mr. Don Todd, who has succeeded Mr. Christensen in the Navy, tends to make what we believe is reasonable consistency of implementation and interpretation as pertains to the negotiation of questioned costs which are related to overhead. Of course, as a practical matter the questioned costs are developed by the DCM auditors and submitted in their audit reports pertaining to contractor overhead proposals. Inasmuch as the audit organization is decentralized, there was always the probability that there will be some lack of consistency in interpretation made by auditors. This lack of consistency is minimized by

the fact that the audit organizations frequently coordinate with each other at the Washington level. I understand that the DOD under Mr. Kilgore is sponsoring a revision and re-write of the Government Audit Manual. This in itself would be a positive factor in reducing lack of consistency insofar as audit interpretation is concerned.

Question No. 2

How do the new Cost Principles affect the role of the auditor vs contracting officer in (a) price negotiations, (b) price redeterminations, (c) overhead allowance? Can a contracting officer overrule the recommendation of an auditor?

Answer

Insofar as the Air Force is concerned the new Cost Principles do not affect or change the role of the auditor vs the contracting officer. As far as I can determine the new Cost Principles have not had any discernible effect on the approach or reporting by auditors. In some areas, the support for items which auditors have been questioning is strengthened by the new Cost Principles. This is especially true with reference to items, such as sale and lease-back which are more definitively covered in the new Cost Principles as compared with the old Principles. With respect to contracting officers, there probably has been some change although it is difficult to definitively establish what the nature of this change has been. Even under the old Cost Principles, contracting officers were using in the main these principles as guides in the review, evaluation and development of negotiation objectives. Under the old Principles where there was no definitive policy statement that these Principles would be a guide for fixed price contracts, Government contracting officers were probably more willing to compromise during negotiations under the old Principles than they are now under the new Principles. There are some types of costs, such as contributions, donations and advertising where greater consideration is probably given in the negotiation of fixed price contracts than will be the practice under the new Principles. Some of these costs were recognized at least to some degree. Such recognition was appropriate inasmuch as some of the costs were regular and necessary costs of doing business even though they were unallowable insofar as cost type contracts are concerned. Some contracting officers have indicated to us their approach since obtaining of the new Cost Principles. It is fundamentally the same as when the old Principles were in effect. As indicated above, however, we believe that there probably has been some change because of greater requirement for justifying departure from the application of Cost Principles now that they are specifically prescribed for guidance in fixed price contracts. We believe that this would apply whether or not we are concerned with price negotiations, price redeterminations or overhead allowances.



There is, however, no change with respect to the responsibility and authority of the contracting officer. He is still charged with negotiating and as such definitely does have authority to depart from such recommendations as may be furnished by auditors.

Question No. 3

Discuss reasoning behind disallowance of certain recognized and unavoidable costs of doing business. For example, contributions, donations, cost of borrowings, most advertising.

Answer

We agree with you that it would be redundant to at this point in time to further discuss all of the factors and reasoning behind the policies contained in Section IV. These were gone over in the many frequent discussions between DOD and contractor organizations. Our previous letter to you included our thoughts on these types of costs and with your experience, you are undoubtedly more knowledgeable regarding the reasoning behind certain provisions of the new Cost Principles than we are.

Question No. 4

Are the new Cost Principles intended to place a premium on increased direct costing?

Answer

I have discussed this question with Mr. George Frost, who is the Chairman of the NSIA Contract Finance Subcommittee and who is to make the welcoming talk at the Seminar. George says that this question was included because it was raised by some member. He believes that it is fundamentally based on the interpretation made by some people that the language of the new ASFR favors direct costing as compared with indirect costing. We have re-read paragraph 15-202 on Direct Costs and paragraph 15-203 on Indirect Costs and are unable to ascertain the basis for a conclusion that these paragraphs favor direct costs as compared to indirect costs. Our attitude and interpretation is that the present Section IV is defined to give recognition to the various and varying methods followed by contractors with respect to direct and indirect costing and as such is not designed to either favor one or the other. As a practical matter, however, we recognize that most of the arguments regarding the application of Section IV revolve around overhead and applications and allocation of overhead. Seldom are there arguments regarding direct cost in relationship to Section IV provisions.

For this reason, rather than any particular provision in Section IV, to believe that there could be a premium on direct costing. We do not, however, advocate the development of expensive and refined accounting methods and procedures merely to increase the number of cost categories that are costed directly. Instead, we recommend reasonable business-like methods of accounting and costing in relationship to the type of business organization, methods of manufacture, types of contracts, and other factors.

Question No. 5

In connection with internal transfers what constitutes a "market price"? Does it mean your own or your competitor's market price?

Answer

There has been what seems to be a growing practice in industry, especially in the electronics industry, for contractors to put items under so-called catalog prices. We are not sure whether this represents a trend consistent with the developing nature of the electronics business or whether it is a reaction to the fact that the Services, especially the Air Force, had placed considerable emphasis on negotiating and supporting reasonable prices. The practice is that contractors tend to classify items as falling within the market price category on one or more of the following bases:

- a. Items regularly sold on both the military and non-military markets with definitely published price catalogs.
- b. Items regularly sold on military and non-military markets with published markets but not published price catalogs.
- c. Items sold substantially for military end use with either published price catalogs or published catalogs without prices where there is more than one contractor capable of providing items to perform similar functions.
- d. Items which are manufactured for stock on the basis of economical production runs and estimates of potential markets, whether such items are actually cataloged, price cataloged or even in competition. Obviously, such practices have created problems in negotiating reasonable prices, especially where the contractor can only allege that the item is competitive and is unable to demonstrate the existence of price competition. We have not in public speeches to industry made reference to this problem simply because we were afraid that some contractors who are now furnishing cost data might develop the bright idea of putting items in the catalog category. In our discussions of



this problem with contractors, we have taken the position that the public nature of our business is such that we cannot live with any system whereby the contractor unilaterally establishes prices. We are ready to recognize market prices where contractors can reasonably demonstrate that the prices are established under conditions of price competition. We now have under consideration for publication in the AFPI the following statement:

"The Government will accept the price of an item identified as a catalogue or standard commercial item without a cost breakdown only where the contractor can demonstrate the price of the item is determined by effective competition on each procurement. Effective competition is presumed to exist whenever an item has been sold regularly in the markets where other products, capable of performing the same or similar functions or otherwise usable in place of the item, are available from other sources and where competitive pricing can be demonstrated. In the absence of such a demonstration the price of such items will be negotiated on the basis of actual and estimated cost data furnished by the contractor on each item."

We believe that the above approach is better than an attempt to define catalog price, market price, standard commercial, semi-commercial and other terms. The question as to whether the market price is your own or your competitor's market price is really a new one to us. Where we recognize market prices, it is normally the contractor's market price rather than the competitor's market price. However, we do visualize that if the buying activity, whether it be the Government or a prime contractor, was aware that a competitor's market price was lower, then the buyer would most likely refuse to accept the supplier's market price which is in excess of his competitor's. This is, of course, on the assumption that the items were very similar and that there were not other factors, such as reliability, maintainability, delivery schedules or others involved.

2. We hope that the above will be of help to you. In the event that you have further questions, please call either Dale Babione, whose home phone number is AX 1-7586 or me. I can be reached at TX-85664.

3. We will look forward to seeing you next week.

Sincerely yours

PHILIP J. BLATTEN  
Colonel, USAF  
Chief, Pricing & Negotiation Division  
Directorate of Procurement & Production

## CONTRACT COST PRINCIPLES

By

Captain John M. Malloy, SC, USN

Chairman, Armed Services Procurement Regulation Committee  
Office of the Assistant Secretary of Defense (Supply and Logistics)

at the

NSIA Seminar on Department of Defense Procurement  
Under the Revised Contract Cost Principles and Procedures

Washington, D.C.

January 24, 1961

I would like to congratulate the National Security Industrial Association for its sponsorship of this seminar on cost principles. This exceptionally large turnout is ample evidence that interest in cost principles has not diminished.

I think it is a particularly good idea to have this type of meeting from time to time to talk about our common problems. However, this poses certain fundamental problems for the Government representatives. We are here today to trade experiences with you and to listen closely to what the industry spokesmen have to say. We will be particularly interested in the type of questions which you put to us as this should be a good barometer with respect to trouble spots in the application of our cost principles. The Government representatives who are here today, including myself, are not authorized to speak officially for the Department of Defense. In fact, we have had only a minimum of advance coordination with respect to our presentations. However, we intend to provide you with our best informal views and, realistically speaking, this should be quite helpful to you. As you are aware, the subject of cost principles is an area in which opinions vary widely. This is true obviously within the Department of Defense and it would not surprise me to hear conflicting views expressed by individual Government representatives. This, however, is the nature of the beast and it is our feeling that the full expression of individual views is the most practical way of reaching the right decision with respect to any particular cost item or cost interpretation.

It has been our experience that it is not possible to provide formula or book solutions to every costing problem. From time to time, we are asked by contracting officers for such neat solutions and, oddly enough, we get just as many requests from individual company representatives for such automatic solutions. Everyone, of course, wants these neat packages when it suits his own particular purpose, but I am rather certain that our discussion over the next two days will amply demonstrate the fallacy of this approach.

Our goal, during this meeting, it seems to me, should be to isolate any possible soft spots that may come to light, so that we in Government

may study the particular area further. While we have found that there are often no easy answers to some problems associated with the cost principles, particularly insofar as changing the Armed Services Procurement Regulation is concerned, we frequently are able to take other administrative action to advise our contracting officers and negotiators of the underlying purposes of some of the ASPR provisions.

In any event, please be assured of our good intentions and motivations in connection with our continuing study of contract cost principles. Above all, I suggest that you not develop a feeling of frustration just because easy solutions are not forthcoming on the spur of the moment. After all, I need not remind you of the problems that remain in your own companies from week to week.

I do not feel that any good purpose would be served by re-hashing the many arguments and counter-arguments which were fully explored and evaluated prior to publication of our cost principles. Rather, I intend today, to cover briefly the basic underlying purposes which motivated us to adopt so-called comprehensive cost principles and some of the current problems that we face in implementing any regulation, particularly one as complicated and as far-reaching as is involved in cost principles. I will cover the use of cost principles and cost breakdowns in the pricing and negotiations of contracts as I am sure that this subject will bubble to the surface several times during our discussions. I believe that you may be particularly interested in some of the areas of the cost principles that we are currently studying and, hence, I will outline these areas for you.

Most of you are aware of the fact that the cost principles were in the process of consideration within the Department of Defense for a period of several years prior to their publication on 2 November 1959. When finally adopted, they had been considered, in some detail, at high levels within the Department of Defense. We had several basic purposes in mind in this exercise. We had the obvious problem of updating our then existing cost principles, which were originally published in 1949, and which remained essentially unchanged over the years. Also, we were seeking to achieve a greater degree of uniformity on costing matters within the Department of Defense and among our various contractors. I recall a discussion which I had about two years ago with the Congressman from my own District who was an active member of the House Armed Services Committee. For some reason, he just could not understand why, for example, the cost of incentive bonus plans was not allowed by one military department, while the other two departments had testified before the Committee that they could see nothing wrong with this type of expense per se, and that it was being allowed to the extent that over-all compensation was reasonable. His rather pointed question to me was, "Why doesn't the Department of Defense make up its mind with respect to this area of cost and put all contracting officers on the same team?"

In addition to seeking uniformity, we were also attempting to provide a framework so that a particular cost would be treated, policy-wise at least, the same way, regardless of the type of contract employed. We could see no

reason why our policy should be different on an item -- such as contributions and donations -- under a cost-type contract as against a follow-on contract of a fixed-price type. In other words, we feel that a cost is a cost regardless of the type of contract involved. In making this generality, however, we do not intend to lose sight of the inherent differences which are reflected in the particular type of contract used. However, these inherent differences, such as degree of risk, for example, should be looked at squarely, and evaluated on the merits, rather than be buried in a different cost treatment.

In connection with the individual elements of cost, we adopted what we consider the best result possible under all of the circumstances. By this, I mean that other elements of the Government, such as the General Accounting Office and the Congress, have long held strong views in some areas, and these views could not be ignored. Up to the present time, we have been successful in defending several of the allowable cost items against critics who feel strongly that the Government should not pay for certain particular types of cost.

Many of you have bent my ear privately to convey the word that the implementation of these cost principles throughout the Department of Defense has been rather harsh. There are inherent problems of implementing policy decisions in any organization, particularly one as large as the Department of Defense. This is probably the most difficult problem that we face in developing any important part of the Armed Services Procurement Regulation. We attempt to develop policy which is at once applicable to the large contractor and to the small contractor, and to the contractor doing a large volume of business with the Department of Defense and a contractor whose total volume of business includes only a small portion devoted to the Department of Defense. Interestingly enough, during the development of our cost principles, one of the strongest industry objections was concerned with the degree of specificity and detail which we insisted was a necessary part of the cost principles package. We are now finding that industry representatives are complaining that our regulation is not specific enough. In other words, industry, on the one hand, argues for general policy guidelines with maximum reliance on the application of individual judgment to specific situations while, on the other hand, industry seeks specificity in the cost principles as a protection against the application of the wrong kind of judgment (from their point of view) being exercised by a contracting officer.

In any event, the military departments have issued very little in the way of implementing instructions. All of the departments are in complete agreement that it would be unwise to allow extensive unilateral implementation of the cost principles. This is not to say that there have been no suggested implementations. For example, many contracting officers feel that our coverage on travel per diem, and moving expenses is too broad. They want yardsticks, such as suggested per diem rates, or maximum limitations on the weight of household effects such as are applicable to Government personnel. For the moment at least, we are of the opinion that these matters are best left for individual evaluation against the over-all test of reasonableness.

I would like to turn now to the use of cost principles in pricing. I have found that feeling often runs high whenever this subject is broached. As a matter of fact, the applicability of our new cost principles in the fixed-price area was the most significant area of discussion within the Department of Defense in our consideration of the cost principles. Many knowledgeable people within the Department were genuinely concerned that any cost principles developed for use outside of the cost reimbursement contract area would inevitably result in formula pricing, or the automatic resolution of pricing problems strictly along accounting lines. Others felt just as strongly that it was essential to sound pricing that the parties have a clear understanding of the cost base, and that the peculiarities of the contracting situation should thereafter be handled through appropriate types of contracts or special contract provisions.

We have set forth our policy direction on the application of cost principles to other than cost type contracts in Section XV, Part 6. Here we have done our level best to come at this problem in a realistic fashion. We made what I consider to be a valid distinction between retrospective pricing and forward pricing. We very carefully indicated that our basic pricing policies and procedures, which are contained in Section III, Part 8 of the Regulation, are governing and shall be followed in the negotiation of fixed-price contracts. We have indicated, in a straightforward manner, that the cost principles are to be used as a guide in the evaluation of cost data, when such evaluation is required to establish fair and reasonable prices.

I have often been asked to elaborate on the term "shall be used as a guide." Here we simply mean that our cost principles should be followed in the usual situation, and that a contracting officer who departs from the cost principles assumes the burden of justifying his action. This seems only fair, and is the type of compliance which you would expect from the employees of your company in carrying out stated company policies. However, we mean what we say when we indicate that cost and accounting data may provide guides for ascertaining fair compensation, but are not rigid measures of it. Other types of data, criteria, or standards may furnish reliable guides to fair compensation. The ability to apply standards of business judgment, as distinct from strict accounting principles, is at the heart of a negotiated price or settlement.

I am aware of the industry contention that, however well intended our policy pronouncements in this area, the actual fact is that defense contracting officers are engaging in formula pricing on a large scale. It is most difficult for us to objectively evaluate this contention. I think it safe to say that we are paying a great deal more attention to cost analysis now than we did in the past. We are also requiring our major prime contractors to do the same thing. This greater attention to cost on our part is not necessarily attributable to the publication of the cost principles. We have a great deal of evidence, particularly from reports issued by the General Accounting Office, that we and our prime contractors have not been attentive enough to the cost aspects of our negotiation procedures.



We fully intend that our people pay more attention to cost, but only in those areas where such attention is essential to sound pricing. We make no apology for this, and consider it to be a sound step in our determination to tighten up all along the line in our pricing and administration of large contracts.

I would like to change direction slightly at this point in order to advise you of some of the actions which we have recently taken in the area of cost principles, and to outline some of the specific matters which we have under active study at the present time.

We have completed drafts of cost principles applicable to the acquisition of facilities and to construction contracts. These cost principles will appear in Parts 4 and 5 of Section XV. Both of these new Parts incorporate the basic principles found in Part 2, and set forth only those particulars which are peculiar to facilities or construction. Appropriate industry associations are currently being afforded the opportunity of reviewing and commenting on these new Regulations.

The Bureau of the Budget has very recently revised its circular A-21, which prescribes cost principles applicable to research contracts with educational institutions. ASPR Section XV, Part 3 will be changed in the near future to reflect the changes directed by the Bureau of the Budget. These changes are, for the most part, of a clarifying nature, although the cost of the Sabbatical leave will be allowable, whereas this item is unallowable now.

We firmly believe that changes in Section XV, Part 2 should be kept to the absolute minimum. Other speakers on today's program will elaborate on the difficulties that are encountered when different sets of cost principles are being used by a particular contractor. We have been thinking seriously of establishing a new Part 7 in Section XV, which would contain so-called cost interpretations. Here we might include additional guidelines as to reasonableness or allocability in connection with a particular cost item, even though the cost principle itself remains undisturbed. This may sound like an easy solution to the problem of minimizing changes in the cost principles themselves, but we have found, on analysis, that the creation of a part on cost interpretations might well introduce a myriad of additional problems, particularly of a legal nature. While we have not necessarily abandoned this idea, we have not as yet come upon a specific situation which would lend itself to this treatment.

Now, for some specific areas that have been, or are currently occupying our attention. We are making a change in Paragraph 15-205.6 which concerns the reasonableness of location allowances -- sometimes called "supplemental pay" or "incentive pay." The effect of this change is that these costs will be recognized only where, and so long as, the isolation or unfavorable environment of a particular site makes such payments necessary to the accomplishment of the contract work without unacceptable delays. This change which will be published in Revision 3 on 31 January 1961 should have a minimum of effect on most contractors, and will be applicable only to certain situations where abuses have developed.



The total cost involved in the area of recruiting expense continues to be a matter of concern to us. A recent study by the Department of Defense indicates that the level of recruiting expense for defense contractors is considerably in excess of that being experienced by contractors engaged in civilian business. While we might logically expect higher costs, in the less stable area of defense business, we can all recognize the potential abuses which are possible. The Military Departments will continue to administer this particular category of expense with a heavy hand. We do not, however, contemplate any change in the cost principles covering this item.

Advertising in trade and technical journals is presenting some very difficult problems of administration. This area involves a small fraction of the total cost picture, but there is, nevertheless, a substantial amount of money involved. Our cost principle is couched in general terms, and we have been faced with different applications within the Department of Defense in this area. We are also aware that the number of trade and technical journals is increasing at a fast clip. We have attempted to develop an amplification and clarification of our cost principle, but without much success. We are now undertaking a basic study to determine just what our defense policy in this area should be. I am unable to predict the outcome of this study at this time.

A question has arisen with respect to whether independent development expense can be allocated to all work of the contractor in the contract product line (including research and development work), or whether independent development expense can be allocated only to production contracts. While the problem arose with respect to the interpretation of the provisions of the cost principles as now worded, we are studying the matter to seek the right solution. In other words, a de novo look. This is a close question and we hope to have this matter clarified in the near future.

A problem has arisen with respect to the allocation of certain personal property taxes. This problem is aggravated in states where the applicability of state taxes to defense material is in dispute. The question is whether such taxes should be segregated and allocated directly to each class of customer, i.e., Government work and commercial work, or whether these taxes should go into an overhead pool for allocation in the usual manner. It is our tentative view that these taxes, when significant in amount, should be handled as direct costs. We are in the process of studying the appropriate method of implementing this conclusion. This may result in a change to the cost principles and to our standard tax clauses, as well.

We are beginning to hear that some contractors are seeking to gain a liberalization of the cost principle concerned with charges for material transferred between plants or divisions under a common control. Our present ASPR coverage on this subject represents a liberalization from the prior treatment. Many of you will recall that industry recommended a more liberal policy in this area. However, the present regulation is essentially one of compromise between the industry and Government positions. Some companies

have indicated that they do not want to give the Government the "most favored customer" price. Problems have also arisen with respect to the term "sold by the contractor through commercial channels." Problem areas arise here in connection with an item that has only a military application, and is sold as a subcontract item exclusively to other defense contractors. I think it safe to say that we are not disposed to make any basic change in this particular cost principle at this time.

One final item concerns itself with bidding expense. Several abuses have been reported in this area, such as extensive research and development effort that is improperly labelled as bidding expense. There are also problems in the area of unsolicited proposals. We are receiving a great many unsolicited proposals which are submitted in great detail -- that is, they are completely engineered to the final line on the blueprint, rather than being presented in broad framework for evaluation. The costs of this effort go into overhead and are, of course, reimbursable through our contracts. We feel that there is an area of excess cost involved here and, more important, there may be a waste of critical engineering talent. This is an area in which we have very little control today. Obviously, we want to continue to receive unsolicited proposals for evaluation, but we definitely do not need such extensive engineering detail, and we definitely want to cut down on needless cost in this area. Our appropriation situation is such that we can only fund a small fraction of the proposals which are received. Continued lack of restraint in this area will inevitably require that we impose additional restrictions in our Regulation.

It has been my purpose this morning to provide you with some background material with respect to the contract cost principles. We do not claim that everything is perfect. We recognize that both Government and industry are still acquiring experience under the new cost principles. However, we have heard nothing yet to indicate that any basic or major changes are necessary or desirable in our current Regulation. We are most anxious, however, to take such steps as may be necessary to clarify and improve our Regulation. We most certainly are desirous of preventing the misuse of the cost principles. I have indicated to you the areas that are currently causing some difficulties and are requiring our attention. I am looking forward with anticipation to a discussion in depth over the next two days on this important subject. It will surely produce good results -- if only to make everyone, on both the Government and industry sides, more precisely aware of the ground rules.

REMARKS  
by  
CAPTAIN JOHN M. HAILLY, SC, USN  
BEFORE THE  
BRIEFING CONFERENCE ON GOVERNMENT CONTRACTS  
SPONSORED BY  
THE FEDERAL BAR ASSOCIATION  
PHILADELPHIA, PENNA.  
Feb 9, 1961

It is always a pleasure for me to participate in these briefing conferences. They provide an excellent forum for the public discussion of the really important issues of the day in the field of Government contracting.

This afternoon we will be engaged in a discussion of defense cost principles -- their content, administration, and use. Costs always seem to remind one of profits, so it is only natural that our discussion include this most important and interesting subject.

I don't intend to discuss the cost principles in much detail today. You are all aware of the fact that the Department of Defense published its new cost principles in November 1959. This was the culmination of many years of effort to resolve conflicting views within the Department of Defense and with industry. While we were able to resolve our differing views internally, I am afraid that some segments of Industry remain in the opposition to cost principles which deny recovery of certain costs, irrespective of the rationale supporting the disallowance. Secretary McGuire once observed that he expected the epitaph on his tombstone to read like this: "Here lies the man who published the new cost principles."

In any event, they were published and we all survived -- and, strangely enough, so has Industry. The new principles were generally effective on 1 July 1960, although many large companies did not cut over to the new principles until 1 January 1961. This was possible under our ground rules in line with

our determination to make the transition from old to new as painless as possible. In effect, we provided the flexibility to have the effective date coincide with the contractor's fiscal year.

The Department of Defense has been watching the actual application of the new cost principles very closely. Our contracting officers and auditors report that no insurmountable difficulties have developed so far, although all recognize that we are still acquiring experience under the new cost principles. However, we have heard nothing yet to indicate that any basic or major changes are necessary or desirable in our current Regulation.

This is not to say that there are no problems being encountered. We have many of the usual problems of interpretation of the printed word. Many contractors have been searching diligently for loopholes, while the Government representatives on the firing line have been trying to stay one jump ahead of the opportunists.

Much remains to be done in the area of advance understandings. Many contractors are seeking advance understandings where no solid reason exists for the use of this technique. On the other hand, some Defense contracting officers seem to be reluctant to make use of this provision in the cost principles. Mr. Steger will pursue this interesting area in greater depth today.

The research and development principle was the most difficult of all the cost principles for us to develop. In making a contractor's independent research and development costs allowable, we were aware that our biggest problem would be one of administration. An increasing amount of Defense business must be awarded on the basis of technical superiority.

This situation provides a substantial incentive to many companies to get the jump on their competition. This type of industrial competition is, of course, not bad in itself. In fact, it is the kind of free enterprise drive that has made our country great. However, we were quite aware of the dangers inherent in this area if some type of reasonable restraint and surveillance was not imposed on the enthusiasm of our contractors. These potential dangers involve both money and technical manpower. The problem we faced, then, was one of control - - to avoid extremes and to avoid providing competitive advantages through our support. We found no easy solution for across the board application. Rather, we determined that it would be necessary to examine each situation involving significant expense on a case by case basis. We established the administrative mechanism to handle this program on a defense wide basis. Many contractors have already been through the mill on this one. The results have been generally satisfactory for both sides. Some companies have received approval of their total program. Others have been approved in part only. There is no automatic answer to every case. Particular emphasis is placed on the degree of excellence of the contractor's program and the amount of effort previously devoted to this area. For example, one company asked us to approve a seven million dollar independent research program. The company had previously devoted about one-half million dollars to this area. We did not intend that our cost principle have this effect on costs. This company has agreed to a cost-sharing formula.

Other problems have arisen in the subcontract area. These involve the control of costs, advance understandings, and the audit of subcontractor costs.

In connection with the latter, our Government auditors are making every effort to assist prime contractors by providing audit reports, particularly in instances where we have a Government auditor in residence at a particular contractor's plant.

As most of you are aware, the new cost principles are applied to future periods on a contract by contract basis. Many existing contracts will continue for months, some for a period of years. This situation results in the use of both the old and new principles at the same time by many contractors. We did the best we could to prevent this situation, but the problems were unsurmountable. We are hopeful that at some time in the future, perhaps by the end of this year, we will be in a position to provide practical guidelines that will enable us to amend existing contracts to provide for the use of the new cost principles across the board.

It is our hope that changes in our cost principles can be kept to the absolute minimum. While certain clarifications may well be in order, we realize that the problem of different sets of cost principles would be compounded if we made important changes frequently. We also intend to control rigidly the issuance of implementing regulations. You have seen few, if any, such implementations so far. In fact, any implementation, by either the procurement or audit elements of the military departments requires the advance approval and authorization of the Office of the Secretary of Defense.

We have completed drafts of cost principles applicable to the acquisition of facilities and to construction contracts. These cost principles will appear in Parts 4 and 5 of Section IV. Both of these new Parts incorporate the basic principles found in Part 2, and set forth only those particulars which are peculiar to facilities or construction. Appropriate industry associations are currently being afforded the opportunity of reviewing and commenting on these new Regulations.



The Bureau of the Budget has very recently revised its circular A-21, which prescribes cost principles applicable to research contracts with educational institutions. ASFR Section IV, Part 3 will be changed in the near future to reflect the changes directed by the Bureau of the Budget. These changes are, for the most part, of a clarifying nature, although the cost of Sabbatical leave will be allowable, whereas this item is unallowable now.

Now, for some specific areas that have been, or are currently occupying our attention. We are making a change in Paragraph 15-205.6 which concerns the reasonableness of location allowances -- sometimes called "supplemental pay" or "incentive pay." The effect of this change is that these costs will be recognized only where, and so long as, the isolation or unfavorable environment of a particular site makes such payments necessary to the accomplishment of the contract work without unacceptable delays. This change, which will be published in Revision 3 of ASFR, should have a minimum of effect on most contractors, and will be applicable only to certain situations where abuses have developed.

We are continuing to watch the area of recruiting expenses. This cost element is of particular interest to the Congress. The potential abuses in this area need no elaboration.

Advertising in trade and technical journals is presenting some very difficult problems of administration. We are in the process of studying this item closely to determine just what our defense policy should be.

We are also working on the cost principles dealing with the allocation of independent development expense, certain personal property taxes, and charges for material transferred between plants or divisions under common control.

This review on our part is occasioned by problems which have arisen in the application of the cost principles over the past year.

The use of cost principles in pricing is a very interesting and important area. I have found that feeling often runs high whenever this subject is breached. As a matter of fact, the applicability of our new cost principles to fixed-price contracts was the most significant area of discussion within the Department of Defense in our consideration of the cost principles. Many knowledgeable people within the Department were genuinely concerned that any cost principles developed for use outside of the cost reimbursement contract area would inevitably result in formula pricing, or the automatic resolution of pricing problems strictly along accounting lines. Others felt just as strongly that it was essential to sound pricing that the parties have a clear understanding of the cost base, and that the peculiarities of the contracting situation should thereafter be handled through appropriate types of contracts or special contract provisions.

We have set forth our policy direction on the application of cost principles to other than cost type contracts in Section IV, Part 6. Here we have done our level best to come at this problem in a realistic fashion. We made what I consider to be a valid distinction between retrospective pricing and forward pricing. We very carefully indicated that our basic pricing policies and procedures, which are contained in Section III, Part 3 of the Regulation, are governing and shall be followed in the negotiation of fixed-price contracts. We have indicated, in a straightforward manner, that the cost principles are to be used as a guide in the evaluation of cost data, when such evaluation is required to establish fair and reasonable prices.

I have often been asked to elaborate on the term "shall be used as a guide." Here we simply mean that our cost principles should be followed in the usual situation, and that a contracting officer who departs from the cost principles assumes the burden of justifying his action. This seems only fair, and is the type of compliance which you would expect from the employees of your company in carrying out stated company policies. However, we mean what we say when we indicate that cost and accounting data may provide guides for ascertaining fair compensation, but are not rigid measures of it. Other types of data, criteria, or standards may furnish reliable guides to fair compensation. The ability to apply standards of business judgment, as distinct from strict accounting principles, is at the heart of a negotiated price or settlement.

I am aware of the industry contention that, however well intended our policy pronouncements in this area, the actual fact is that defense contracting officers are engaging in formula pricing on a large scale. It is most difficult for us to objectively evaluate this contention. I think it safe to say that we are paying a great deal more attention to cost analysis now than we did in the past. We are also requiring our major prime contractors to do the same thing. This greater attention to cost on our part is not necessarily attributable to the publication of the cost principles. We have a great deal of evidence, particularly from reports issued by the General Accounting Office, that we and our prime contractors have not been attentive enough to the cost aspects of our negotiation procedures. We fully intend that our people pay more attention to cost, but only in those areas where such attention is essential to sound pricing. We make no apology for this, and consider it to be a sound step in our determination to tighten up all along the line in our pricing and administration of large contracts.

I would like to turn now to a brief discussion of profits.

One often hears the statement that profits generated on Government business are too low. Depressed profit levels, it is said, discourage companies from doing business with the Government. It is drying up investment funds and making it impossible to replace ageing plant and equipment. Government personnel, it is alleged, do not take into consideration that the profit or fee must absorb most of the unallowable costs that must be incurred by contractors, even though not allowed as costs by the Government. Some have estimated this area to be as high as 2%. So the argument goes.

The generality of this argument is of serious concern to the Department of Defense. It goes to the very heart of the incentive problem. It is an area that we in Government should be aware of on a continuing basis. The fact is, however, that we have not experienced any lack of interest in our business on the part of American industry. In fact, the line at the door of contracting officers is getting longer each day. As you are fully aware, we endeavor to instill as much competition into our procurements as is possible. In these situations, we in Government do not depress profits. We buy at a price, a good tight price we hope, and the profit element is governed by conditions in the market place. This is as it should be in the best tradition of the American free enterprise economy I submit that it would be improper for Government buyers to be other than hard-headed businessmen in acquiring the goods needed for the Defense of this country. We strive to buy at a good price and to insure that profits thereafter are earned - - - by the application of management efficiencies and tight control of costs. Profit should not be guaranteed - - it should be earned.

There is, of course, a large segment of our business that must necessarily be non-competitive as to price. In these instances, we use the criteria set forth in ASPR Section III, Part 8. These, I submit, are good criteria. They provide for certain plus and minus considerations in relation to the relative risks involved, and in relation to assistance provided by the Government, such as when facilities and financing are provided. We intend that these criteria be applied on a case by case basis, depending on the individual situation. We don't like to see the automatic application of a fixed percentage as the fee. We are aware that this is sometimes the case --- sometimes by our own people and sometimes by contractors. The real problem here, as I see it, is not to raise the general level of everyone's fees, but rather, to reward the efficient contractor, or recognize the difficult job, by allowing higher fees.

And, of course, it follows that we should reduce the currently allowed fees when such conditions do not exist. In other words, I think there are too many instances today where the best, the routine, and the poor contractor are receiving the same recognition in the fee area by the routine application of so-called standard fees. If we can find a way to break up these current practices, we will surely introduce sound incentive to do business with the Government.

One final thought. While I have talked to you today about cost principles and their use, and of profits, I suggest that all of us not become so engrossed in this type of discussion that we lose our perspective with respect to the most important area of all --- the mounting cost of Defense. I would like to see us all more concerned with finding ways to reduce costs --- perfectly legitimate costs in themselves (such as overtime) instead of spending so much of our time proving and debating the relatively minor items which are listed in our cost principles as being unallowable.



DEPARTMENT OF THE AIR FORCE  
WASHINGTON

C O P Y

Office of the Assistant Secretary

June 11 1959

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)

SUBJECT: Contract Cost Principles

1. Reference is made to your memorandum dated 13 May 1959 on the above subject. We have reviewed the latest draft attached to your memorandum and recognize the compromises that have been made in several items to accommodate divergent views among the Departments as well as with industry. Accordingly, we think it should be clearly understood that if actual experience under the proposed principles reveals any deficiencies, we will seek reconsideration of the matters involved. Since the proposal seems to offer an acceptable basis for early adoption, we concur subject to the comments noted below.

2. We note the deletion in paragraph 15-205.22(e) of the prohibition relating to "write downs" or "write ups" of material values which had appeared in earlier drafts and which now appears, in part, in current ASPR 15-202.1. We understand that discussions on this point have taken place between the top Comptroller people in the Air Force and the Department of Defense. We also understand that agreement in principle has been reached to the effect that it is our common understanding that Department of Defense policy generally is not to accept such costs. Apparently this understanding is to be made a matter of record so that, should the problem arise, such an understanding could be relied upon to give a common answer. As you know, such an understanding cannot form the basis of a contractual obligation. Accordingly, we would urge for consideration the inclusion in the Cost Principles of appropriate language covering the point.

(Signed)

P. B. TAYLOR

Assistant Secretary of the Air Force



structions under (41)(b)(i) and take action directed by the contracting officer under (41)(b)(ii). Any problem in this respect can be avoided by revising ASPR 15-205(41)(b)(ii) to read:

"(ii) takes all action directed by the contracting officer arising out of (b)(i) above or an independent decision of the Government as to the existence of a claim of illegality or erroneous assessment, including cooperation with and for the benefit of the Government to (A) determine the legality of such assessment or, (B) secure a refund of such taxes."

*MHS.*

Meritt H. Steger  
Deputy General Counsel

cc: Mr. W. H. Moore  
Mr. Harry R. Van Cleve

# Pentagon to Stand Fast On Contractor Ad Policy

By L. EDGAR PRINA  
Star Staff Writer

The Pentagon will stand fast on its policy of allowing defense contractors to charge the Government for company advertisements in trade and technical journals.

This was disclosed by Defense Department officials when asked yesterday whether any changes in the Armed Services Procurement Regulation were contemplated in the wake of President Eisenhower's blast at the "munitions lobby."

The President has been described as primarily disturbed over ads taken by the weapons makers in newspapers and other media which are obviously intended to influence military decisions.

The recent Boeing Co., ad extolling its Bomarc missile was said to have particularly annoyed him, coming as it did while the Pentagon was drafting a new air defense plan and Congress was considering funds for Bomarc and the Army's rival Hercules weapon.

## Taxpayer Pays

Although the Pentagon does not allow general circulation advertising, such as the Boeing ad, as a direct contract cost, some members of Congress are convinced that the taxpayer, in the end, foots the bill—or most of it—just as he does in the trade and technical journal ads. They say that the entire advertising and public relations programs of the big defense industries need examination.

What the Pentagon does permit is stated in a key provision of its Procurement Regulation, Section 15-204 (). Headed "Examples of Items of Allowable Costs" it reads:

"Advertising in trade and technical journals, provided such advertising does not offer specific products for sale but is placed for the purpose of offering financial support to journals which are valuable for the dissemination of technical information within the contractor's industry."

The regulation does not define "trade and technical journals" but one official said the Pentagon approves as "allowable costs" only those advertisements placed in nonprofit publications.

## Helped Wanted Ads

The Pentagon also allows "help wanted" ads as defense contract costs no matter what

which is paid by the Federal Treasury, and you know where the Treasury gets its money—from you and me and every other taxpayer."

Mr. Ford, who is a member of the House Defense Appropriations Subcommittee, said many weapons ads "create the wrong impression because the manufacturers tend to magnify their accomplishments." Then he added:

## "Most Disgusting"

"But the most disgusting thing to me is the tremendous number of ads these companies place in various trade and semi-official service publications."

The Congressman asserted that the advertising policies of the defense contractors were, in effect, helping to finance inter-service fights over weapons and roles and missions.

There is no doubt that the Air Force Association, Association of the United States Army and Navy League monthly publications obtain much of their revenue from weapons manufacturers' ads. These publications, of course, are sounding boards for individual service viewpoints.

Other sources say that concern at the White House comes from the feeling that the public ultimately pays for the large-scale advertising and public relations campaigns of the giant defense industries and that in some cases these campaigns are directed at overriding decisions of officials in the Executive Branch and Congress who are paid by the public to make these decisions.

## Big Contractors

Most of the controversial ads are placed by aircraft companies, which are the prime contractors for the big missile programs. When it is considered that the aircraft industry, the largest in the country both in terms of labor force and dollar volume of business

really engaged in this activity. The others are registered "just to be safe."

The records filed with Congress would indicate that even Mr. Mosier does little lobbying. He reported expenditures of only \$1,159.05 in 1958 and a salary of \$16,224.

Congressmen concerned with tightening lobbying regulations—Senator Kennedy, Democrat of Massachusetts, for one—are known to feel that many organizations have turned their real efforts at influencing legislation on officials of the Executive Branch. The reason given: Much legislation actually is proposed to Congress by the Executive Branch and there are no regulations governing "lobbying" in that area.

This matter may very well be explored by a House Armed Services Subcommittee headed by Representative Hebert, Democrat of Louisiana, when it holds hearings on the controversial problem of the employment of retired Army, Air Force and Navy officers in defense industries.

LATEST ALLEN SMYTHE ARTICLE - CONTRACT COST PRINCIPLES  
NY HERALD TRIBUNE 9/29/59

Assertion: Cost Principles "may" be soon published.

Evaluation: True.

Assertion: New rules will affect \$14 billion per year in new procurement.

Evaluation: True.

Assertion: \$26 billion in outstanding contracts would be amended to include the new "liberalized" rules.

Evaluation: Our party line is that the new rules are not a more liberal set than existing principles and practices. Provision is made for applying the principles to existing procurement for a "consideration." We don't know wherein, however, the "consideration" will be found.

Assertion: Publication is expected about 15 October.

Evaluation: Substantially accurate.

Assertion: Effective date 1 January 1960.

Evaluation: Actual outside effective date 1 July 1960.

Assertion: There were historical difficulties with Congress and industry but latest draft has been "screened from trade and congressional groups."

Evaluation: The latest drafts have been carefully guarded.

Assertion: Industry still opposed since not sufficiently generous.

Evaluation: Our best judgment is that industry will not seriously oppose the document.

Assertion: Requires changes in contractors' accounting systems.

Evaluation: Our party line is that this is not true to any significant extent.

Assertion: AIA prefers the status quo to the new "completely revised" set.

Evaluation: This is the historical AIA position.

Assertion: Some trade group officials estimate increases at "only several million dollars" which they believe insufficient.

Evaluation: See above re party line vs generosity of the new set.

Assertion: Small businessmen believe the new set will "only confuse and not help."

Evaluation: If true, this is news to us.

Assertion: Main increases are (1) general research, (2) executive benefits, overtime, and administrative expenses.

Evaluation: General research may be increased; executive benefits shall not be different than PRESENT practices; overtime and "administrative practices" should be about the same as current practices.

## New Contract Cost Rules Likely To Get Approval

By Allen M. Smythe

After six years of effort, top procurement officials of the Pentagon may be on the point of revising their contract cost allowance rules, by far the most important defense fiscal regulations. The new proposed rules will affect an annual expenditures of \$14,000,000,000 in new negotiated contracts for military hardware. More than \$26,000,000,000 in outstanding active contracts would be amended to include these new liberalized rules and thus standardize the defense accounting system.

The final July 26 draft of these cost principles are awaiting approval by Assistant Secretary of Defense E. Perkins McGuire, who has just returned from vacation. They will then go to Secretary of Defense Neil H. McElroy for an expected routine indorsement and then be printed in the Federal Register. This procedure could be completed by Oct. 15, 1959. Effective date would be Jan. 1, 1960.

Several times before in the last few years new cost rules have come near to official approval but have been held up at the last minute by vigorous business or Congressional opposition. However, the final July 26 draft has been carefully

screened from trade and Congressional groups. Only twenty keyed copies were made and these are carefully guarded.

Although increases are allowed to defense contractors in a number of cost items, the defense industry is generally opposed to the new rule. Main complaint is that the increases are not great enough to offset the cost and inconvenience of changing the accounting systems to fit the new rules.

Robert W. McMillan, top legal official of the aviation industry trade group, the Aerospace Industries Association, said, "Apparently the final draft is a compromise of various viewpoints in the Pentagon. The present rules are workable and in general industry would prefer them with some changes in the most controversial items rather than a completely revised set."

Other trade group officials thought the increases granted would amount to "only several hundred million dollars" and that this was not sufficient. Officials representing small business thought the new rules would only confuse and not help their members. Main increases granted are in the items of general research, executive benefits, overtime, and administrative expenses.

24 Herald Tribune - 9/29/59

Headquarters  
U. S. Army Audit Agency  
Washington 25, D. C.

USAAA Bulletin 316-10  
26 July 1960

**MAJOR AREAS OF DIFFERENCE BETWEEN THE "NEW" AND  
"OLD" COST PRINCIPLES AND PROCEDURES APPLICABLE TO  
CONTRACTS WITH COMMERCIAL ORGANIZATIONS**

**Expiration Date: 30 June 1961**

**1. PURPOSE**

This bulletin highlights for the attention of auditors certain of the major areas of difference between the contract cost principles set forth in ASPR Section XV Part 1, 2 and 6, ASPR Revision No. 50 dated 2 November 1959 and those principles in the previous edition of ASPR Section XV dealing with corresponding matters. These major differences relate, for the most part, to the applicability of the principles, and to the treatment of certain items of cost under supply and research contracts with commercial organizations. For the purpose of identification, the revised cost principles contained in ASPR Section XV, Parts 1, 2 and 6, Revision No. 50, will be referred to as the "new principles". The edition of ASPR Section XV dated prior to 2 November 1959 will be referred to as the "old principles". With minor exception the new principles become fully effective for all applicable-type contracts issued after 1 July 1960. The information contained in this bulletin is not intended as a substitute for a thorough reading and understanding of the new principles by each auditor.

**2. APPLICABILITY OF THE NEW PRINCIPLES**

**a. General**

The new principles represent the introduction of a comprehensive set of contract cost principles and procedures which are applicable for use under both fixed-price type contracts and cost-reimbursement type contracts for supply and research with commercial organizations. In accordance with the implementation referred to in paragraph 3 below, the new principles will ultimately supersede both the old principles prescribed for use in determining reimburseable costs under cost-reimbursement type contracts and the separate set of cost principles previously applicable to termination settlements (ASPR Section VIII).

**b. Cost-Reimbursement Type Contracts**

The applicability and use of a definitive set of cost principles for cost-reimbursement type contracts does not represent any change from that previously in effect. The new principles are prescribed to be incorporated by reference in all cost-reimbursement type contracts for supplies and research with commercial organizations. They serve as the basis for (1) the determination of reimburseable costs under such contracts and cost-reimbursement type subcontracts thereunder;



(2) the negotiation of final overhead rates under ASPR 3-700; (3) the determination of costs of terminated cost-reimbursement type contracts where the contractor elects to voucher out its costs or where settlement is made by determination; and (4) the determination of reimbursable costs under the cost-reimbursement portion of time and material contracts.

#### c. Negotiated Fixed-Price Type Contracts

No definitive set of cost principles was previously available for the evaluation of cost data in connection with the pricing of negotiated fixed-price type contracts. The applicability and use of a definitive set of cost principles for negotiated fixed price type contracts as prescribed in Part 6 of the new principles therefore represents a significant change. The new principles are not expected to be incorporated in fixed-price contracts. Pursuant to ASPR XV Part 6 however, the principles are prescribed for use as a guide by contracting officers in the evaluation of cost data in connection with the negotiation of fixed-price type contracts when costs are to be considered for the purpose of establishing a fair and reasonable price. Under such circumstances, the evaluation of cost data is to be made in conjunction with other pertinent considerations as set forth in ASPR III Part 8.

#### d. Negotiated Settlements of Terminated Contracts

The new principles are prescribed for use as a guide (see paragraph c above) in the settlement of advertised and negotiated contracts terminated for the convenience of the Government where settlement is made by negotiation.

### 3. IMPLEMENTATION OF THE NEW PRINCIPLES

DOD Memorandum dated 10 February 1960 from the Assistant Secretary of Defense (Supply and Logistics) to the corresponding Assistant Secretaries of the Military Departments provides guidelines for the implementation of the new principles in the areas of (a) existing and new cost-reimbursement type contracts and fixed-price type contracts; (b) terminated contracts; (c) cost-reimbursement type subcontracts; and (d) audit services. Supplementary implementing instructions have been issued by the three military departments. (See USAAA Bulletin 316-6 dated 17 February 1960).

### 4. EXPANDED COVERAGE OF THE NEW PRINCIPLES

a. The old principles did not contain any definitions of reasonableness or allocability. By contrast, the new principles contain overall definitions of reasonableness and allocability as well as guidelines for selecting base periods for allocating indirect costs. More extensive treatment is also given to the general subject of direct costs and indirect costs. The importance of advance understandings between the

contractor and contracting officer on particular cost items prior to award continues to be stressed as a means of avoiding possible subsequent disallowances and disputes regarding those cost items whose reasonableness or allocability may be difficult to determine.

b. Individual items of cost were listed in the old principles only as allowable or unallowable. Expanded coverage is accorded in the new principles to definitions of individual items of cost and to explanations of the criteria and special tests for determining their allowability.

## 5. DIFFERENCE IN TREATMENT OF INDIVIDUAL COST ITEMS

Some of the major differences between the new and the old principles in the treatment of individual cost items are set forth below:

### a. Advertising Costs

With the exception of the items enumerated below the basic treatment to be accorded to advertising costs is essentially the same under the new and old principles. In providing for the allowability of advertising in trade and technical journals the old principles required that such advertising be placed for the purposes of offering financial support to such journals. The old principles also did not specifically provide that advertisements which offered specific services for sale were unallowable. In contrast thereto, the new principles (a) do not require that advertisements in trade and technical journals be placed for the purposes of offering financial support; and (b) provide that advertisements which offer specific services for sale are unallowable. The new principles also (a) define the term "advertising media"; (b) describe the conditions under which costs of exhibits are allowable; and (c) specify that advertising is allowable when placed for the exclusive purpose of obtaining scarce materials, plant or equipment, or disposing of scrap or surplus materials in connection with the contract.

### b. Compensation

This item receives detailed coverage in the new principles, not only as concerns the various forms of compensation which may be encountered but also as concerns specific criteria and tests of allowability to be applied to the general subject of compensation and to the individual forms thereof. Of particular significance is the treatment in the new principles accorded to (1) compensation of owners of closely held corporations, partners, sole proprietors, etc., (2) incentive compensation for management employees, and (3) the unallowability of the cost of stock options. These items were either not covered in the old principles or were referred to in Part 5 thereof as a subject affecting costs which may require special consideration.

Under the new principles, compensation for personal services may be paid in any form whatever. Except as otherwise specifically provided in ASPR 15-205,6, such costs (compensation) are allowable to the extent that the total compensation of an individual employee is reasonable for the services rendered and is not in excess of those costs which are allowable by the Internal Revenue Code and regulations thereunder.

Thus, compensation paid in the form of profit-sharing plans is allowable if it meets the above general criteria and any other criteria specifically applicable per ASPR 15-205.6.

c. Depreciation

The computation of the allowable cost of "normal depreciation" and "true depreciation" under the new principles represents essentially the same considerations which were applicable under the old principles and the interpretation thereof in ASPR 15-602. Use or rental charge for fully depreciated facilities was set forth in the old principles as an item requiring special consideration. The more definitive coverage for rental or use charges under the new principles provides that a reasonable use charge for fully depreciated facilities may be agreed upon or allowed provided a substantial portion of the depreciation previously recovered was not recovered on a basis that represented, in effect, a charge against Government contracts and subcontracts.

d. Interest and Other Financial Costs

Contrary to the general rule set forth in the old and new principles regarding the unallowability of interest expense, interest expense was previously allowable under contract termination settlements made pursuant to ASPR Section VIII. Interest expense is unallowable under contract termination settlements made under the new principles. The new principles also definitively specify as unallowable certain financial costs in connection with financing operations which were previously stated to be unallowable in broad general terms. Interest which is assessed by state or local taxing authorities as a result of the non-payment or lack of timely payment of taxes under the special situations set forth in ASPR 15-205.41(b) and (c) is allowable under the new principles.

e. Losses on Other Contracts

This item is unallowable under the old principles and continues to be unallowable under the new principles. The new principles specifically designate a contractor's contributed portion under a cost-sharing contract as an unallowable item within the definition of "losses on other contracts".

f. Material Costs

In the old principles, inter and intracompany transactions were listed in Part 5 as an example of subjects affecting cost which may require special consideration. The new principles provide that charges for materials, services, and supplies sold or transferred between plants, divisions or organizations under a common control are allowable to the extent of the lower of cost to the transferor or current market price. However, a departure from this basis is permitted under the conditions set forth in

subparagraph 15-205.22(e) for items regularly manufactured and sold by the contractor through commercial channels. The new principles specifically provide that where the contractor can demonstrate that the failure to take cash discounts was due to reasonable circumstances, such discounts need not be credited to allowable costs.

g. Precontract Costs

Precontract costs, are specifically made allowable under the new principles to the extent such costs would have been allowable if incurred after the date of the contract. By a cross reference to paragraph 15-107, however, it is stated that an advance agreement with respect to these costs would be particularly desirable. Coverage in the old principles was limited to a reference to this item in Part 5 thereof as a subject affecting costs which may require special consideration.

h. Professional Service Costs - Legal, Accounting, Engineering and Other

This paragraph includes certain criteria to be considered in determining the allowability of these costs in any particular case. Retainer fees are specifically designated as allowable but such fees must be reasonably supported by evidence of bona fide services which are either rendered or available. Paragraph 15-204(l) of the old principles was so worded as to create a doubt whether allowable costs for professional services could include those services which were available in addition to those actually rendered.

i. Rental Costs

No specific coverage of this item was contained in the old principles. Coverage in the new principles is now broken down into four major categories: (i) rental costs in general; (ii) charges in the nature of rent between plants, divisions, or organizations under common control; (iii) rental costs specified in sale and leaseback agreements; and (iv) rental costs under unexpired leases in connection with terminations as covered in ASPR 15-205.42(e). Guidelines with respect to the extent of allowability of rental costs are set forth for each category.

j. Research and Development Costs

The treatment of the cost of research and development activities represents one of the principal changes in the new principles. The old principles provided for the allowance of the cost of research and development specifically applicable to the supplies or services covered by the contract. General research was listed as an unallowable cost unless specifically provided for elsewhere in the contract.

Under the new principles, the terms research, (which comprises basic and applied research), and development are separately defined for the purpose of cost allowability. As part of the definition research and development activities are further categorized as either (1) independent or (2) as sponsored by a contract, grant, or other

arrangement. The costs incurred for independent research and independent development are allowable as indirect costs in accordance with the separate conditions and allocation bases set forth in subparagraphs (d) and (e) respectively of ASPR 15-205.35.

The remaining subparagraphs of ASPR 15-205.35 discuss (1) the treatment of indirect and administrative costs applicable to independent research and development; (2) the unallowability of research and development costs incurred in prior periods except where allowable as precontract costs; (3) the criteria for determining the overall reasonableness of the contractor's research and development program; and (4) the approaches which may be followed where it is desirable that the Government bear less than an allocable share of the total cost of the contractor's independent research and development program.

#### k. Selling Costs

Although the old principles appeared to indicate under ASPR 15-203(b) that reasonable and properly allocated selling and distribution expenses are an allowable cost, the specific listing of "selling and distribution activities not related to the contract products" and "commissions and bonuses in connection with obtaining or negotiating for a Government contract" as unallowable costs under ASPR 15-205 tended to result in some difficulty in determining the allowability of this item of cost. The new principles define selling costs and state that selling costs are allowable to the extent they are reasonable and allocable to Government business in light of the reasonable benefit to the Government from the technical, consulting, demonstration, and other services related to application or adaptation of the contractor's products to Government use. Notwithstanding the latter statement, salesmen's or agents' compensation, fees, commissions, etc., are allowable only when paid to bona fide employees or bona fide established commercial or selling agencies.

#### 1. Severance Pay

The new principles make a distinction between normal turnover severance payments to employees who leave or are dismissed on an individual basis and abnormal or mass severance payments made by reason of the cessation of operations or plant closures. Normal turnover severance pay is allowable on an actual payment basis or reasonable accrual basis where it is required by law, agreement, established policy of the contractor that constitutes in effect an implied agreement, or by the circumstances of the particular employment. Such pay must be allocated to all work performed in the contractor's plant. Accruals for mass severance pay are unallowable because of the conjectural nature of this item. The new principles provide that the allowability of mass severance payments will be considered, however, on a case by case basis in the event of occurrence. The old principles briefly mentioned severance pay as an allowable cost. Recommended disallowances of accruals for mass severance pay under the old principles were based on the inability to determine the reasonableness of the amounts accrued.



m. Termination Costs

As stated in paragraph 2 of this bulletin, the new principles apply to both advertised and negotiated cost-reimbursement type and fixed-priced type contracts terminated for the convenience of the Government. The separate set of cost principles set forth in ASPR Section VIII for terminated contracts is therefore not effective with respect to those contracts to which the new cost principles apply. To cover the special considerations involved in terminations, such as treatment of common cost items, initial costs, settlement expenses, etc., a separate paragraph 15-205.42 entitled "Termination Costs" has been included in the new principles to indicate the extent of allowability of these items. The prior provisions in ASPR Section VIII with respect to the treatment of interest expense and product advertising as allowable costs of terminated contracts have been eliminated from the new principles.

n. Training and Educational Costs

The brief mention of training of personnel as an example of allowable costs under the old principles has been replaced by an expanded statement to clarify any questions regarding the allowability of training and educational costs paid to outside institutions, to company training personnel, or to employees receiving the training. The new principles set forth the specific items of allowable costs applicable to (1) training and educational activities designed to increase the vocational effectiveness of bona fide employees; and (2) part-time education, at an undergraduate or post-graduate college level, related to the job requirements of bona fide employees. Excluded from allowable costs are (1) grants, scholarships and fellowships, donations of facilities or other properties to educational institutions, (ASPR 15-205.44(e)); (2) straight time compensation for part-time education during working hours which is in excess of 156 hours per year per employee, (ASPR 15-205.44(b)(v)). With respect to full-time undergraduate and post-graduate college education, the new principles provide only for the allowability of certain costs in connection with full-time scientific and engineering education at a post-graduate level not normally exceeding one year.

6. CROSS REFERENCE INDEX TO THE NEW AND OLD PRINCIPLES

The attached Appendix A sets forth selected costs and the corresponding paragraph references covering the treatment of these items in the new and old principles.

FOR THE CHIEF, U. S. ARMY AUDIT AGENCY:

Appendix A

DISTRIBUTION:

D

B. B. LYNN, Asst. Chief  
U. S. Army Audit Agency  
for Policies and Plans



CROSS REFERENCE TABLE OF SELECTED COSTS IN NEW AND OLD  
SECTION XV, ASPR

<u>Cost Item</u>	<u>New Section XV Paragraph</u>	<u>Old Section XV Paragraph</u>
Advertising Costs	15-205.1	15-204(a)(r) 15-205(a)
Bad Debts	15-205.2	15-205(c)
Bidding Costs	15-205.3	-
Bonding Costs	15-205.4	15-204(b)
Civil Defense Costs	15-205.5	-
Compensation for Personal Services	15-205.6	15-202.2 15-204(p)(t)(x) 15-204(e)(c) 15-601; 15-603 15-502(u)
Contingencies	15-205.7	15-205(e)
Contributions and Donations	15-205.8	15-205(f)
Depreciation	15-205.9	15-204(d) 15-205(b)(o) 15-502(k) 15-602
Dividends	-	15-205(g)
Employee Morale, Health, and Welfare Costs and Credits	15-205.10	15-204(g)
Entertainment Costs	15-205.11	15-205(h)
Excess Facility Costs	15-205.12	15-205(o)
Fines and Penalties	15-205.13	-
Food Service and Dormitory Costs and Credits	15-205.14	15-502(g) 15-502(q)

CROSS REFERENCE TABLE OF SELECTED COSTS IN NEW AND OLD  
SECTION XV, ASPR

<u>Cost Item</u>	<u>New Section XV Paragraph</u>	<u>Old Section XV Paragraph</u>
Termination Costs	15-205.42	ASPR Sec. VIII 15-502(r)
Trade, Business, Technical and Professional Activity Costs	15-205.43	15-204(1)
Training and Educational Costs	15-205.44	15-204(r)
Transportation Costs	15-205.45	15-204(f)
Travel Costs	15-205.46	15-204(w) 15-502(j) 15-502(t)

CROSS REFERENCE TABLE OF SELECTED COSTS IN NEW AND OLD  
SECTION XV, ASPR

<u>Cost Item</u>	<u>New Section XV Paragraph</u>	<u>Old Section XV Paragraph</u>
Pension Plans	15-205.27	15-601
Plant Protection Costs	15-205.28	15-204(q) 15-502(n)
Plant Reconversion Costs	15-205.29	15-502(l)
Precontract Costs	15-205.30	15-502(a)
Professional Service Costs - Legal, Accounting, Engineering and Other	15-205.31	15-204(i) 15-205(l)
Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets	15-205.32	15-205(m)
Recruiting Costs	15-205.33	15-204(r)
Rental Costs (Including Sales and Leaseback of Facilities)	15-205.34	-
Research and Development Costs	15-205.35	15-204(s) 15-205(j) 15-502(m)
Royalties and Other Costs for Use of Patents	15-205.36	15-204(o) 15-502(i)
Selling Costs	15-205.37	15-205(d)(q)
Service and Warranty Costs	15-205.38	-
Severance Pay	15-205.39	15-204(x)
Special Tooling Costs	15-205.40	15-204(h) 15-502(s)
Taxes	15-205.41	15-204(v) 15-205(i) 15-205(r)

COMPTROLLER OF THE NAVY  
CHANGES IN TEXT OF NAVY CONTRACT AUDITORS COURSE  
IN CONTRACT COST PRINCIPLES

FOREWORD

1. Remove the word "and" from line 8 of paragraph I.
2. Delete paragraph III.

Section I-B, page 2

Item III.A.1. - Change (15-201.9) to (15-202.9)

Section I-C, page 2

Item III.C. - Delete and substitute the following:

In the absence of advance understandings, it is the auditor's responsibility to make a determination of the allowability on the basis of information available. Where a contractor contends there was an advance understanding but presents no evidence in support thereof, the matter generally should be referred to the Contracting Officer via appropriate channels.

Section I-D, ASPR 15-205.7 thru 15-205.15, page 2

Paragraph 15-205.7 Contingencies

Change paragraph V to read:

"A proposed cost based upon contingent events which cannot be measured within reasonable limits of accuracy should not be considered in the evaluation of bid price."

Section I-D, ASPR 15-205.7 thru 15-205.15, page 14

Paragraph 15-205.14 Food Service and Dormitory Costs and Credits

Item II.A. - Change 15-502.14 to 15-202.14

Section I-D, ASPR 15-205.16 thru 15-205.25, page 12

Paragraph 15-205.23 Organization Costs

Item III.A.2, line 4 - Change "unallowable" to "allowable"

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Section I-E, page 4

Item I.c. (4) (b) - Change "Sale" to "Sole"

Section I-F, page 1

Make a new item III as follows:

III. Situation in respect to subcontracts

Make the following changes in the present item numbers:

III to IV, IV to V, V to VI

Section II-C, page 15, sixth line from top of page

Delete the following words:

"and buildings"

Section II-C, page 27

Item (b) (1) - Change "10/12" to "50/52"

Section II-D, ASPR 15-307.3(n) thru 15-307.3(bb), page 2

Paragraph 15-307.3(s) Material

Item II. - Change "(ii)" to "(iii)"

Section II-D, ASPR 15-307.3(n) thru 15-307.3(bb), page 3

Item I. under Other Business Expense - In line 2 change "3" to "2"

Section II-D, ASPR 15-307.3(n) thru 15-307.3(bb), page 5

Paragraph 15-307.3(v) Pension Plan Costs

Item IV.A.2.a. - Delete this item in its entirety

COMPTROLLER OF THE NAVY  
QUESTIONS AND ANSWERS IN  
TRAINING CONFERENCE HELD 16-20 MAY 1960  
RE CONTRACT COST PRINCIPLES, ASPR  
SECTION XV, PARTS 1, 2, 3 AND 6

Section I-A - Introduction - Mr. Cook

Q. Will the coordination of future cost interpretations involve both the audit and procurement personnel of the three Services or will it be restricted to personnel on the audit side?

A. The precise mechanism which will be set up in DOD for cost interpretation development is not presently known. However, since we are dealing with a procurement regulation, there would normally be some procurement representation. At the present time there is one cost interpretation in preparation by an ASPR Subcommittee. The procedure followed in this one case may serve as a guide for the future. This ASPR Subcommittee includes both procurement and audit representatives.

Q. Is the Navy's Contract Auditors' Handbook applicable to the new principles?

A. The statements as to the treatment to be accorded specific items of cost now in Chapter II, Section 4 of the Navy Contract Auditors' Handbook do not apply to the new cost principles. They apply only to the old principles. Consideration will be given to incorporating a statement to this effect in an early change to the Handbook.

Q. Will the Navy Area Audit Offices as a group receive information as a result of individual cost interpretations made within the Navy?

A. It is not expected that each individual cost interpretation issued on a specific case basis will be disseminated to all Navy Area Audit Offices. If this were to be done, it could be regarded as a semi-official or perhaps an official interpretation and implementation of the principles and, under those circumstances, would have to be cleared with DOD. It could very well be that the answer in a particular case might warrant consideration for general publication. In such an instance the matter will be brought to the attention of DOD for possible development of an official cost interpretation. If a question arises which appears to be extremely important and of widespread interest, it might be possible to get DOD permission to publish the answer on an interim basis but with the thought in mind that it would either be adopted as an official interpretation or dropped as not having broad enough applicability.



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Q. How will cost interpretations be published?

A. Cost interpretations may be published as a separate part of Section XV, although no final decision on this question has been reached as yet. This has some troublesome aspects. Contracts are generally written to provide that costs shall be determined in accordance with a specific part or parts of Section XV as in effect on the date of the contract. Cost interpretations if included in another part of Section XV would have to be so worded as to indicate that they are nothing more than clarification or application of the test of reasonableness or allocability so that they in themselves will not be construed as having effective separate dates of their own. Any other course would present a very complicated contract referencing problem later on.

Section I-C - Value of Advance Understandings - Mr. Kuttner

Q. Can any consideration be given to any understandings reached prior to execution of a contract but which are not written into the contract?

A. Such an understanding takes on the complexion of an agreement or a contract and it is believed that it should not be ignored even though not written in the contract. If the understanding represents an inequitable arrangement, it would be advisable to alert the negotiator to the fact so that he will be careful about reaching such an understanding on other contracts.

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Section I-D - Specific Cost Items - Mr. Rutenberg - ASFR 15-205.1 thru 15-205.6

Advertising

Q. Does the ASFR Subcommittee which is considering the cost principle concerning advertising in trade and technical journals intend to come up with an acceptable list of trade and technical journals?

A. The answer is no. To put out such a list would create a storm of protest. Those companies who publish journals whose names would not be on the list might say that they were being discriminated against and there could arise many more problems than are already present.

Q. Can those advertisements which have just the two words "Help Wanted" in small letters in one corner of the advertisement be considered as falling in the category of Help Wanted Advertising?

A. This is an old device adopted by some companies in an attempt to get their advertising considered allowable. As a generalization the allowability in full of advertisements of this kind as Help Wanted ads because some small portion or a minor portion thereof contains the words "Help Wanted" does not appear warranted. However, in order to be fair, perhaps a reasonable portion of the advertisement should be considered as an allowable cost of Help Wanted Advertising or recruitment expense.

Q. Are not exhibits really for the purpose of promoting sales?

A. Companies are not altruistic and there usually is a sales motive behind their exhibits. While there may be some specialized knowledge which they are attempting to convey in an exhibit, they actually are not conveying it for one purpose only. They usually intend to promote sales as well as disseminate technical information. As the cost principles are now worded, costs of exhibits can be allowed if there is no product involved. However, there are not many exhibits that can completely conceal the product that the company developed. This is an extremely gray area and not clear-cut. The decision will have to be made in the light of the circumstances.

Q. What constitutes a trade or technical journal?

A. The ASFR Subcommittee is currently attempting to develop some guidance in this area. The guidelines issued may not give the specific and correct answer in every case. Discretion will have to be used.

Any questions that arise will have to be considered on a case-by-case basis and an attempt made to come up with the best decision within whatever guidelines are provided.

#### Bidding Costs

Q. Should the direct labor of bid and proposal expense go into the base for distribution of engineering overhead and then the total bid and proposal expense be included as part of G and A for distribution to all work?

A. Direct labor of bid and proposal expense should go in the base for distribution of engineering overhead and the total of the expenses--direct labor, direct material, plus the allocable engineering overhead--should go into an expense pool which will distribute the bid and proposal expense over all work of the contractor. This does not necessarily mean that the bid and proposal costs should be included as a part of G and A. If putting such costs in with G and A will accomplish distribution to all work of the contractor, then that is all right. However, contractors sometimes have different bases for distributing G and A which might not accomplish the result which is desired. In that event, some other base for distribution would have to be used.

Q. Does not the Kellett Aircraft ASBCA case establish a precedent that bid and proposal costs should be distributed only to the work resulting therefrom rather than distributed over all work?

A. No, the decision is not considered to be a precedent with respect to bid and proposal costs. The Kellett Aircraft case dealt with the question of whether or not certain amounts represented a loss under a contract and, therefore, under the provision of Section XV of ASPR would not be allowable as costs under other contracts. The costs in question were not originally incurred as bid and proposal expense. Basically the Board ruled that the amount in question was not a loss under a contract even though the contractor had charged the cost to the projects under the contract and the costs were involved in the performance of the contract. The Board said that these overruns of costs are similar to bid and proposal expenses that the contractor might have incurred under other projects, but in the final analysis the Board seemed to classify the overruns of cost as unsponsored research and development costs. The Board held that the costs were in connection with and represented a proper cost allocation to any contract which might involve the particular product with which the original contract was concerned. Under this reasoning the Board permitted an allocation of the overrun

to two contracts which involved the same product as that under the contract on which the overrun was incurred but did not allow any part of the overrun against a third contract. It is considered that the provisions of paragraph 15-205.19 of the new principles captioned "losses on other contracts" should prevent a decision similar to the Kellett decision in the future.

Q. Has any decision been reached as to the allowability of research and development expenses as related to the preparation of a bid and proposal particularly in those instances where the Government has asked a contractor to submit a bid?

A. No decision has been reached. However, in making a determination of allowability, there seems to be one factor which must be taken into account. This is whether or not the Government has asked a contractor to submit a bid. If a certain amount of investigation was necessary in order to submit the bid in response to the Government's request and what was undertaken was reasonably necessary in order to submit a proper bid, the cost of such investigation should properly be considered as bid and proposal expenses. Then there is the other situation where a contractor undertakes a research project, develops something he thinks is pretty good, and then goes to one of the Services and says, "Here is what I've developed. Don't you think you could use this?" In this particular case, there seems to be some difference in the sequence of events which would preclude the cost of investigation from being considered as bid and proposal expense. All of the circumstances would have to be examined carefully, however, before a proper determination could be made.

Q. What position should be taken in those instances where the Government asks a contractor to investigate the feasibility of a certain project or program without issuing a contract for such work and the contractor spends rather large sums of money pursuant to the request of the Government?

A. Whenever this involves a substantial amount which is clearly identifiable, it should be watched very carefully because even though the Government requests the contractor to do such work, it is questionable whether the costs are acceptable as bid and proposal expense in the absence of a specific contract. In these instances, it is considered that the costs should be questioned and advice sought from the technical inspector or the matter referred to NavCompt.

Q. Should all research and development costs which are included as part of bid and proposal expense be referred to the contracting officer?

A. No, they should not. The question to be resolved in this area is whether the research and development can properly constitute part of bid and proposal costs or is to be considered as research and development per se. If it is determined that the costs involved fall in the latter category, then the cost principles with reference to research and development will come into play and not those cost principles which have reference to bid and proposal expenses. This is proper in the light of the position of the auditor whereby under cost-type Navy contracts he is responsible for determining costs; whereas, under fixed-price contracts, if the auditor cannot make a determination on his own, he recommends items for the consideration of the contracting officer.

Q. Should not Government contracts be charged only with the bid and proposal expenses related to such contracts?

A. This would seem rather difficult because it leaves unresolved the question of where to charge unsuccessful bids. It would be possible, of course, and proper, too, that if a contractor chose to charge directly to contracts the cost of successful bids, he could, if he followed the proper system, put all unsuccessful bids in overhead for allocation to all work.

#### Civil Defense Costs

Q. The new principles allow the costs of Civil Defense measures for a contractor's own premises but do not allow the costs of Civil Defense measures for the area in general. Why is there this difference? Fundamentally there is no difference in the results to be obtained.

A. Actually there is a fundamental difference between the two situations. In the first instance, the contractor has his own property to consider and will want to protect that property. This is of direct interest to him and, of course, is directly related to any work performed in his plant. The other situation is of more general interest for the public welfare. Since taxes are expected to provide for the needs of the public and the contractor pays such taxes, any voluntary contribution in this respect is considered to be in the nature of donations or contributions. The Federal Government has generally followed a policy of not participating under cost-type contracts in the cost of donations, grants and gifts.

#### Compensation

Q. How do you determine the amount of reversionary credits due the Government in connection with a contractor's pension plan contributions



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for terminated employees (other than mass terminations)?

A. Paragraph N2-4.010 (f) (5) of NCAH contains information in this connection. Ordinarily it will not be necessary for the auditor to determine an amount due the Government for normal turnover since this contingency is generally factored out by the actuaries in determining current contributions under the plan or is credited to the next due contribution to the plan.

Q. How long a period of time does the Government have in which to attempt to recover any abnormal reversionary credits under a recapture agreement?

A. With respect to the assignment of credits and refunds under Navy cost-type contracts, the answer probably is "indefinitely." This is to say that at any time that it can be determined that the contractor has received a credit to which it is believed that the Government is entitled, or a portion thereof, the agreement can be invoked and the contractor asked to refund the proper amount to the Government. It is not known to what extent if any the statute of limitations applies. Any question as to the time element should be referred to NavCompt for resolution with Counsel.

Section I-D - Specific Cost Items - Mr. Anderson - ASPR 15-205.7 thru  
15-205.15

Contingencies

Q. May a bonus based on earnings and determined at the end of an accounting period be considered in the evaluation of a bid price?

A. It will be observed that the changes to text of manual revised this item to read:

"A proposed cost based upon contingent events which cannot be measured within reasonable limits of accuracy should not be considered in the evaluation of bid price."

It is considered that where a contractor has an established plan or implied agreement to pay bonuses of this type and the costs can be estimated within reasonable limits of accuracy, the contingent cost may be considered in the evaluation of a bid price.

Depreciation

Q. If a negotiated use charge in connection with facilities, which have been fully depreciated and a substantial portion of such depreciation was recovered under Government contracts or subcontracts, is agreed to in advance and incorporated in contracts, what effect does ASPR 15-205.9(f) have thereon which states that no use charge shall be allowed on this type of fully depreciated asset?

A. The terms of any specific advance agreement or contract term would be controlling although such action would be contrary to the stated principle. Some extenuating circumstance may justify the charge in some given case. In any event, it would be up to the contracting officer to justify the agreement to allow the use charge.

Q. (a) May a contractor use one of the depreciation methods authorized by the Internal Revenue Code for tax purposes and another for costing purposes?

(b) Also, which basis should he keep his books on?

A. (a) Yes. Although it is necessary that normal depreciation be computed upon the property cost basis used for Federal income tax purposes, it is not mandatory that the same method of computing depreciation

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expense be employed for costing and income tax purposes. The principles provide that "Normal depreciation . . . is an allowable element of contract cost; provided that the amount thereof is computed: . . . by the consistent application to the assets concerned of any generally accepted accounting method, and subject to the limitations of the Internal Revenue Code of 1954, as amended . . . ."

(b) As a general proposition the depreciation for costing purposes will be that reflected in the general books of account, but the principles do not specifically require it. However, if the method of computing depreciation for costing purposes differs from that reflected in the books, it is considered necessary that a satisfactory memorandum record, capable of being fully supported for costing purposes, be maintained.

Excess Facility Costs

Q. If 50 per cent of a contractor's equipment is idle, would the idle facilities be considered excess facilities?

A. It is necessary to consider all the facts in a particular situation. No categorical answer can be given based on a per cent. To the extent all or some portion of the equipment will be needed for foreseeable volume of business and other reasonable standby purposes, the costs of maintaining it may be allowable. All other excess equipment costs would be unallowable.

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Section I-D - Specific Cost Items - Mr. Ahmann - ASPR 15-205.16 thru 15-205.25

Interest and Other Financial Costs

Q. Are costs incident to a stock dividend allowable?

A. Yes. It is considered that they are normal expenses of doing business.

Material Costs

Q. Is the term "commercial channels" to be interpreted as items for commercial end-use as opposed to military end-use as in the past?

A. It is our view that an item which has military end-use only does not meet the test of "sold through commercial channels."

Q. If an item is listed in a catalog, may it be considered as an item sold through commercial channels?

A. The fact that an item is a catalog item does not necessarily indicate its end-use. It could be listed so that other military suppliers would know of a source for the item.

Q. What is the position of NavCompt re off-the-shelf items?

A. The conclusion has been reached that "sold through commercial channels" refers to items for commercial end-use and not military products in the sense of specialized items. The basic idea or premise on which this concept of acceptance of items "sold through commercial channels" is based is that the prices of the items are controlled or lowered by effective competition for commercial end-use. If Navy contracts are charged at prices not in excess of the most favorable prices that may be given to commercial customers, we don't have to be too concerned about any small element of profit that might be included. However, a very large volume of this type of transaction would raise some question. In such a case, it might be well to suggest a special contract provision and consideration of those items. It is expected that normally the dollar amount for such commercial items utilized will be relatively small with respect to the size of the contract and that the acceptance on a commercial price basis is more economical and practical than attempting to determine the actual cost. We've had such cases in the past in connection with such items as lamp bulbs and small electrical motors. In such a case, it might

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cost three times the price of the bulbs to perform special cost studies to determine the actual cost to the company. In that type of situation the use of the most favored customer basis is obviously preferable.

Q. If a contractor secured competitive bids on an item to be made according to specifications which is not a standard or off-the-shelf item and awarded the work to one of his divisions on the basis of low bid, what treatment would be accorded cost incurred in excess of the bid?

A. In determining the allowable cost of intra-company purchase of such nonstandard items, allowable cost is based on cost to the transferor unless the items are the same or substantially similar to items for which prices have been established by other suppliers. In the latter case the cost to the transferor or the prices of other suppliers, whichever is lower is allowable. Where the contractor, in connection with an item for which established prices do not exist, acted in good faith at the outset, secured competitive bids, sincerely analyzed them, and concluded they could do the work cheaper than the other bidders, the fact that they subsequently incurred costs in excess of the other bids would not be a good premise for disapproving these excess costs.

Q. Is the requirement for contracting officer's approval of purchase orders applicable to inter-divisional work (i. e., work within the same company)? Some contracting officers seem to think so!

A. While each case must be considered on its own merits, generally the answer is "no."

Q. When a company writes off obsolete stock, is it appropriate for the loss to be included in inventory adjustment?

A. As a generalization, it is not appropriate for Government contracts to be charged for losses or share in gains from adjustments on account of obsolete stock.

Section I-D - Specific Cost Items - Mr. Kuttner - ASPR 15-205.26 thru  
15-205.34

Plant Protection

Q. What criteria should be used in determining whether the expenses of plant protection should be charged directly to a contract or a group of contracts in lieu of being allocated to all work through overhead?

A. If a particular contract or a group of contracts have security requirements significantly in excess of those of the contractor's remaining activities, it is only equitable that the contract or contracts necessitating the increased expense bear the cost thereof. On the other hand, if the contractor's operations are completely devoted to the defense effort requiring the security measures, and more especially if the contracts are mostly of the cost-reimbursable type or are subject to repricing, the expense involved in plant protection may be charged to overhead, because no practical purpose would be served by attempting a precise allocation of the expense. No hard and fast rule can be formulated. Whether the costs should be treated as direct or indirect can best be determined by an evaluation of the specifics of the case.

Precontract Costs

Q. Situations arise in which a contractor may have to perform work which, but for the absence of a contract, would constitute work required under the contract just to be able to submit a bid. Should the costs incurred in doing this work be considered precontract costs or bid and proposal expenses?

A. In a situation of this kind all facts must be considered. The nature of the costs and the contractor's normal treatment of like costs will have a bearing on the matter. If the costs are in the nature of research or investigations to determine whether the pursuit of a certain field of endeavor is feasible or has potential for accomplishment, it may well be in the area of unsponsored research and development. If it is done so that a meaningful bid can be presented, although at the request of the Government, it normally would be to the contractor's advantage to treat it as bid and proposal expense so that it may be recovered in accordance with its normal treatment of bid and proposal expense in the event the bid is unsuccessful. While there may be instances where the formal bid or quotation is submitted after considerable work and negotiations have taken place, ordinarily it is believed that precontract costs would be costs incurred after a proposal or bid was received and after there was an informal understanding that a contract would be awarded.



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*Dept. of the Navy  
Office of the Comptroller*

ENCLOSURE (2)

### Professional Services

Q. Should outside professional services be allowed if a contractor has his own staff? Wouldn't this be a duplication of effort?

A. The key word in this question is "duplication." It may be difficult to prove that there is duplication of effort even though it looks as though there is. If a contractor has a competent legal staff on his payroll, care should be exercised before approving retainers for outside legal counsel. However, since there are degrees of specialties involved in the legal and accounting professions, it may be desirable to have available certain talents which would not be present in the contractor's own staff. There is no categorical answer to the question except to say that special care should be exercised to see that, if a contractor does retain outside professional help, his own staff is not capable of performing whatever services might reasonably be expected of the outside firms.

### Rental Costs (Including Sale and Leaseback of Facilities)

Q. Assume that a contractor began construction of a building and sold the partially completed building with the understanding that it would lease the building upon its completion. Would the rentals paid under such a lease be treated in the same manner as those under a sale and leaseback of a completed facility?

A. This is also a sale and leaseback. As far as the application of the rule contained in ASPR 15-205.34(c) is concerned, it makes no difference whether the facility was or was not suitable for use when it was sold. The important point is that the contractor had title to the property; the property was sold and then leased back.

Q. If the sale and leaseback occurred in a period before the contractor was engaged in defense work, would there be any difference in the treatment of the rentals?

A. The rule set forth in ASPR 15-205.34(c) is unequivocal and applies to any sale and leaseback regardless of the period in which the transaction occurred. If a contractor is paying rent under a sale and leaseback which was consummated 10 years ago, any portion of the rent in excess of the normal costs of ownership would not be allowable. This is an item for which the contractor should seek an advance understanding if he does not want ASPR 15-205.34(c) to be operative.

Q. What treatment will be accorded the rentals paid under a sale and leaseback if the transaction was undertaken by a predecessor organization, which was merged into or with the contractor?

A. It is not possible to give a categorical answer to this question because it may involve a study of the manner in which the merger and sale and leaseback were accomplished. The term merger is used in some states to refer to all types of consolidations, including those where a new corporation is brought into existence, rather than being limited to those cases in which one or more corporations become absorbed into an existing corporation. The problem may become a legal matter or a determination of the primary motivation for the merger, i. e., whether it was effected for some reason other than avoidance of the cost principle here involved. If the auditor is confronted with a problem in this connection, it is suggested that all the facts be submitted for study by this office and consultation with counsel if deemed appropriate.

Q. Are the rentals made in connection with agreements which permit them to be applied against the purchase price of the asset allowable under the present regulation?

A. Where it is clearly evident that the transaction is in substance a conditional sales contract providing for payment on the installment basis, any payment made pursuant to such an agreement is not rent but a portion of the cost of acquisition. Hence, the payment is not an allowable cost. The asset should be accorded depreciation accounting. The facts relating to all such leases must be carefully considered.

Q. Would there be any effect upon the allowability of cost if the sale and leaseback contained an option permitting the contractor to repurchase the facilities after the expiration of a stated period?

A. Since this situation is only a variant of the more usual form of a sale and leaseback, the portion of the rentals not in excess of the cost of ownership would be allowable. Under this interpretation, the contractor could not be reimbursed by the Government for any portion of the rental which represented consideration for the option.

Section I-D - Specific Cost Items - Mr. Dawson - ASPR 15-205.35 thru  
15-205.41

Research and Development

Q. Would you clarify the position taken with respect to the significance of the last sentence of ASPR 15-205.35(e)?

A. It is the view of the Office of the Comptroller that the significance of the last sentence of ASPR 15-205.35(e) is that it supports the position that the first sentence permits an allocation of independent development only to Government production contracts and not to Government R&D contracts. If this were not the case, then the second sentence would be unnecessary because the first sentence would then apply not only to a contractor engaged only in R&D work but also to a contractor performing both production and R&D work. The fact that the second sentence has been included means that additional specific language was necessary so that contractors who were engaged only in R&D could allocate some portion of their independent development work to Government R&D contracts.

Q. In order to qualify under the exception in ASPR 15-205.35(e), must a contractor do no production work at all, or could he perform some production work, for example, 1%, 5%, 10%?

A. The Office of the Comptroller is of the opinion that the exception in ASPR 15-205.35(e) is intended for those organizations whose basic effort is research and whose hardware is limited to a working model, prototypes or processes, with any sales of products being incidental, as distinguished from items manufactured for sale to customers whether or not the production is carried on in a pilot plant or regular manufacturing facilities.

Q. Does the last sentence of ASPR 15-205.35(e) apply only to nonprofit organizations?

A. No. Any research company, profit or nonprofit, could qualify if research work is its basic effort.

Q. In ASPR 15-205.35(f), how shall the word "practices" in the phrase "accounting practices consistently applied" be construed?

A. The word "practices" is to be construed as a course of action continuously followed. A "practice" cannot be established on and off purely for convenience; it is established over a period of time.

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Q. How can you change an accounting "practice?"

A. Since a "practice" represents first a certain course of action, the course of action must first be changed. The mere change does not constitute a changed "practice," however. The "practice" becomes changed only after the changed course of action has been continuously followed for a period of time so as to establish the course of action as the normal method of accomplishing a desired result.

Q. Is it not dangerous to condone an accounting principle or practice which we do not agree with for the sake of expediency?

A. Yes. Any such instances should be thoroughly documented with complete understanding with the contractor that this is being done solely for the sake of expediency. Unless this is done, and the mix of work at a contractor's plant changes at some future date with nonemphasis on Government work, we may be saddled with a precedent contrary to what we think is proper, or what the principles intended.

Q. If we have accepted a contractor's method of accounting for certain costs that does not conform to a sound accounting practice, could not the contractor use this as an argument in justification of changing another of his accounting procedures from one which we consider conforms to sound accounting to one that does not?

A. Yes. However, where a contractor wants to change a practice which conforms to the principles to one which does not conform, no agreement should be entered into for the sake of expediency or otherwise.

Q. Is it true that, if a contractor has been consistently applying accounting practices which are contrary to the principle laid down in ASPR 15-205.35(f), such practices are acceptable?

A. Yes, this is the effect of ASPR 15-205.35(f), but this applies only to R&D.

Q. In some instances, a contractor may change his method but a year or two may elapse before a disapproval is issued or before a case gets before the ASBCA. Could it still be contended at the time of the disapproval that the contractor does not have a new accounting practice?

A. Under these circumstances, we would probably have to admit that the contractor now had a changed accounting practice. The way to prevent this from happening is to be prompt in reviewing the accounting system and going on record at an early date as to the acceptability thereof so that the passage of time will not enable the contractor to assert that its changed method has become its practice.

Q. Won't it be difficult for the auditor to make a determination that a particular project is basic research, applied research, or development?

A. Yes, and this was probably recognized by the military departments when they established the Tri-Departmental Committee. However, since all contractors are not on the list for consideration by the Committee of their research programs there may be instances where we will have to ask assistance from the Committee in the case of other contractors if we are unable to make a definite determination as to whether the contractor's activity falls in the category of research or development.

Q. Will the Tri-Departmental Committee involve itself with accounting matters?

A. It is our understanding that the Committee will not concern itself with the accounting aspects of a contractor's research and development program. Its efforts will be confined to a contractor's research and development program as such, type of endeavor, budgeted effort, and matters of that kind. However, if they should approve dollar amounts rather than projects or percentages of a contractor's research program, it would appear desirable that they obtain audit advice.

Q. Will it not be difficult in some instances to make a determination as to what constitutes a product line?

A. Yes. The determination as to a product line can be narrow or so broad as to include almost anything. Judgment will have to be exercised to keep the determination within reasonable limits. Technical assistance should be solicited. If a contractor persists in taking a broad view of what constitutes his product line, it may be necessary to resort to formal disapproval and have the issue decided through the appeal procedure.

Q. In the case of a contractor who is not on the list to be considered by the Tri-Departmental Committee, should the auditor attempt to make his own determinations regarding the contractor's research and development programs?

A. Yes. If the auditor is unable to make a determination at the field level, then the matter should be referred to NavCompt together with the same type of information that the contractor would have to submit to the Committee.

Q. What happens if an advisory report has to be released and no decision from NavCompt has been received?

A. The auditor will have to do the best he can even if it means setting the costs out for further consideration. Sufficient information will have to be presented, however, to enable the negotiator to have something to work with so that he can make a determination.

Q. Will the auditor be called upon to assist the Tri-Departmental Committee through the submission of accounting advisory reports?

A. It is not presently known whether this will happen or not. If so, we should think in terms of total costs of the projects rather than in terms of cost of individual elements, such as, labor, material, and overhead.

Q. Must the principles be followed even though contrary to good accounting practice?

A. Yes. If the principles provide leeway for any action contrary to sound accounting principles, then no exception can be taken.

Q. Will the Tri-Departmental Committee police the contractor's program?

A. Our impression is that the Committee will not police the programs and that the ultimate determination of the amount of allowable costs will be left up to the auditor and the technical inspector. There should be no particular problem if the Committee picks out special programs and has indicated the degree to which the Government will share in the cost thereof and the contractor's methods of accounting for the costs and controlling the planning and execution of research projects is acceptable. However, if the program is discontinued and a new type of program is instituted, it is not considered that the original Committee approval would continue; a new approval would have to be secured.

#### Royalties

Q. What is the auditor's position with respect to handling claims for royalties?

A. The auditor should make every attempt to determine if the royalties that are claimed are or are not allowable. If this cannot be done, an advisory report should set such costs out for further consideration in the case of a fixed price contract. In the case of a cost type contract the matter should be referred to NavCompt for further action.



Severance Pay

Q. If an adjustment for severance pay is carried back over a number of years, isn't there a good chance that a contractor would be barred from recovery if he had submitted unqualified releases on completed contracts?

A. This is true. However, since the new Principles, in the case of abnormal severance pay, specifically state that the Government recognizes its obligation to participate in such cost, the period to be covered by the adjustment should not be one that will enable the Government to evade this obligation.

Q. Although the new Principles state that normal severance pay is to be allocated to all work of the contractor, would it be permissible to allocate the payments to all work within the department where the charges originate?

A. Technically, this would seem to be a deviation from the Principles but there would not seem to be any great objection to such a procedure since the net result is more precise costing.

Section I-F - Concurrent Use of the New and the Old Principles - Mr. Cook

Q. May a prime contractor insert the new Principles in new subcontracts entered into under prime contracts which contain the old Principles?

A. No categorical answer can be given to this, but there would not seem to be any restriction by implicit directive which would prevent a prime contractor from so doing from the date they were issued. However, it is considered that reimbursement to the prime contractor for the subcontract costs would have to be determined on the basis of the old Principles regardless of the commitment on the part of the prime contractor to reimburse the subcontractor on the basis of the new Principles. This would seem to be the case because the language of paragraph 15-200 of Part 2 of the old Principles makes such Principles applicable to the determination of cost type subcontract costs for which the prime contractor seeks to be reimbursed. It is believed that this phase of the matter may require further clarification if it becomes a problem.

19 Jul 1960

General Questions in Connection with ASPR, Section XV, Parts 1, 2, and 6  
Mr. Ruttenberg

Q. What consideration, if any, should be given to contracts for research, investigations, etc., at no cost to the Government or at the most a very nominal sum such as \$1.00?

A. Although no payments, or any payments beyond the nominal sum stipulated in the contract, could be made under the contract for the work performed, it is not considered that it is intended that the contractor should be denied recovery of the cost of performance as an independent research program. In this event, the principles applicable to research and development costs could be applied. However, it may be advisable to obtain clarification of the intent of the agreement from the contracting officer if it is not evident from the contract since the project may be cost sharing with the Government furnishing the facilities.

Q. Is the negotiator bound by the recommendations in an advisory accounting report submitted for the purpose of negotiating overhead rates?

A. Strictly speaking he probably is not, but it would seem that any negotiator would have to have positive proof to the contrary before overruling an auditor's recommendation that a particular item of cost should not be accepted.

Q. Why are negotiated overhead rates still being used, particularly since the overhead is now on an historical rather than prospective basis?

A. It is true that the need for negotiating an overhead rate is considerably lessened since the rates now reflect historical costs and actual experience. There still remain certain advantages, however. One advantage is that there will be uniformity of treatment of similar costs under like circumstances by all the Services of the Department of Defense. Another advantage is that the requirement to submit a report and negotiate a rate within a specified period of time tends to get the overhead audit on a more current basis.

Section II-C - Categories of Direct and Indirect Costs - Mrs. NiedlingDirect Costs - Salaries and Wages

Q. Is it not possible that institutions may budget a certain amount of time for instruction and a certain amount of time available for research work for each professor and establish different rates of pay for each category of work with the rate for research being greater than for teaching? The principles state "... that the excess of salary and wage rates paid to personnel working on Government research agreements over salary and wage rates paid to personnel working on the institution's departmental research or other research will not be allowed unless specifically provided in the agreement or approved by the contracting officer."

A. This may be possible, but the institutions have contended that there is no way to segregate certain research performed by professors from instruction. They refer to this type of research as nonbudgeted departmental research. It would not appear that any estimate they make of over-all research performed by a professor which includes departmental non-budgeted research would be too realistic. Furthermore, since it is contended that it is not separable from instruction, there would be no justification for paying different rates for time devoted to teaching and this type of research.

Q. Does the fact that employee benefits, such as pension costs, are not calculated on summer salaries paid to faculty members justify exclusion of such salaries from the salary and wage base?

A. Without all the details, a definite answer cannot be given. However, it may be appropriate to make a special allocation of certain employee benefits and include the salaries and wages in question in the base for apportionment of those G&A expenses which do benefit the work involved.

Indirect Costs - Departmental Expense

Q. Is it not possible that the reason indirect departmental expenses are much greater than the expenses they were intended to offset under the Blue Book is that the indirect departmental expenses now include a share of O&M, G&A, employee benefit expense, etc?

A. This may be true. It is possible also that certain expenses now being included in this pool previously were included in direct charges. If this is the case, the advisory report should point up these facts and indicate approximately how much other factors have been reduced so that the effect on over-all costs can be evaluated.

19 Jul 1960

Section II-D - Specific Cost Items - Mr. Kiser - ASPR 15-307.3(a) thru  
15-307.3(m)

Depreciation

Q. Is it possible for an institution to claim depreciation on certain of its building and equipment and use charges on the balance?

A. Yes, I believe this would be possible where they maintain actual records of usable buildings and equipment as distinguished from original complement or reasonable estimates. However, there would have to be consistency of treatment once an election was made. When an item, for which depreciation allowances have been claimed, is fully depreciated use charges would not be allowable thereon.

Q. Where there has been special agreement between the Government and the institution to amortize the cost of a building or laboratory over a given period, could the institution claim a use charge on the building or laboratory after the amortization period has expired?

A. It would not appear proper. However, consideration is presently being given to some ASPR coverage in this connection in order to effect some uniformity of treatment of costs of this nature.

General Questions in Connection with ASPR, Section XV, Parts 1, 3, and 6  
Mr. Kiser

Q. Is difficulty being experienced in the application of BuBud Circular A-21 to cost type contracts that are being audited for other governmental agencies, such as, Federal Aviation Administration, National Science Foundation, Department of Health, Education and Welfare, Atomic Energy Commission, etc., and ASPR, Section XV, Part 3, as implemented by Department of Defense Joint Letter No. 41?

A. The members of the training class indicated that no difficulties were being encountered.

Q. Will we be able to make recommendations regarding revisions to BuBud Circular A-21 by 30 June 1960?

A. We are required, in accordance with the directive of BuBud and the ASPR Committee, to recommend, by 30 June 1960, revisions of BuBud Circular A-21 that we feel are desirable. It is indicated that we have not had enough audit experience to make positive recommendations to BuBud, through the ASPR, Part 3 Subcommittee by this date. At present we are in a vacuum, so to speak, with regard to such recommendations and will possibly request a delay of six months to a year. We expect to convene our ASPR Subcommittee soon to plan for future action.

Since recommendations submitted to BuBud will be based largely on information received from auditors, it is incumbent on the auditors to furnish information on problems that are being encountered in administering the revised Part 3. Auditors have a responsibility for recommending changes where principles are unrealistic. It is impossible for Headquarters to visualize all circumstances. Auditors are in a better position to formulate ideas for solving a problem since they are continually applying these principles in their daily work.

We will welcome recommendations as to those areas where Part 3 should possibly be changed for purposes of audit approach simplification, clarification of expense treatment, and elimination of unnecessary detail. If you have any suggestions, send them to us. Your assistance will be very helpful. Since any changes to BuBud Circular A-21 will be largely dependent upon our experience, it is considered that suggestions and information originating with the auditors will constitute the major source of recommended revisions. It is requested that such information be furnished in timely fashion, that is, promptly after you have reached a conclusion on a particular aspect or item of Circular A-21.



NAVCOMPTNOTE 12410  
19 Jul 1960

ENCLOSURE (2)

Q. What is the purpose of the College and University Federal Committee?

A. The National Association of Colleges and Universities has established a federal committee, with an office in Washington, D. C., to maintain close liaison with and to work with the Department of Defense, ASPR Subcommittee and BuBud on problems arising in the application of Circular A-21, gathering information from member schools, consolidating views of the association, and distributing information to the association members. This committee may be helpful in improving our relations with the group of educational institutions and individual members of the association. The ASPR Subcommittee has informally suggested to the federal committee that in submission of their problems to the ASPR Subcommittee, the problems be based on an actual case, or cases, and not on generalities, and, to the extent practicable, the problem be presented via the military auditor cognizant of the educational institution where the case arose.

Excerpt from Transcript of Eisenhower's News Conference on Domestic and Foreign Affairs

New York Times, January 19, 1961 - Page 18 C

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For Informed Citizenry

A. - I know nothing here that is possible, except - or useful - except the performance of the duties of responsible citizenship. It is only a citizenry, an alert and informed citizenry which can keep these abuses from coming about. And I did point out last evening that some of this misuse of influence and power could come about unwittingly but just by the very nature of the thing, when you see almost every one of your magazines, no matter what they are advertising, has a picture of the Titan missile or the Atlas or solid fuel or other things, there is becoming a great influence, almost an insidious penetration of our own minds that the only thing this country is engaged in is weaponry and missiles. And, I'll tell you we just can't afford to do that. The reason we have them is to protect the great values in which we believe, and they are far deeper even than our own lives and our own property, as I see it.

OL 6 2597

SPEECH BY MR. AARON J. RACUSIN, DEPUTY FOR PROCUREMENT AND PRODUCTION,  
OFFICE OF THE ASSISTANT SECRETARY OF THE AIR FORCE (MATERIEL) AT THE  
NATIONAL SECURITY INDUSTRIAL ASSOCIATION (NSIA) SEMINAR ON DEPARTMENT  
OF DEFENSE PROCUREMENT ON 24 JANUARY 1961 AT THE SHERATON-PARK HOTEL,  
WASHINGTON, D. C.

Gentlemen:

Thank you for giving me an opportunity to address a few remarks  
to your seminar. This is the kind of forum where an exchange of views  
cannot help but result in a better understanding of our common problems  
to our mutual benefit.

I should like to consider my remarks as a part of the continuing  
assault by the military departments on the cost of defense programs.  
I am certain that most of you have heard this theme repeated by our  
representatives in speeches at gatherings such as this in various  
parts of the country in recent times past. Yet it is of such  
importance that it demands repetition.

The reasons are quite obvious. The magnitude of the Defense  
procurement program is about \$25 billion a year--three times the  
combined purchasing volume of General Electric, General Motors, and  
U. S. Steel. It is 30% of the total Government budget. Its impact on  
our economy is enormous. Accordingly, our management of a program of  
such magnitude and importance is quite naturally a subject of close and  
continuing scrutiny by the Congress. And the attitude of Congress  
toward our procurement operations is a matter of great significance  
to the Department of Defense, and, I am sure, to industry as well.

Congress has called for a general improvement in our procurement practices and procedures and for renewed efforts to reduce the constantly rising cost of defense materials. It expressed its views in a most significant manner in the last session--an across-the-board reduction in appropriations by three percent.

As you know, the Department of Defense, during the past year, adopted several significant changes in the Armed Services Procurement Regulation relating to our pricing practices at the prime and sub-contract levels. They concern our review of "make or buy" decisions, the review of subcontract prices and the provision for two-step formal advertising, to name a few. We believe they will have a salutary effect. But in large measure, the benefits to be derived depend upon our mutual diligent efforts to give meaningful effect to the printed word.

Since I am in the Department of the Air Force, I cannot, of course, give you the details of the accomplishments of the Army and Navy in their efforts to achieve cost savings. I am certain, however, that they have excellent programs in effect and have attained significant dollar reductions. I am in a better position to describe our own course of action. We embarked on a vigorous cost reduction program with our contractors. The response of many of them has been most gratifying. Major cost reductions are being realized through increased management attention given to this subject. Significant savings have been made

through such measures as improved purchasing techniques, better management of subcontracts, greater use of value engineering, closer control of overhead, and a generally tightened cost control. We have found excellent examples of aggressive action by our contractors to establish a general climate of cost consciousness. They have concentrated on expanding competition through the development of new sources of supply, elimination of sole source situations, and use of more and broader competition. Further economies have been achieved through quantity procurement, consolidation of orders, use of blanket purchase agreements, special handling for high value items and maintenance of surveillance teams in major subcontractors' plants.

One department of an Air Force contractor has produced over 2500 cost reduction ideas over a three-year period resulting in documented savings of \$17,700,000. Another reports annual savings of \$20 million as a result of a formal cost reduction program. Still another reports savings of \$2.4 million over an 18-month period as result of value analysis techniques. Yet another, through vigorous measures in the field of overhead expenses has achieved savings in such expenses of \$3,600,000 annually, or 20% of total expenditures. These are but a few of the instances of cost reduction brought about through well designed, vigorously executed plans put into effect by our contractors. A census of less than half of the contractors involved shows tangible cost reductions of about \$575 million. This is something about which both the Department of Defense and industry can both be rightfully

proud. But it is not enough. Much remains to be done. Public confidence in our departments as well as your industries is at stake. We are under a continuing obligation to buttress that confidence by eliminating cases of poor procurement practices and preventing their recurrence.

At this point it would be well for me to bring to your attention some areas which we have noted that give us concern.

(1) Spiraling Engineering Costs--As most of you know, we have in the recent past been grappling with contractors' independent research and development effort. ~~This has increased during the past three years by 10%.~~ But there is an infinitely greater problem about which we are now gravely concerned and that is the vastly increased amount of dollars devoted to design, preproduction, production and field engineering effort on our contracts. The cost of this effort has increased by approximately 45% over the past three years. Expressed in dollars, this is an increase of approximately \$1 billion. We are faced with an example such as at one major contractor's facility where less than \$1 million was spent on independent general research and development, while during the same time period the contractor spent nearly 200 times this amount on false starts in production engineering charged directly to the contract. While we recognize that such false starts are not unusual in any technological development of a new weapon system, the magnitude of this high cost area emphasizes the need for closer management control. We are giving this subject a searching

review and will take whatever practicable means are available to assure tighter control. We expect industry to take similar action.

(2) The Manpower Utilization Subcommittee of the House Committee on Post Office and Civil Service published a report in September 1960 entitled "Personnel Procurement Costs of Selected Defense Contractors for Recruitment of Engineers and Scientists, FY 1959." The data included in the report was developed by the departmental audit agencies. FY 1959 recruitment programs for the 102 companies in the report cost approximately \$21 million. The report also indicated an overall recruitment cost average of \$1,022 per new hire for "predominantly Defense" contractors as against \$751 for "predominantly commercial" firms. In three cases the cost per new hire for "predominantly Defense" contractors was well over \$2,600. The report is clear that recruitment costs represent a significant expenditure of funds and I can assure you that this matter will be given particularly close review in the pricing and administration of contracts. In this connection, some questions you should ask yourselves are:

What analysis has our firm made of recruitment costs to justify the procurements made?

What controls do we have in respect to recruitment expense and what do we plan in this area for the future?

Are elaborate help wanted ads really necessary to hire engineers and scientists?

I submit that efficient management dictates that these matters be accorded serious attention.



(3) Another area that must be reviewed is that of the use of overtime. Because of the high priority assigned the ballistic missile and space programs, they have been exempted from overtime restrictions set forth in ASPH. Appropriate guidance, I am sure, has been disseminated to all procurement field activities as well as applicable contractors regarding the exemption, controls and usage of overtime for ballistic missile contracts. On the basis of the high contract overtime performed at missile sites, it appears to us in the Air Force, that this exemption has evidently been construed to mean that any and all overtime is permissible. Continuous use of overtime on the same task is indicative that other basic factors may be at fault. Generally, high overtime usage reflects adversely on the quality of management resulting in unnecessary costs. We have suggested that this matter be reviewed by all the military departments to determine the appropriate measures required to assure proper control of the use of overtime in the performance of contracts involving high priority programs.

(4) There is another area which I think requires your prompt attention. I am sure you will agree that a business of approximately \$100 million has a direct and vital bearing on the costs of Air Force programs. This is the amount involved in our procurement of technical data such as manuals, handbooks and other technical guides that relate directly to hardware. While we are naturally concerned about the editorial quality and accuracy of that technical data, I would point out to you the need for reducing technical paper work costs without compromising the operation and maintenance functions related thereto.

We have recently conducted extensive surveys in order to find out what our technical data weaknesses are and what steps are necessary to correct these weaknesses. We have taken corrective actions to strengthen our managerial responsibility in this area. We urge you to subject this function to a thorough management review at the top level of your organizations to eliminate existing or potential weak spots. Of particular importance in this area are the cost and accounting procedures related to technical data. All too often, the actual costs of specific publications related to individual systems are difficult to identify and isolate. The Air Force is moving in the direction of inserting clauses in contracts, which will require industry to identify these costs and enable us to know exactly what we are paying for.

These are some of the soft spots which we think require close review by you gentlemen and those at all levels of your corporate management. I assure you we intend to give them our closest attention.

I should like to turn now briefly to two other subjects listed for discussion on the program. The first relates to types of contracts in use in the Department of Defense. As you know, the various types of contracts we use were the subject of an intensive review by Congressional committees during the last session. This was undertaken as part of a study required by the Statute which extended the Renegotiation Act. Special attention was devoted to the incentive type contract. The previous shortcoming in the negotiation of these contracts as revealed in several Comptroller General Reports raised significant questions in

Congress as to their efficacy. We believe that, if properly used, and I emphasize the word properly, such contracts serve a very valid purpose in obtaining reduced costs to the Government and increased profits to industry where true economy and efficiency are practiced in the procurement of our complex weapon systems. Certain corrective measures have been taken to assure the accuracy, currency and completeness of cost information which is used as the basis of negotiating target costs. An additional change, designed to eliminate a weakness by providing for a contractual right to amend the price where incorrect cost information has been used, is being adopted. For our part, we are exploring the application of incentive features to performance criteria, without waiving consideration of the very vital cost aspect. Here is an excellent technique where greater emphasis on the use of the incentive approach should be applied in your own purchasing procedures. I suggest that this can be a truly effective way that cost consciousness in your suppliers can be stimulated through opportunities for increased profits attributable to efficient performance and control of costs.

There are those, however, who contend that the incentive contracts contain the seeds of unwarranted higher profits without commensurate efficiency and economy on the part of the contractor. The continued use of the incentive contract will depend, in large measure, upon how well representatives on both sides discharge their responsibilities.

Our procurement practices are rightly of continuing interest on the "Hill". In its deliberations on such matters, Congressional committees are confronted with the difficult task of evaluating a mass of conflicting advice in an effort to reach sound decisions. Those deliberations are made even more difficult by the fact that the committees are removed from the day-to-day operations of this gigantic procurement program. We must be able to demonstrate conclusively that our joint efforts have brought about meaningful results, in improving procurement practices. Armed with such evidence, we feel confident we will be in an excellent position to convince the majority of our legislators that existing legislation is sound; that it is being soundly administered.

The second point is that relating to profits. This is a matter which could probably be the subject of an address in itself. I should merely like to emphasize that in this field we are confronted with the problem of trying to avoid the establishment of rigid levels of profits for application to all contractors for similar items, irrespective of the efficiency and economy and know-how of the individual contractor. Fixed patterns of profits are inequitable in that they reward the least efficient more favorably than the most efficient. Similarly, we have avoided attempting to establish a common profit level applicable to all types of work and to all types of contracts. We believe that profits should be negotiated based upon the application of sound judgment, taking into consideration the many factors outlined in the ASPR to be used in determining the appropriate level to be allowed in a particular case.

Without going into a lengthy discussion, I think I can state our fundamental philosophy succinctly in this fashion: we want to see you make a reasonable profit based upon demonstrated superior timely performance, and cost reduction.

If it seems that I have neglected a fuller treatment or any treatment of some of the items which appear in the printed program, you're right. I have done so deliberately in an effort to focus your attention on a subject which I feel is of utmost importance in our mutual desire to attain our common objective of obtaining a maximum military posture at minimum necessary cost. I can think of no more apt language to highlight what I have sought to stress earlier than to paraphrase some remarks made by General Anderson, the Commanding General of the Air Materiel Command, in a recent address to the Washington Chapter of your Association. He said: "Unless we--the Department of Defense and industry--do a better job of curtailing costs, the reflection of arbitrary percentage cuts will continue to be the cutback or elimination of urgent projects. We, in effect, have been told that so long as we don't exert maximum pressures for best cost result, then what we consider to be the very minimum dollars for our procurement will be further reduced."

I trust this seminar opens new avenues for our mutual improvement in an area that has so much significance to all of us today.





ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON 25, D.C.

COMPTROLLER

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (SGL)

SUBJECT: Contract Cost Principles and Procedures

By memorandum of May 15, 1959, you requested my approval of the May 12th draft of cost principles. In consideration of the many divergent viewpoints which had to be accommodated therein and the urgent need for principles in the negotiated fixed-price area, I give my approval.

M. J. McNeil

**DIRECTOR OF DEFENSE RESEARCH AND ENGINEERING**  
**WASHINGTON 25, D. C.**

**MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (S&L)**

**SUBJECT: Contract Cost Principles**

This will confirm the concurrence of this office with the revised draft, dated May 12, 1959, of the Contract Cost Principles for inclusion in the Armed Services Procurement Regulations.

It is my understanding that your office has already been notified by telephone of our concurrence.

**Herbert F. York**





CP

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (CCL)

SUBJECT: Merck, Sharp, and Dohme Decision on Rapid Amortization

The Minutes of the Materiel Secretaries' Weekly Conference of 4 June 1959 requested a progress report on the actions taken as a result of the subject case.

The draft of the contract cost principles dated 12 May included provisions designed to take care of the decision. DDPO 4125.34, as amended, authorized the contractor to elect whether to apply "true" or normal depreciation in the pricing of the items sold. This policy is continued in the cost principle draft with two additional concepts (underscored portion is most pertinent):

1. While the contractor is given an election to use true or "normal" depreciation, it is stated that his election must be consistently applied. In the Sharp and Dohme case, the petitioner collected \$100,000 on the basis of his election to be paid at "true" depreciation rates, but shifted his election to "normal" in the ABSC case to collect his losses of economic value.

2. A second clarifying provision was included as follows:

"(d)(1) . . . the emergency period (5 years) shall be computed in accordance with the determination of the Emergency Facilities Depreciation Board and allocated ratably over the full five-year emergency period: provided no other allowance is made which would duplicate the factors, such as extraordinary obsolescence, constituting 'true depreciation' . . ."

Since the Emergency Facilities Depreciation Board considers the factor of extraordinary obsolescence, in its finding of "true depreciation", and since the revised principle bars "duplicate" allowance of costs for this factor, we believe that the addition

*John J. C. Day*  
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of these provisions will remedy the sharp and sudden decision for the future.

G. C. BERNERMAN  
Director for Procurement Policy

Prepared by: TAPilson  
Rewritten by: TAPilson/mt/19Jun59  
3D774 X79391

See attached green for coord.

Not Dispatched from  
Mail & Records -----

DEPARTMENT OF THE NAVY  
OFFICE OF THE SECRETARY  
WASHINGTON

29 MAY 1959

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)

Subj: The Contract Cost Principles and Procedures, comment on

Ref: (a) Memorandum from ASTSECDEF(S&L) of 15 May 1959 re Contract Cost Principles and Procedures revised draft of 12 May 1959

1. Reference (a) has been reviewed by my staff and with the exception of the following comments, I approve its issuance:

a. Page 4, line 19, after "will not," insert "with the exception of the limitations on rentals paid under sale and leaseback agreements. (See ASPR 15-205.34 (c))." Also include on page 5, as one of the examples of costs for which advance agreements may be particularly important, "(ix) Sales and leaseback agreements." This is considered necessary in view of the specific limitation on such rentals in ASPR 15-205.34 (c).

b. Page 11, line 4, change (i) to read "the item is regularly manufactured and sold by the contractor through commercial channels for commercial and use." (Underscoring supplied). Change (ii) to (iii) and add a new (ii) as follows: "the charges for the item(s) are nominal in amount." These revisions are considered essential to avoid a situation where the "commercial" customer of the vendor is a prime or subcontractor to the Government and the prices of the items have not been established in the non-governmental market. Also, if the total volume of such items is substantial, it seems only equitable that they should be charged to the Government contracts on a cost basis (rather than at a price which includes a profit element) in order to avoid the payment of what may be hidden profits.

c. Page 45, top line: the word "allowable" should be changed to "unallowable."

d. Page 47 - Either add (i) after "instances" in the fourth line or delete (ii) in the fifth line.

2. As you know, industry has been primarily concerned with the applicability of the cost principles to other than CPFF contracts. The recent letter from NAPI to many of us is a strong reiteration of this position. Although I do not agree that issuance of the principles should be delayed to accommodate further discussion of this subject, I recommend that in the practical implementation of the principles, the services be cautioned to avoid the "formula" pricing which industry fears. Should evidence of such pricing exist after a reasonable period of implementation of the principles, I strongly recommend further consideration on this matter at that time.

C. P. MILNE  
Assistant Secretary of the Navy (Material)

HEADQUARTERS  
AIR MATERIEL COMMAND  
UNITED STATES AIR FORCE  
WRIGHT-PATTERSON AIR FORCE BASE, OHIO



REPLY TO  
ATTN OF

MCPPP

2 July 1959

SUBJECT

Latest Draft of Proposed Revision ASPR Section XV

TO:

Hq USAF (AFMPP-PR2 - Mr. Vecchietti)  
Washington 25, D.C.

1. In looking over the 26 June 1959 draft of ASPR Section XV, we have come across two items which may require clarification. We realize this may not be possible but if you agree and if the changes can be made, we recommend them.
2. The first is in paragraph 15-205.6(f)(2) which says, "Deferred compensation is allowable to the extent that (i) except for past service pension costs it is for services rendered during the contract period; ...". This citation excepts past service pension costs from the general requirement that deferred compensation costs are allowable only to the extent they are for services rendered during the contract period. However, "pension" is a specific term of reference and is not inclusive of retirement plans in general. In other words "retirement" rather than pension is the generic term and we suggest the insertion of words "and retirement" between "pension" and "costs" in that paragraph.
3. It is possible to interpret the cost principles so as to make substantial segments of management incentive award payments unallowable. For example, a contractor might make incentive awards early in calendar year 1959 with respect to services performed by recipients during calendar year 1958. Most often an award is paid in installments over several years. Therefore, the latest draft could be interpreted to cause incentive compensation payments made on an installment basis to be unallowable when not for services during the contract period. We do not believe this is the intent.

FOR THE COMMANDER:

L. E. TODD  
Acting Chief, Pricing  
and Financial Division  
Directorate of Procurement & Production



DEPARTMENT OF THE AIR FORCE  
WASHINGTON

OFFICE OF THE ASSISTANT SECRETARY

JUN 11 1959

**MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)**

**SUBJECT: Contract Cost Principles**

1. Reference is made to your memorandum dated 15 May 1959 on the above subject. We have reviewed the latest draft attached to your memorandum and recognize the compromises that have been made in several items to accommodate divergent views among the Departments as well as with industry. Accordingly, we think it should be clearly understood that if actual experience under the proposed principles reveals any deficiencies, we will seek reconsideration of the matters involved. Since the proposal seems to offer an acceptable basis for early adoption, we concur subject to the comments noted below.

2. We note the deletion in paragraph 15-205.22(c) of the prohibition relating to "write downs" or "write ups" of material values which had appeared in earlier drafts and which now appears, in part, in current ASPR 15-202.1. We understand that discussions on this point have taken place between the top Comptroller people in the Air Force and the Department of Defense. We also understand that agreement in principle has been reached to the effect that it is our common understanding that Department of Defense policy generally is not to accept such costs. Apparently this understanding is to be made a matter of record so that, should the problem arise, such an understanding could be relied upon to give a common answer. As you know, such an understanding cannot form the basis of a contractual obligation. Accordingly, we would urge for consideration the inclusion in the Cost Principles of appropriate language covering the point.

P. B. TAYLOR  
Assistant Secretary of the Air Force



OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON 25, D. C.

COMPTROLLER

5 June 1959

MEMORANDUM FOR COMMANDER MALLOY  
OASD (S&L)

SUBJECT: Cost Principles

Pursuant to our conversation of yesterday concerning the Air Force's position on paragraph 15-205.22(c), page 30 of the cost principles, I talked with Bob Benson this morning. While he would much prefer to use the wording which the Air Force suggested in order to make it clear on the record that we would not accept costs relating to write-downs of material values, he would go along with not raising official objection to the proposed wording which everyone else has agreed upon. However, he suggested that we retain something in the way of "legislative history" to indicate that Defense policy generally is not to accept such costs. I agreed that this would be a satisfactory solution since it would avoid either (1) the possible inconsistency of the proposed revised wording or (2) the necessity for going into a long explanation of our position. If we run into any difficulty on this score after issuance of the principles, we can take another look with the view to clarification. I am furnishing a copy of this memorandum to Mr. Benson.

K. K. Kilgore

Copy to:  
Mr. Benson

0700 (367)

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UNCLASSIFIED





OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON 25, D. C.

CR

SUPPLY AND LOGISTICS

30 June 1959

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)  
ASSISTANT SECRETARY OF DEFENSE (COMPTROLLER)

SUBJECT: Contract Cost Principles

We have concluded our staff efforts with respect to the contract cost principles and a fully coordinated draft, ready for publication, is attached as Tab A. There remains, however, the problem of determining what action, if any, the Department of Defense should take with respect to the General Accounting Office and discussion with Dr. Saulnier of the Committee on Government Activities Affecting Costs and Prices. (Tab C)

It appears to us that there are 4 alternatives with respect to the GAO which are enumerated below:

1. Formal Coordination. This would entail submission of our draft to GAO, the receipt of their written comments, the evaluation of these comments, and the probable need for further coordination among all interested parties. Previous correspondence with the GAO on this subject is attached as Tab B. Our last previous communication to the GAO was dated 22 October 1957 in which we indicated that it was "our intention to consult with your office prior to publication." The GAO responded on 3 April 1958 indicating that "we prefer to review and comment on the cost principles after industry comments have been analyzed and accepted suggestions have been incorporated in the proposed principles."

2. Staff Level Discussions. This would entail a meeting between Mr. Powers, GAO Audit Chief, and Mr. Kilgore and Cdr. Malloy. Previous informal discussions lead us to the conclusion that Powers would seek Mr. Campbell's reaction prior to making any GAO commitment. If this alternative is adopted, the effort would be to convince GAO that our current draft represents an acceptable compromise among the many differing points of view which are involved in this project. Hence, we would endeavor to


convince GAO that the success of this entire effort might be jeopardized and, in any event, would be seriously delayed, if the many controversial points were opened up for discussion.


3. Publish Without Prior Reference to GAO. This alternative would have the obvious advantage of obviating detailed discussions with GAO and would save many months, even years, in consummating this project. It is our understanding that this alternative was adopted by the Munitions Board in 1948 when the current ASPR provisions were published. GAO immediately responded in a strong manner and caused a change of the newly published regulation in several particulars.

4. Secretarial Level Discussions. This would entail a meeting by Secretaries McGuire and McNeil with Mr. Campbell. The effort here would be to endeavor to convince Mr. Campbell of our immediate need for these cost principles. We could assure GAO of our willingness to re-appraise the validity of our principles after they had been in effect for a reasonable period of time.

It is our feeling that we should either publish the principles without reference to GAO or we should initiate discussions at the Secretarial level. Were it not for the commitment to the Comptroller General referred to in 1. above, we would recommend publication without reference to the GAO. However, in view of this commitment, we believe that a high level discussion with Mr. Campbell of the broad considerations offers the best solution. We are of the opinion that detailed consideration by the GAO, either by staff level discussion or by correspondence, will result in ultra-conservatism in the individual principles, and will jeopardize our concept of applicability of the principles to fixed-price type contracts. The result would be violently objected to by industry and by many elements of the Department of Defense. In effect, we would either have to arbitrarily publish the principles as revised or start the project all over again.

With respect to Dr. Saulnier, we believe that a discussion citing the improved control resulting from application of the principles to fixed-price type contracts and the complaints of industry that we are being too restrictive in cost allowances will satisfy his group. Participation in this discussion by the Assistant Secretaries would be desirable, but might be handled by the staff.

  
J. M. MALLOY  
Cdr, SC, USN  
Staff Director, ASPR Division  
Office of Procurement Policy

  
KENNETH K. KILGORE  
Director, Audit Policy Division  
Office of Accounting, Finance  
and Audit Policy

by making it an allowable overhead item. Budgeteers want the principles as restrictive as possible. Auditors want them so detailed as to give them a pat answer to every question. Of course I hasten to add that what I have just said is in the nature of a caricature, and certainly not true of all representatives of each group mentioned.

All of the proponents of these different views have much to be said in their favor. During the some ten years that I have been struggling with this problem, I don't recall a single argument that did not have some merit under a specific set of circumstances. Likewise, I don't recall many proposals which couldn't justly be criticized under another set of circumstances.

This brings me to a point which I want to cover before we start trying to answer some of your questions. The point is this: these principles are, for the most part, intended to be stated in terms of objectives rather than specifics or allowable and unallowable costs. They are not intended to give the pat answer in black and white to every question you can dream up, but rather are intended to be sufficiently flexible to permit an equitable resolution of any problem that arises, depending on the circumstances. So, if we can't answer some of your questions precisely, I hope it will be because of lack of knowledge of sufficient facts surrounding the problem, rather than plain ignorance.

Since I have a captive audience, I would like to impose upon your good nature to do a little preaching on one of my favorite bits of philosophy. There is considerable criticism, not only of Sec. XV, but of Government regulations in general, that they are too detailed, too rigid and too restrictive.



**MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (S&L)**

**SUBJECT: Contract Cost Principles**

The Department of the Army concurs in the draft of Section XV, Contract Cost Principles and Procedures, dated 12 May 1959, referred to in your memorandum of 15 May 1959, subject as above.

Courtney Johnson  
Assistant Secretary of the Army  
(Logistics)

not agree with industry in <sup>not</sup>liking all of these restrictions which sometimes straightjacket us and deter us, in some cases, from doing what appears to be reasonable in a particular circumstance. But let us look at why we have all these controls and restrictions. Most of them, in the area we're discussing, were instituted to outlaw abuses by those who attempted--either through bad judgment or greed--or even <sup>with</sup>a touch of larceny in their hearts, to get more out of the Government than that to which they were equitably entitled. Human nature, operating in the gold-fish-bowl atmosphere which is such a necessary and integral part of our Government, dictates that some action must be taken by the executive department when these abuses are aired in the public press, by the legislature, or <sup>4</sup>others. This action usually takes the form of a regulation whereby, even though the abuse sought to be prevented may be more or less isolated, the restriction applies across the board. Thus industry, individually and through its associations, can do much to prevent the expansion of such regulations by recognizing their quasi-public responsibility when dealing with the Government, and avoiding abuses which must necessarily lead eventually to regulation. All too often, unfortunately, when it becomes known in industry that one contractor has found a "loophole," other contractors tend to climb on the bandwagon instead of trying to use their influence toward self-policing. Thus is born another regulation!

Now I will get out of the pulpit and on to the next general point. It concerns the degree of applicability of the cost principles to negotiated fixed-price contracts. Resolution of problems in this connection was the cause of--I would say--90% of the difficulty and delay in getting them out.



hope you will take my word that compromises made in order to reach agreement on this aspect, account for what I'm sure many of you consider some pretty weird wording and arrangement.

Few people objected to having cost principles for determining costs under cost-reimbursement type contracts. However, many objected to their application in the fixed price area and for various reasons. They said for example:

1. They will lead to "formula" pricing; i.e. costs plus a percentage profit will become price.
2. Negotiation and competition will disappear.
3. Pricing will be done by armies of auditors checking costs in the most minute detail.
4. The nature of risk in negotiated contracts is such that cost treatment should be different here than in cost type contracts.

However, right prevailed in the end because the opponents were not able to successfully refute such ideas as:

1. Costs are costs regardless of the type of contract. No type of contract should be more advantageous than another merely because of differences in cost treatment.
2. Only by this means could we hope to achieve at least a degree of uniformity of treatment by the thousands of individuals negotiating, administering, and auditing contracts.
3. That no one could deny that pricing of some forms of contracts (e.g. final formula pricing of an incentive contract) was based almost exclusively on costs.
4. But finally and most importantly, we found the words to describe the application to fixed-price contracts which allayed the fears of



those who predicted "formula" pricing.

This last was accomplished by words which set forth clearly that the principles are to be used in evaluating costs only "where such evaluation is required to establish prices." Secondly, by conceding duplication, we reiterated much of the pricing philosophy contained in Section III, Part B of ASPR by stating that "cost and accounting data may provide guides for ascertaining fair compensation, but are not rigid measures of it" and then going on to describe more fully, the degree to which costs should be evaluated in varying situations such as retroactive, forward, and competitive pricing. Finally the principles were prescribed as a guide rather than as a basis for determining costs in the fixed-price case.

This brings me to the question of what them, is the significance of the principles insofar as fixed-price contracts are concerned? These will be my ~~an~~ opinions, not necessarily shared by all others. The principles probably are not "legally" binding (in the strict sense of the word) on the contractor. They are not required to be incorporated in the contract. <sup>They are in the contract.</sup> He is not even required to submit his cost or price proposals in connection with fixed-price contracts in accordance with the principles. However, I have hopes that they will be used intelligently and in consonance with the spirit in which they were promulgated. For example, when a disagreement revolves around a specific element of cost and there are no other overriding considerations, I will expect the principles to govern. Likewise, I would anticipate that contractors will recognize the benefits of submitting cost proposals using the principles as a guide. This would not prevent them from proposing so-called "unallowables" for consideration in negotiating a price, but they would be identified as such.

In this way, once past experience<sup>has</sup> indicated to negotiators or auditors that a contractor's proposal does not have a lot of hidden unknown's, they will be able to rely upon it as a basis for pricing with a minimum of audit and analysis. To some, it may seem that the wording used in describing applicability of the principles to fixed-price contracts represents over-cautiousness to the point of ineffectiveness. They may be right. If so, the guidance will have to be strengthened after we have had some experience.

Finally I'd like to touch upon some of the problems involved in implementation, that is, in switching over from the old to the new principles. You will recall that Revision 50 of the ASPR published on 2 November 1959 prescribed mandatory use of the new principles after 1 July 1960, with permissive use upon publication. Shortly after publication, however, it became apparent that additional policy guidelines were necessary to provide a more orderly application of the principles, particularly to cost reimbursement type contracts. Our first thought was naturally that it would be desirable to avoid having two sets of principles applicable to a contractor's business. Many were of the opinion that increased cost allowances, if any, under the new principles, would be more than offset by administrative savings through operating under one set of principles. Thus we first considered seriously a general policy finding to this effect, permitting amendment of old contracts to incorporate the new principles without a contract-by-contract analysis to determine the specific effect. The lawyers among you can readily understand why we soon began to have misgivings regarding this approach. There appeared the spectre of later charges of amendment without consideration. These misgivings were strengthened when one of our contractors offered himself as a guinea pig for test. We studied the problem<sup>in that company</sup> and concluded that mass cutover was not practical for

several reasons. For example, the effect on future allowances of independent research and development cost under old long-term contracts could not be determined because of possible changes in the level of his R&D effort. To achieve the objective of a single set of cost principles, subcontracts which he was performing under other contractor's primes would have to be amended--but this might not be practicable. Likewise he would have to amend subcontracts under his own primes. Finally, because of the almost insurmountable problems due to contract-by-contract analyses of effects, the sheer volume of old contracts, and the subcontract complication, we concluded that mass conversion would be impractical.

Thus, in the policy guidelines issued on 10 February 1960, it was indicated that existing cost reimbursement contracts would, in most instances, be costed out on the old basis. However, criteria were established to permit amendment under circumstances wherein the administrative burden would not be unreasonable. Under these criteria, and later on, when the volume of old contracts has been reduced, we believe it will be practicable to amend <sup>the few remaining old</sup> contracts to achieve the single costing basis. Obviously, no such amendment can be made without mutual consent of the two parties.

As to new cost-reimbursement type contracts, we want to start using the new principles as soon as possible. However, where all of a contractor's contracts are now being costed under the old cost principles, any new contracts will provide for the use of the revised cost principles, but may carry a proviso for the use of the old principles for the period between the date of the contract and the end of the contractor's fiscal year. Our aim here, of course, is to minimize the administrative problems involved in the changeover period.

provision that I just outlined will carry <sup>use of</sup> the old cost principles past our



previously stipulated mandatory date of 1 July 1960 in some cases.

In the case of existing fixed-price type contracts, we will use the new principles as a guide as soon as possible. Such use, however, will be only to the extent that it is not inconsistent with any contractual provisions, understandings, or agreements established in the negotiation of the contract. As to new fixed-price type contracts, our contracting officers will be expected to use the new principles as a guide as soon as practicable, but in no event later than 1 July 1960.

In the case of fixed-price contracts terminated for the convenience of the Government, we will use the termination cost principles which were in effect on the date of the contract. Terminated cost type contracts will, of course, be costed out in accordance with the allowable cost clause in the particular contract at the time of termination.

In these introductory remarks I have touched on only a few high spots to try to give you some of my views on why the principles are as they are, how I anticipate that they will be used, but most important of all--how I believe industry, by following the dictates of good conscience and the exercise of self control, can help to avoid further expansion of red tape and Government regulation.

Binder #6

untitled

November 1959

HOOVER COMMISSION

June 1955

Recommendation No. 3 - page 33

Contract cost principles. - Current efforts to revise the contract cost principles of Section XV, Armed Services Procurement Regulation, are commendable. The final products of this effort should result in a set of cost principles for cost reimbursement type contracts in keeping with recognized commercial accounting standards. These principles should be supplemented by guidelines for auditors in gathering cost information on fixed price contracts, including terminated contracts.



Hebert - Report on Aircraft Production  
Costs and Profits  
7/13/56

22,3123

VI. SALARIES, BONUSES, AND INCENTIVE PAYMENTS

These 12 companies have widely varying policies on the compensation for executives. Air Force and the Navy have different policies on allowances for salaries, bonuses, and incentive payments.

We were told during our hearings in March that the Defense Department had under consideration a definitive policy for both services. But, on January 4, 1956, and again on June 4, 1956, Air Force procurement circulars were issued, the general purport of which was that the Air Force would undertake to approve salaries in excess of \$25,000.

The Navy, on the other hand, has had no regulation and has handled executive salaries, bonuses, and incentives as cost allowances on a company-by-company basis, with no particular formula for any company.

There has not been forthcoming, from the Department of Defense, any statement of a unified policy.

Air Force Procurement Circular No. 19 of June 4, 1956, closely parallels Navy practice, as we view it. Paragraph 54-900 says that "any acceptance" of wage and salary schedules "should be considered as a determination of acceptance of costs resulting from such schedules for allocation to Air Force contracts."

Paragraph 54-904 provides that when salaries "appear as a part of a negotiated overhead rate" they must again be reviewed for acceptability.

Section 54-905(b) (1) covering salaries "in excess of \$25,000" provides for consultation and approval by Headquarters AMC "unless an agreement and approval had been reached prior to January 4, 1956," or the "contractor's proposals were not in excess of those previously approved" or if the administrative contracting officer "determines that prior approvals and authorizations ought to be reviewed, the matter should be referred to Headquarters AMC for final determination."

All of this means the same welter of confusion which has heretofore existed.

The subcommittee recognizes the importance of an adequate reward for the skilled management and executive competence. However, the subcommittee is not persuaded by company statements on the importance of salaries, or of incentive bonuses for doing a job for which a basic salary is paid and of the other devices which have been set out in the presentation of the several companies to us. We find there is no pattern among industrial concerns generally in this regard. (See exhibit A (pp. 3129 to 3139) on industrywide salaries, bonuses, etc.)

We think, in short, that the proposal to charge all executive salaries and bonuses, incentive or otherwise, as cost allowances on Government contracts, is unwarranted.

The position of the subcommittee is this:

There should be set up among all services a salary allowance schedule for

Executive compensation which could be included in the cost allowances for general overhead assigned against various contracts of the Government. Beyond such a level, which we think should be reasonably conservative, we believe that all additional compensation, be it salary, bonus, incentive payment, or the like, is a subject for payment out of the profit earned on Government contracts. It is a matter between executive officers and their board of directors to determine the use a company makes of its profits.

The Government has not stinted in supplying plant and working capital through the medium of advance capital, and balance sheets indicate that they are adequately rewarded for capital and management supplied, and are financially sound, even though almost entirely dependent upon Government business. The public has assessed that soundness in stock quotations of outstanding shares.

Earnings are clearly set forth in the foregoing tables and we think it unnecessary, in these circumstances, that excessive executive compensation should be made a part of the cost or overhead for performing Government contracts.

Contrasted with executive salaries are the salaries of their opposites in the military service who are expected to be qualified to contract in the name of the United States. We think a wage scale, which is generally GS-11, and in a few instances reaches GS-16, for men who are expected to match wits and wisdom with the representatives of the contracting companies, is grossly inadequate.

The Air Force, in testifying before the House Appropriations Committee, said that 95 percent of its procurement personnel are civilians with a tremendous value and a great responsibility resting upon them.

We recommend a reappraisal of qualifications and salaries of Government civilian procurement personnel and a prompt adjustment of salaries commensurate with responsibilities.

C O P Y

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE  
Washington 25, D. C.

RB

March 23, 1956

MEMORANDUM FOR THE DEPUTY ASSISTANT SECRETARY OF DEFENSE (S&L)  
DEPUTY ASSISTANT SECRETARY OF DEFENSE (COMP.)

SUBJECT: Approach to development of "one" set of cost principles

In order to avoid wasted effort, to the extent possible, in developing principles for the handling of individual elements of cost, we consider initial approval of our contemplated general approach to be desirable. It is set forth below:

1. Cost treatment should be equalized as much as possible between the several types of contracts so that one type of contract will be neither less nor more attractive to a contractor or to the Government, by reason only of the cost treatment. Thus, the selection of contract type can be based upon the merits of the negotiation, i. e., conditions surrounding the required product or services and the extent of any contingencies covering risks rather than external influences arising out of cost treatment.

2. Risk in the form of a contingency principle ought to be recognized in those instances in which there is risk exposure.

3. Our objective ought to be fairness and equity in the development of "one" set of cost principles. We should not deny nor restrict allowability of a cost otherwise fair because it would be costly to the Government, or because reasonableness of amount is difficult to assure.

4. We should seek to allow legitimate costs of doing business to the extent that such allowance is reasonable and is allocable to the contract in question.

/signed/

T. A. PILSON  
Chief, Policies Branch  
Purchasing & Contracting  
Policies Division  
OASD (S&L)

/signed/

K. K. KILGORE  
Assistant Director  
Accounting Policy Division  
OASD (Comp.)

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE  
Washington 25, D. C.

November 5, 1956

MEMORANDUM FOR THE DEPUTY ASSISTANT SECRETARY OF DEFENSE (S&L)  
THE DEPUTY ASSISTANT SECRETARY OF DEFENSE (COMP.)

SUBJECT: Industry Proposals - "One Set" of Cost Principles

Attached (TAB A) is our appraisal of the five industrial proposals concerning "One Set". While there are some points upon which there is agreement, some upon which there is partial agreement, the industry proposals are not acceptable in the really important points made. We believe that industry has viewed this problem with something less than real objectivity, has been largely persuaded to its own self-interest, and has refused to see the nature of the DOD problem. In this paper, we have tried to state our problem.

This is a digest of our conclusions:

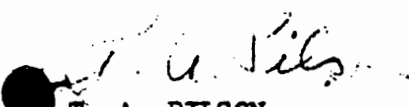
- (a) There is nothing really new in the proposals. We have read the same things as criticisms of previous Section XV drafts.
- (b) We believe that uniformity of treatment as between the several types of contracts is a MUST. Industry says "not necessarily".
- (c) We believe we must define "reasonableness" and "allocability". The words alone will not secure the needed uniformity - additional guidance must be found for some of the elements of cost.
- (d) We must reject the notion that the cost principles ought not be "explicit" or "specific". Reasonable uniformity is otherwise unobtainable.
- (e) We must establish reasonable accounting standards. "Generally accepted accounting principles and practices" is not enough.
- (f) NSIA is very close when they indicate that the principles ought to be applied in "negotiated contracts in which costs constitute to some degree a factor for consideration in contract negotiation."
- (g) If there is such a thing as an "unreasonable" or "unallocable" cost, we must state unallowability somehow. Industry must make the argument against the words to support consistently the ALL costs contention.
- (h) Indirect costs represent an important aspect of the "one set" problem. We believe that in the interest of "across-the-board" application, we must state our policies in generalized language. Furthermore, we do not believe that we can stress indirect expenses, and disregard direct - which may have been the industry goal.

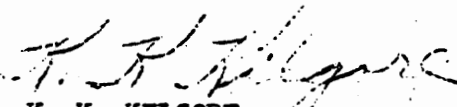
- (1) Whether all "gains" obtained by industry in suits in the courts and the ASBCA ought to be considered allowable is dependent upon many circumstances. Rather than to allow the "gains" automatically, we ought to consider the items on their merits.

Where do we go from here? We suggest that the nature of the comment be revealed to industry through use of the DOD Procurement & Production Industry Advisory Committee. In light of the personal responsibility of the DASD (S&L) and the DASD (Comp.), it is our suggestion that both attend the meeting for the purpose of hearing industry present their point of view. We suggest also that the course of the meeting be controlled by limiting the subject matter to the important principles proposed by industry. Attached is an agenda which may be useful for the purpose. (TAB B)

It is our recommendation that Messrs. Pilson and Kilgore, at a minimum, be present for the purpose of exposing the industry contentions to the DOD problem, point out inconsistency of views, etc. This would enable Messrs. Lanphier and Shannon to occupy the place of judges evaluating the totality of the positions developed.

The above approach seems to be consistent with the revised modus operandi of the PPIAC.

  
T. A. PILSON  
Chief, Policies Branch  
Purchasing & Contracting  
Policies Division  
OASD (S&L)

  
K. K. KILGORE  
Assistant Director  
Accounting Policy Division  
OASD (Comp.)

- 2 Incls.  
1. TAB A  
2. TAB B

11/5/56

GENERAL EVALUATION OF INDUSTRY COMMENT

All Associations join in a criticism of all of the drafts of Section XV that they have seen, and their proposal for "One Set" largely represents these criticisms stated as suggestions. We do not believe that there is included in the proposals anything new.

CRITICISMS OF SECTION XV

As indicated above, there are universal industrial complaints that all editions of Section XV have been less than just and equitable. NSIA says that "the principles embody unduly severe restrictions". NAM expresses the same feeling in almost identical words. MAPI says that we talk of reasonableness but we then "negate this...general standard by an (objectionable) item-by-item specification and definition of allowable and unallowable costs". AMA discloses the restrictions to be "selling, distribution and advertising, contributions and donations, membership in and activities of trade, business and professional organizations, interest and other financial expenses, and depreciation and contingency reserves". In so doing, they say affirmatively and strongly urge that "one set" should recognize ALL of the legitimate costs of doing business without restriction.

UNIFORMITY IN COST TREATMENT

Several associations have inferred that there are cost differences which should be recognized as between the several types of contracts and particularly as between the cost-reimbursement contracts as a class and the so-called fixed price contracts as a class, BUT THEY DID NOT SAY WHAT THE DIFFERENCES WERE. They said only that cost reimbursement and pricing were not the same thing. AMA and NSIA seemed to recognize the "universal application" concept of the comprehensive set, although the latter preferred a contract clause for cost reimbursement purposes. NSIA came closest to expressing uniformity when it

TAB A



said, "... in contract negotiations some sort of rules or philosophies are logically required" and indicates that industries' apprehensions grow from the "severe restrictions" of Section XV. This raises the problem of viewing each cost element and ascertaining wherein there should be any cost difference.

COMMENT: At this time, we can see only contingencies as a possible area for different treatment, and then only where pricing judgments are future in their operation. If there are differences, industry must support them.

Since industry's "one set" proposals are the same as their criticisms heretofore levelled at Section XV, we must presume that if Section XV were to be modified to their satisfaction, uniformity would be well. Therefore, we conclude that industry believes that it is not possible at this time to get their ALL COSTS view accepted in Section XV and therefore, seek to establish the ALL COSTS basis in "one set". To do so, they must contend that there is a difference between it and cost reimbursement.

#### INDUSTRY ADVOCATED CONCEPTS

a. The basic objective should be one of fairness and justice to both parties to the negotiation, recognizing ALL COSTS OF DOING BUSINESS to the extent that they are (i) allocable and (ii) reasonable. Allocability and reasonableness are not further defined and, as to Section XV, industry has said that further definition is unnecessary.

COMMENT: The concepts of allocability and reasonableness are difficult.

There are several possible bases for allocation, several of which are mentioned by industry. For example, NAM says, "... we recognize that there may be unusual situations wherein certain items of cost may apply in less degree to Government than to commercial business. There may be cases where none of a particular cost would apply--or perhaps 100% in other cases."

Again, reasonableness is not defined by industry, except that they

say that the expenses ought to be in accord with "good" and "sound" business practices. AMA says that whatever it is, it does not include second guessing by the Government. They say, "The principles should be based on the philosophy that the contractor has been selected because of reputation, ability and organization. Among other things, this means that its organizations must function through the judgments and discretion of its executives in accomplishing the purpose for which the contract has been let." NSIA says roughly the same thing. They say, "The Government should have the opportunity to review the accounting system of the contractor...and once approved...the results of consistent application of that system should not be questioned." We believe our definitions of the two terms, along with more detailed treatment in connection with certain individual cost elements, is the minimum acceptable.

b. The principles ought to be FLEXIBLE AND NOT EXPLICIT OR SPECIFIC. AIA suggests that the principles be stated in "broad terms". NAM says that accounting is not an exact science and precise determinations of all costs is not possible and therefore one set should not be "detailed treatment of the various cost elements...or cover peculiar circumstances or special cases." NSIA says that the principles ought to be "broad in scope, rather than detailed".

COMMENT: The DOD has always thought that its drafts provided the necessary flexibility both as to system and as to range of allowances in those expenses in which there ought to be a range of allowances. Our problem is that we can't see how we can act within any reasonable degree of uniformity of policy or practice, operating as we do in 100 plus principal purchasing offices and using some 6,000 audit personnel without some specific guidance. Furthermore, we believe that UNIFORMITY IS A MUST. In commenting on a previous Section XV draft, NSIA seemed to recognize this when they said: "the development of

uniformity of treatment by working level personnel in the application of cost principles" should be one of our objectives. We cannot see that this proper uniformity objective is achievable without guidance which is, to a proper extent, EXPLICIT AND SPECIFIC.

c. Industry reiterates that the test of a valid accounting system should be GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AND PRACTICES, consistently applied. NAM speaks of "flexibility with respect to allowability" and "flexibility as to (accounting) systems". Only NSIA recognizes a government interest in the system. They say that the Government "should have the opportunity to REVIEW the accounting system and, where...(the) accounting system provides an equitable basis for the allocation of expenses, it should approve it. Once this is done, the results of consistent application of that system SHOULD NOT BE QUESTIONED." NSIA also speaks against "arbitrary allocation".

COMMENT: The Department of Defense is unable to fully accept either of the two above-mentioned philosophies as stated. Our experience is that a system can be developed and maintained "in accordance with generally accepted accounting principles and practices" and yet not necessarily yield costs related to the contract performance to the extent required for cost reimbursement or to support pricing judgments. Thus, we have accepted the concept in its correct sense by adding "applicable in the circumstance." The related point on "consistency" we view in the same way. Consistency is essential only so long as conditions remain static. When conditions change, a system change may be required also. Additionally, rather than BLIND TRUST as suggested, we must monitor the application of standards to a reasonable degree.

d. Industry stated that whatever principles are developed ought to be limited in their application to "COST RELATED AREAS," But the views were not unanimous as to what the cost related areas were. MAPI says that it "sees no reason for

the application of cost principles in any form to FIRM, FIXED-PRICE CONTRACTS". AMA says the same thing and adds that they ought not be applied in "instances of standard commercial product" nor to "a substantially similar modified version thereof" at least in instances in which pricing ought to be by "customary competitive factors such as quality, quantity, time of delivery, etc." NSIA states that the set ought to be applied in those "negotiated contracts...in which costs constitute to some degree a factor for consideration in contract negotiations". NSIA carves out formal advertising and competitive negotiation where "costs do not enter into the negotiations".

COMMENT: Our views are well expressed in the NSIA words. However, while in agreement that the commercial item would often be the one in which competition would tell the pricing story, we cannot see that that should be the basis for the exclusion. In the negotiated firm fixed-price contract area, estimated costs are often a very important consideration in pricing and ought to be evaluated on a consistent basis.

e. There were other ideas expressed upon which there ought to be some discussion:

1. We ought to rid ourselves of the concept of reimbursability and non-reimbursability and allowability and non-allowability.

COMMENT: Under whatever description, we can perceive of no way of expressing yes or no which the observer would accept. He actually is saying that there is no such thing as an unallowable cost. We don't agree.

2. Incorporation by reference should not occur at all, was expressed by one association. Another said that it should only be incorporated in cost reimbursement type contracts.

COMMENT: We ought to study this point carefully and to determine precisely when it ought to be incorporated by reference. In any event, we KNOW that

it should be incorporated into cost-type contracts.

3. One Association observes that direct costs do not represent a serious problem area--but notes that indirect costs do and, therefore, we should give much attention to the indirect cost area.

COMMENT: Industry, by and large, has been extremely critical of past efforts in clarifying the indirect cost area on the basis that it necessarily involves arbitrary allocation of these expenses. Accordingly, in one set we have tried to be rather general in our approach. On the basis of the present evidence, I believe that our approach is probably correct.

4. In the matter of the cost treatment of one set, one Association suggests that it ought to recognize as legitimate costs all gains for which industry has fought so hard in the ASBCA, and although not stated, they must logically say, the gains made in the courts.

COMMENT: We believe that these "gains" ought to be reappraised on an objective basis just as the other cost elements are. To the extent that this consideration indicates disallowance, they should be disallowed. ASBCA and court cases are determinations of existing facts only, which facts sometimes call for remedial action.

f. There were several other ideas expressed by industry which are generally acceptable to the DOD. These are:

1. We ought not to let this project interfere with the current emphasis upon firm fixed-price contracting.
2. Since the total price is important in fixed-price contracting, we ought not to become so preoccupied with the elements of costs to miss our fundamental target--price. Specifically, we ought not to become "profit-happy".
3. The concept of allowability may not be made dependent upon a negotiation--policy coverage must be found.
4. In pricing, the audit and price analysis aids must be made advisory if the one set target is not to result in "formula pricing".

11/5/56

PROPOSED PPIAC AGENDA ITEM ON "ONE SET"

We have received the proposals of five associations presenting their views as to the problem of one set of contract cost principles for application to all types of contracts and all contract situations. As we could expect, there are some similarities and some dissimilarities of views, and some proposals which do not now appear appropriate for application by the DOD. For this reason, I am dedicating our next meeting to this subject believing that from it will result uniformity of purpose. If so, the development work will be greatly facilitated.

Our appraisal of the industry comment brings into view the following areas for consideration:

- a. Standards of Cost. The observation is made that one set should recognize ALL COSTS OF DOING BUSINESS to the extent that they are (i) ALLOCABLE and (ii) REASONABLE. The question arises as to the meaning of allocable and reasonable. Once we reach a conclusion on this question, we will be in a position to apply it in the determination of standards of cost.
- b. To what extent should there be uniformity of cost treatment under the cost aspects of the several kinds of contracts and the several uses within the contracts?
- c. What are the specific COST RELATED AREAS in which an application of one set should be made?
- d. Ought this department specify accounting standards which may be more specific than GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AND PRACTICES? Having determined the standard, to what extent should performance under the standard be subject to appraisal by the DOD, particularly as to Allocability and Reasonableness.

TAB B



- e. Is uniformity of treatment a valid objective? If so, how can we achieve it if our principles are FLEXIBLE, NOT EXPLICIT OR SPECIFIC, and STATED IN BROAD TERMS?
- f. How can one set be cast in terms of yes and no in relation to elements of cost if we do not do it in terms of reimbursability and non-reimbursability and allowability and non-allowability?
- g. In what situations should one set be incorporated by reference?
- h. How should we cover the difficult area of indirect cost? In terms of importance, should it be stressed in comparison with direct costs?
- i. Should the items determined allowable by the ASBCA and the courts be considered allowable without reappraisal?
- j. How can we best prevent the publication of one set from interfering with the current emphasis on firm fixed-price contracting?
- k. How can we best prevent a preoccupation with costs in negotiation resulting in failure to negotiate price?



June 11, 1957

## THE PROBLEM OF ADOPTING A NEW SET OF COST PRINCIPLES

### Background

In the summer of 1953, Mr. Bordner, of Mr. McNeil's staff, submitted for consideration of the military departments a set of cost principles which he had drafted which were intended to be applicable to all types of contracts. These were immediately opposed by the military departments for a variety of reasons, principally because it was believed that the "Applicability" section of these principles would tie the hands of negotiators in negotiating the prices of risk contracts, would subject all pricing to after-the-fact cost and profit reviews and would require a justification of negotiated forward pricing in terms of which projected costs were allowed and which were disallowed. It was felt that this would hamstring bargaining, compromise and negotiated conclusions.

As a result a meeting was held in the summer of 1953 attended by Mr. McNeil and Mr. Bordner and by Mr. Webster of S&L, with procurement representatives of the three military departments. It was concluded at this meeting that the problem would be given to an ASPR subcommittee made up of audit and procurement representatives of the three services. They were to use Mr. Bordner's statement as the take-off point for drafting a revised set of cost principles applicable to cost reimbursement contracts only (to replace the very general statements now in Part 2 of Section XV of ASPR for this purpose). It was agreed that after completion of this effort, but before publication, the product would be reviewed to determine its suitability for use as a comprehensive set of cost principles and decision as to how to publish would be reserved for that time.

The ASPR subcommittee was formed and had exhaustive meetings, usually two or three a week, through much of 1954 and 1955. Every word was carefully considered. Departmental positions were formed, compromised or fought out on a wide variety of minor issues. The subcommittee report was finally submitted to the ASPR Committee with a number of issues remaining. The ASPR Committee, through part of 1955 and into 1956, considered these issues, resolved many and ultimately submitted the package, with a few unresolved issues to the Materiel Secretaries.

During the final ASPR considerations and while <sup>under</sup> consideration by the Secretaries - through much of 1956 - a pattern in these issues became apparent. The Air Force, because it does such a high percentage of its

business with contractors who are almost entirely in government work and who, therefore, are not substantially subject to the discipline imposed by the necessities of commercial competition, was in favor of disallowing several elements of cost, such as "profit sharing incentive compensation", which the other departments favored allowing to the extent such costs were kept within reasonable limits. These issues along with the whole package were submitted to Mr. Wilson in December of 1956 and again in March of 1957. His decision has been to treat profit sharing costs, most advertising expense, all contributions and donations, general research expense not specifically treated in the contract, sales expense other than consulting engineering and the like, and a few other less important items as wholly unallowable. His decision was clearly based on the concept that these principles were applicable only to cost-reimbursement "no-risk" contracts.

By agreement between Mr. McNeil and Mr. Lanphier, a member of each of their staffs, Mr. Kilgore and Mr. Pilson, did very extensive work during 1956 and early 1957 in the drafting of a comprehensive set of cost principles. This was completed and submitted for your consideration on 2 April 1957. This draft acknowledges and accepts in principle a statement of the applicability and use to be made of this comprehensive set of cost principles which, in my opinion, would now be acceptable to the military departments. A copy of this statement is attached. It is considered very important in a resolution of this problem. In its content, the comprehensive set of cost principles is far less rigid in its disallowances than Part 2 of Section XV. It is based on the concept that no legitimate cost of doing business is automatically unallowable although certain costs which have nothing to do with the conduct of government business are normally not allocable to us and many costs, though allowable and allocable to us, may be so unreasonable in amount as to be unacceptable. In other words, it substitutes careful and realistic administration for automatic disallowance. The administration will be more difficult in industries not subject to competitive disciplines and, hence, Air Force objections to this comprehensive set of cost principles can be anticipated.

Over this same period of time there have been two, and possible more, official letters from the Comptroller General of the United States to Mr. Wilson urging the rapid adoption by the Department of Defense of a single, comprehensive set of cost principles applicable to all types of contracts. The last of these letters dated March 11, 1957 is still unanswered.

In its reports two years ago and again last year, the Special Investigations Staff of the House Appropriations Committee (originally the Flatley group) strongly urged the adoption of a single, comprehensive set of cost principles. In its report to the House in connection with the current DOD budget, the Appropriations Committee restated this need in emphatic terms.

In its hearings and report on aircraft procurement last year the Special Investigation Subcommittee of the House Armed Services Committee (the Hebert Subcommittee) brought out and stressed the fact that the practices of the Navy and the Air Force with respect to cost allowances in airframe contracts were different. This Committee pointed out that it was the immediate responsibility of the Department of Defense to eliminate these differences. On May 15 of this year, the Special Counsel of this Subcommittee, in a letter to General Ghormley, has put us on notice that the same issues will again arise in the hearings on procurement of aircraft engines next month. This Committee talks in terms of Part 2 of Section XV of ASPR and they might be satisfied if that Section were issued. However, the contracts they have investigated have been largely of the incentive type or other negotiated types not directly affected by Section XV, Part 2.

In the past, audits in connection with pricing have been conducted in the light of the present Part 2 of Section XV. Hence, the cost principles which are contained therein to govern questions of cost allowability under cost reimbursement contracts are also used by the auditor in setting out costs for special consideration by the negotiator when preparing advisory audits in connection with negotiated price contracts. To a very large extent, then, costs which are disallowed as a matter of regulation under cost reimbursement contracts are, in fact, excluded from pricing in other contracts. Hence, if the proposed Part 2 of Section XV were issued with its rather stringent disallowance it would inevitably be carried over into the pricing of other types of contracts. This might have the effect of rendering it more difficult to adopt less stringent rules with respect to such other types in the future.

#### Summary of Present Situation

We presently have available for issuance to replace Part 2, Section XV of ASPR a proposed set of cost principles applicable by its own terms only to cost reimbursement contracts. This has been fully coordinated within the Department of Defense. When coordinated with industry there was considerable objection to its restrictions. The changes made as a result of discussions with Mr. Wilson, all of which added restrictions, have not been coordinated with industry.

We also have a complete draft of a comprehensive set of cost principles which has received no coordination, either with industry or within the Department of Defense.

The present line-up of the parties at interest is believed to be as follows:

Mr. Wilson has approved Part 2, Section XV and would have been willing to issue it but for Mr. McNeil's objection. Mr. Wilson has not seen the comprehensive set and there are differing guesses as to whether he would approve it.

Mr. McNeil is completely opposed to the issuance of Part 2, Section XV both because he considers it too restrictive and because he feels that the real need is for a set of cost principles for comprehensive application and not for a new set of principles for cost reimbursement.

The Air Force wants Part 2, Section XV issued immediately and can be expected to oppose the present draft of the comprehensive set either before or after the issuance of Part 2 of Section XV.

The Navy and the Army both feel that the present draft of Section XV, Part 2 is too restrictive, but would vastly prefer to have it issued to inaction. They point out the real embarrassment that continued DOD inaction in this field can cause all of us. They both recognize a continuing need for a comprehensive set of cost principles and probably, but for the delay factor, would generally support the new draft.

Industry can be expected to react violently if Section XV, Part 2 is issued in its present form. They will object both to its restrictions and to the fact that they were not consulted as to those which were most recently incorporated.

#### Arguments Concerning the Immediate Issuance of Part 2 of Section XV

##### In favor of immediate issuance

1. It is finished, coordinated and agreed to in detail by Sec/Def.
2. It is the culmination of a vast amount of committee work. It will pin down, for the record, a large number of agreements on principle and language which were reached only after much effort and compromise.
3. It will probably satisfy the Hebert Subcommittee in connection with its July hearings.



4. It is likely that the principles will be used in connection with all pricing and, therefore, the effects of a comprehensive set can be achieved immediately.

#### Opposed to issuance

1. We have presently in ASPR, a set of cost principles applicable to cost reimbursement contracts. There is no particular need for a new set. What is needed is a set which is applicable to all contracts.
2. Because of its austerity, industry will fight it as hard as possible. This opposition is likely to lead to firm industry opposition to any comprehensive set for fear that this, also, would reflect this pattern of disallowances. Industry opposition will be particularly strong because they were not consulted on the most recent changes.
3. Part 2, Section XV will not satisfy the GAO or the House Appropriations Committee since, by its terms, it is only applicable to cost reimbursement contracts. They specifically want a comprehensive set.
4. Part 2, Section XV, which will probably be used to some extent in connection with all pricing, is unsuited for such use. It treats as unallowable or requires special contractual treatment of costs which most parties would agree should be allowed if incurred subject to the disciplines of commercial competition. The allocation of such costs to government work should be controlled as to reasonableness but they should not be uniformly disallowed. This is the wrong way to arrive ultimately at a suitable comprehensive set.

#### Special Arguments Related to Proceeding with the Presently Drafted Comprehensive Set

##### In favor of proceeding

1. Such a set now appears feasible since we can apparently now agree with the Comptroller on our "applicability" section.
2. If there were not extended internal disagreements, it could probably be coordinated quickly.

3. If we were to proceed on this basis immediately, we could probably satisfy the Hebert Subcommittee in July and satisfy the Appropriations Committee and GAO quicker than any other course.

#### Opposed to proceeding

1. The Air Force will immediately oppose it and, hence, a delay is inevitable.
2. The Air Force will probably bring the proposed treatment of such factors as "profit sharing incentive payments", "advertising", "contributions and donations", "general research", et al to Mr. Wilson's attention immediately. While Mr. Shannon thinks that Mr. Wilson will agree to a different treatment of such costs in cost principles used predominantly for negotiating risk contracts, as contrasted with principles used in cost reimbursement, this is not clear. In any event, the comprehensive set cannot be issued without joining this issue before Mr. Wilson.

#### Conclusion

In view of Mr. McNeil's opposition to issuing Part 2, Section XV in its present form and the Air Force insistence on this issuance, coupled with the predictable Air Force opposition to the presently drafted comprehensive set it is clear that another decision by Mr. Wilson is inevitable. It would be very desirable if such a decision were a comprehensive one that resolves all of the issues that appear in this paper. The parties principally at interest should be able to present their arguments to Mr. Wilson. This could not be done as matters now stand, since neither the Air Force nor the other military departments has yet seen the comprehensive set of cost principles. Hence if we were to seek a final decision on all issues from Mr. Wilson, we would first need a briefing session with the military departments and we would have to allow them enough time to marshal their arguments on these issues.

It is my opinion that we should support the comprehensive set in substantially its present form.

If Mr. Wilson will not approve this set I think we should proceed with the issuance of Part 2, Section XV.

  
G. C. BANNERMAN  
Director for Procurement Policy

*yes or no*

(h) Contributions and Donations.

(1) Reasonable contributions and donations to established nonprofit charitable, scientific, and educational organizations are allowable if 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, (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, or (iv) are contributions to local civil defense funds, or to local civil defense projects for use in the community in which the contractor operates. (But see ASPR 15-204.1(b)).

*← Refer to back of last page \**

(2) The reasonableness 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, and should also be judged in the light of the presence or absence of restraints occurring in the conduct of competitive business. 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.

c Compensation for services rendered paid to partners and sole proprietors in lieu of salary will be allowed to the extent that it is reasonable and does not constitute a distribution of profits.

d In addition to the general requirements set forth in a through c above, certain forms of compensation are subject to further requirements as specified in (2) through (10) below.

(2) Salaries and Wages. Salaries and wages for current services include gross compensation paid to employees in the form of cash, products, or services, and may include payroll taxes, workmen's compensation insurance, and the cost of supplemental unemployment benefit plans, and are allowable subject to the qualifications of (8) below. Deferred wages and salaries are allowable to the extent authorized in (6) below.

(3) Cash Bonuses and Incentive Compensation. Cash bonuses and incentive compensation <sup>AF</sup> (whether or not) dependent upon or measured by profits based on production, cost reduction, or efficient management or performance, and suggestion awards and safety awards, <sup>NAT</sup> are allowable to the extent paid or accrued pursuant to an agreement entered into in good faith between the contractor and the employees before the services were rendered, or pursuant to an established plan followed by the contractor so consistently as to imply, in effect, an agreement to make such payment. (But see ASPR 15-204.1 (b)). Deferred bonuses and incentive compensation are allowable to the extent authorized in (6) below.

*\*  
Referral is  
all back to  
just pay*

(4) Bonuses and Incentive Compensation Paid in Stock.

Costs of bonuses and incentive compensation paid in the stock of the contractor or of an affiliate, are allowable to the extent set forth in (3) above (including the incorporation of the principles of paragraph (6) below for deferred bonuses and incentive compensation), subject to the following additional require-

ments:

- (i) valuation placed on the stock shall be the fair market value, determined upon the most objective basis available; and
- (ii) accruals for stock prior to acquisition by the employees shall be subject to adjustment according to the possibilities what the employees will not acquire such stock and their interest in the accruals will be forfeited.

Such costs otherwise allowable are subject to adjustment according to the principles set forth in (6) c and d below. ( But see ASFR 15-204.1 (b)).

*out* (5) Stock Options. The cost of options to employees to purchase stock of the contractor or of an affiliate, shall be allowed to the extent that the market value of the stock exceeds the option price at the date the option is granted. If employees are given the opportunity to purchase stock of the contractor at a certain time or during a certain period (other than through a stock option) the excess of the market value of the stock over the cost to the employee shall be allowed as a cost. The current market value of the stock shall be determined according to the criteria set forth in (4) above. If the exercise of an option is conditioned upon future contingencies, the cost shall be amortized rateably over the period commencing from the issuance of the option to the earliest date (other than death of the employee) when the contingencies can be fulfilled. Allowable costs for options that may not be exercised shall be adjusted according to the principles set forth in (6) c below.

*ph* (6) Deferred Compensation

a As used herein, deferred compensation includes all remuneration, in whatever form, for services currently rendered, for which the employee

is not paid until after the completion of the year in which the services are rendered, except that it does not include normal end of accounting period accruals. It includes (i) contributions to pension, annuity, stock bonus, and profit sharing plans; (ii) disability, withdrawal, insurance, survivorship, and similar benefits, and (iii) other deferred compensation, such as salaries and wages and bonuses and incentive awards, whether paid in cash or in stock.

b Deferred compensation is allowable to the extent that (i) it is for services rendered during the contract period; (ii) it is, together with all other compensation paid to the employee, reasonable in amount; and (iii) it is paid pursuant to an agreement entered into in good faith between the contractor and employees before the services are rendered, or pursuant to an established plan followed by the contractor so consistently as to imply, which constitutes, in effect, an agreement to make such payments. (But see ASHR 15-204.1(6)).

c In determining the cost of deferred compensation allowable under the contract, appropriate adjustments shall be made for credits or gains arising out of both normal and abnormal employee turnover, or any other contingencies that can result in a forfeiture by employees of such deferred compensation. Adjustments shall be made only for forfeitures which directly or indirectly inure to the benefit of the contractor; forfeitures which inure to the benefit of other employees covered by a deferred compensation plan with no reduction in the contractor's costs will not normally give rise to adjustment in contract costs. Adjustments for normal employee turnover shall be based on the contractor's experience and on foreseeable prospects, and shall be reflected in the amount of cost currently allowable. Such adjustments will be unnecessary to the extent that the contractor can demonstrate that its contributions take into account normal forfeitures. Adjustments for possible



future abnormal forfeitures shall be effected according to the following rules:

- (i) abnormal forfeitures that are foreseeable and which can be currently evaluated with reasonable accuracy, by actuarial or other sound computation, shall be reflected by an adjustment of current costs otherwise allowable; and
- (ii) abnormal forfeitures, not within (i) above, may be made the subject of agreement between the Government and the contractor either as to an equitable adjustment or a method of determining such adjustment.

d In determining whether deferred compensation is for services rendered during the contract period, or is for future services, consideration shall be given to conditions imposed upon eventual payment, such as, requirements of continued employment, consultation after retirement, and covenants not to compete. Similar consideration should be given to the cost of past service credits of pension and annuity plans.

(7) Fringe Benefits. See (o).

(8) Overtime, Extra-Pay Shift and Multi-Shift Premiums.

See (y).

(9) Training and Education Expenses. See (qq).

(10) Insurance and Indemnification. See (p).

See pages 2 & 3

(f) Compensation for Personal Services.

(1) General.

a. Compensation for personal services includes all remuneration paid or accrued, in whatever form and whether paid immediately or deferred, for services rendered by employees to the contractor during the period of contract performance. It includes, but is not limited to, salaries, wages, directors' and executive committee members' fees, bomuses, incentive awards, employee stock options, fringe benefits, and contributions to pension, annuity, stock-bonus and profit-sharing plans. <sup>Eligibility</sup> Subject to the limitations set forth in this paragraph (f), such costs are allowable to the extent that the total compensation of individual employees, in whatever form paid, is reasonable for the services rendered.

b. Compensation is reasonable to the extent that the total amount paid or accrued, in whatever form, is commensurate with compensation under the contractor's established policy and conforms generally to compensation paid by other contractors of the same size, in the same industry, or in the same geographic area, for similar services. Compensation will be particularly scrutinized to determine whether the compensation is reasonable in amount and is for actually personal services rather than a distribution of profits when paid (i) to owners of closely-held corporations, (ii) to partners and sole proprietors, (iii) to members of the immediate families of persons included in (i) and (ii) above or (iv) to persons who are committed to acquire a substantial financial interest in the contractor's enterprise. In addition, compensation expenses must be particularly scrutinized in light of the presence or absence of the restraints occurring in the conduct of competitive business.

THE CONTINUATION OF THE EXISTING SET OF PRINCIPLES WITHOUT CHANGE. THE AIA HAD, HOWEVER, PREPARED REVISIONS CONCERNING WHICH WERE NOT FORTHCOMING, AND WHEN IT BECAME EVIDENT TO MR. FOWLER OF THE AIA STAFF THAT HE WERE GOING AHEAD WITHOUT CONSIDERING THE AIA POINT OF VIEW AT ALL, HE INFORMALLY BROUGHT A CASE FOR OUR CONSIDERATION. WE THEREUPON CONSIDERED THE AIA VIEW UPON THE MERITS AND DISREGARDED THEIR DESIGN FOR A CONTINUANCE AND THEIR DESIGN TO KEEP THE COST PRINCIPLES AS IS.

This "final" effort culminated in a meeting with all of the industrial associations on May 21, 1956, which was held for the purpose of infusing industry of our final decisions. Notwithstanding the fact that there had been a succession of efforts with industry, industry strongly protested the procedure and indicated a desire to provide another comment on the basis of the draft distributed shortly before the 21 May meeting. Notwithstanding the fact that the latest comments were largely repetitions of comments previously submitted, we endeavored to consider their points of view more. This effort was finally terminated with the preparation of a draft dated September 27, 1956. In light of the industrial differences, together with the fact that the Air Force was reluctant to accept one of the principles regarding a major item of cost, Mr. Langley decided to confer with the Secretary of Defense and his Deputy about the problem.

COMPREHENSIVE SET OF COST PRINCIPLES. As indicated above, within the DOE there are currently two sets of cost principles for use, (1) in reimbursement of cost under cost-reimbursement type contracts and (2) as a basis for termination settlements. The OAO, certain Congressional groups and the Comptroller (OSO and the military departments) have noted that these uses did not cover completely the areas of procurement in which costs represented a significant feature of the negotiation. Thus, they observed, costs are an important consideration in the development of price but there were no standards of cost to apply in aid of the judgment. This resulted in a release of Section IV for the broader purpose. It is estimated that approximately 15% of our procurement appropriation is spent under these so-called fixed-price contracts and without a yardstick to measure the cost. In facing this problem before the House Appropriations Committee, Secretaries Fife and McNeill agreed with the Committee that this problem should be explored and each designated one representative to more fully develop the proposed comprehensive set. At the meeting with industry on May 21, 1956, industry was taken into our confidence with respect to the project and an invitation was issued to the industrial associations to provide their philosophical proposals, which they believe should underlie the broader principles. As of November 5, 1956, five associations had submitted proposals.

Attached are three papers dated November 5, 1956, regarding:

- (1) The Task Force's report on their principles, including a digest appraisal of the comments;

- (ii) a full evaluation, including in more precise terms the industrial comment and more fully our appraisal, and
- (iii) a proposed Procurement and Production Industry Advisory Committee Agenda Item, reporting a proposed method of going ahead with the problem.

Since November 5, 1956, AFMA has provided additional comment, which, to some extent, supports the staff appraisal but in material respects emphasizes the points of view already expressed by the other associations.

W. K. GERMER  
Brigadier General, USA  
Staff Director  
Purchasing & Contracting  
Policies Division

1 Incl.  
Memo for Dep. Asst. Sec. Def. (S&L)  
and DEP. Asst. Sec. Def. (Comp.)  
with Tabs A and B

Prepared by: TAPilson/lsh/1-18-57  
RB 3-D-773 x72026

Coordinated with:  
RB, Col. A. Fragosì \_\_\_\_\_



\*  
15-204.1 (b) The extent of allowability of selected costs covered in ASPR 15-204.2 has been stated so as to apply broadly to many accounting systems in varying contract situations. Thus as to any given contract the reasonableness and allowability of certain of the items of cost identified below in this paragraph (b) may be difficult to determine, particularly in the case of contractors whose business is predominantly or substantially with the Government. In order to avoid subsequent disallowance based on unreasonableness or non-allocability, the extent of allowability of such costs should be specifically negotiated and agreed to in advance of the contractor's incurring such costs under cost-reimbursement type contracts, fixed price incentive contracts, and fixed price contracts subject to retroactive price redetermination. Any such agreement should be incorporated in cost-reimbursement type contracts or made a part of the contract file in the case of negotiated fixed-price type contracts, and should govern the cost determinations covered thereby throughout the performance of the related contract.

✓

*Cost from after*  
OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

August 21, 1957

MEMORANDUM FOR MR. McGUIRE

*Marked in red*  
There are attached the sections of the cost principles which remain in dispute. These are the section on contributions and donations and the sections, within the compensation article, on stock options and profit sharing bonuses.

In the attached, these elements of cost are all shown as allowable subject to limitation. In each case the Air Force wants them shown as unallowable. Our compromise proposal has been to treat contributions and donations and stock options as unallowable with executive profit sharing bonuses as allowable.

All other elements of the cost principles has been agreed to by all three services in principle and the issues listed above are all that remain.

*Bannerman*  
G. C. BANNERMAN

Attachments

A 9407



## Office Memorandum • UNITED STATES GOVERNMENT

TO : Mr. G. C. Bannerman  
Director for Procurement Policy

DATE: 18 July 1957

FROM : T. A. Pilson  
Procurement Policies & Regulations Div.

SUBJECT: Comprehensive Set - Rationale for Allowability of Stock Options as Compensation.

In the "comprehensive" set, the compensation principle has been entirely recast. In so doing, we have accepted two basic concepts, strongly urged by industry in the industry proposals.

- (i) That if the expense is payment to the employee for services rendered, IT IS A COST to the contractor, and
- (ii) If it is a cost to the contractor, the DOD has the fundamental obligation to allow it, insofar as the compensation is reasonable in amount in light of the services rendered.

The above results in the conclusion that the DOD should not concern itself with the compensation technique employed, but should dedicate its attention to the more basic question, i.e., whether the total compensation to the individual, whatever technique or combination of techniques is employed, is reasonable in light of the services rendered.

We believe that the treatment provided in the "comprehensive" set results in fairness to the government and to the contractor. In the past development of the compensation principle, we have heard the argument that reasonableness of expenses is difficult to assure under certain of the techniques, and to allow as a cost the expenses of certain techniques would result in greater expenditures for defense products. In connection therewith, attention is called to the basic principles adopted at the outset of the "comprehensive" effort, wherein it is stated:

"Our objective ought to be fairness and equity in the development of 'one set' of cost principles. We should not deny nor restrict allowability of a cost otherwise fair because it would be costly to the government, or because reasonableness of amount is difficult to assure."

In any event, we believe that difficult fairness is to be preferred over simplified inequity.

The question arises as to whether the costs of stock options are to be considered as compensation of the individual for services rendered. If they are, the principle ought to be one of allowability of the stock option technique. The Supreme Court decided a case recently which gives guidance on this problem, and to us, conclusive guidance. The Case is Commissioner of Internal Revenue, Petitioner, v. Philip J. Lo Bue, 76 S. Ct 800. In that case, Lo Bue was given a series of stock options to purchase stock at great bargain prices, by his employer, in recognition of

his "contribution and efforts in making the operation of the company successful." Lo Bue exercised his option to his advantage. In the suit for taxes on the gain, Lo Bue contended that:

"The said options were not intended by the Corporation or the petitioner to constitute additional compensation but were granted to permit the petitioner to acquire a proprietary interest in the Corporation and to provide him with the interest in the successful operation of the Corporation deriving from an ownership interest."

The Tax Court stated the issue this way:

"Lo Bue had a taxable gain if the options were intended as compensation but not if the options were designed to provide him with 'a proprietary interest in the business'".

The Supreme court ruled that the option gain was compensation. The syllabus of the case stating:

"When assets are transferred by an employer to an employee to secure better services, they are 'compensation' . . . . and it makes no difference if the compensation is paid in stock rather than in money."

"Where employee received very substantial economic and financial benefit, consisting of stock options, from his employer because of employer's desire to get better work from employee, this was 'compensation for personal service'. . . ."

Since, as the Court observed, the stock option technique was a method of providing "compensation for personal services; and since it is the fundamental premise of this paper that the total amount of the compensation is the critical consideration as to the allowability of the costs, we believe that a proper use of the technique must be "allowable."

The one possible argument against allowability of the technique is to contend that the item relates to the capital of the company and is therefore not a cost which can be allocated to the contract by reason of the definition of allocable cost (15-201.2) as follows:

- " (iii) Thus, a cost allocable to the Government contract is one which:
- d. does not involve transactions relating to the capital of the business, . . . ."

The Lo Bue case did not, of course, cover specifically the problem of proper treatment of the expense by the contractor. It did, however, say this:

"Thus, at the end of these transactions, Lo Bue's employer was worth \$8,230 less to its stockholders and Lo Bue was worth \$8,230 more than before."

It must be pointed out that the "capital" argument applies in equal force to stock bonuses (paragraph iii), as both relate equally to capital of the Company. As to

stock bonuses, so far as we have been able to determine, the technique is presently allowable, has been allowable in all recent drafts of Section XV, at least not disapproved by the Material Secretaries Council in its many considerations of the Compensation principle.



DEPARTMENT OF DEFENSE  
OFFICE OF GENERAL COUNSEL  
WASHINGTON 25, D. C.

August 6, 1957

MEMORANDUM FOR MR. G. C. BANNERMAN  
Director for Procurement Policy  
Office of the Assistant Secretary of Defense  
(Supply and Logistics)

SUBJECT: Treatment of Stock Option Arrangements as Costs by Contractors

Reference is made to your memorandum dated July 25, 1957, in which you ask the question whether it is legally proper for the Government to pay as part of the cost of a contract the amount that represents the difference in the fair market value of stock in the company and the price at which the stock is offered an employee under an employee stock option plan.

While it is technically legal for the Government to compensate a contractor for any legal expense, the question arises whether or not the Government should compensate a contractor for an expense not permitted as a business expense under Section 162 of the Internal Revenue Code of 1954.

Section 421 of the Internal Revenue Code provides that if an employee purchases stock under a restricted stock option, no income shall result to the individual at the time of transfer of such share upon his exercise of the option and that no deduction is allowable to any time to the employer under Section 162 (relating to trade and business expenses).

A restricted stock option is defined as an option granted to an individual for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any such corporations, but only if --

- a. the option price is at least 85 per cent of the fair market value at such time of the stock subject to the option,
- b. the option by its terms is not transferable by such individual except by will or laws of descent and distribution, and is exercisable during his lifetime only by him,

VECTIAED

- c. the individual does not own more than 10 per cent of the total combined voting power of all classes of stock (with certain exceptions), and
- d. the option is not exercisable after the expiration of ten years from the date the option is granted.

It is understood that a preponderance of the employee stock options are now of the restricted type in order to permit the employee to avoid an increased income tax. It would appear anomalous for the Department of Defense to be more generous than the Internal Revenue Service.

Although your memorandum did not raise the question, this office expresses an interest in item (cc), Taxes, on page 26. This area is currently under consideration by this office as a result of litigation in California. We would like to look further into this proposed section and desire to comment on the subject at a later date.

SIGNED

*Jack L. Stempler*  
Jack L. Stempler  
Assistant General Counsel (Logistics)

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RECEIVED



ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON 25, D. C.

SEP 27 1957

SUPPLY AND LOGISTICS  
CD

MEMORANDUM FOR THE SECRETARY OF DEFENSE

SUBJECT: Contract Cost Principles

There is attached a comprehensive set of contract cost principles, designed for use in all types of pricing situations where costs are a factor in our contracts with commercial organizations. These principles will be used for accumulating, reporting and evaluating costs and cost estimates in connection with fixed price negotiations, price redetermination negotiations, cost allowances in cost reimbursement contracts and in the settlement of terminated contracts. Thus they will be used in connection with contracts having a high element of risk as well as in contracts with relatively little risk. Subject to the resolution of one remaining issue, which is described below, it is proposed that this set of cost principles be furnished immediately to the industrial associations for comment and, after full consideration of such comments and appropriate modifications of the principles, that they be incorporated in the Armed Services Procurement Regulation.

This set of cost principles is the result of an immense amount of work by many people. A large number of controversial issues have been resolved and the resultant principles, subject to one unresolved issue, have the full support of all interested elements within the Department.

The remaining issue is concerned with the treatment of cash bonuses and incentive compensation which are dependent upon or measured by profits. The Secretary of the Air Force is of the opinion that this portion of compensation should never be allowed or treated as a cost. The other Departments, Mr. McNeil and I are of the opinion that, where a contractor's income is predominantly derived from non-governmental work or from governmental work obtained as a result of price competition or from a combination of the two, the payment of bonuses or incentive compensation dependent upon or measured by profits should be allowed or treated as a cost provided the total compensation is reasonable. There are attached statements in support of each of these positions.

Inclosures

*Perkins McGuire*  
PERKINS MCGUIRE  
Assistant Secretary of Defense  
(Supply and Logistics)

10/98



Draft 10/21/59

**BACKGROUND DISCUSSION  
SECTION XV--CONTRACT COST PRINCIPLES AND PROCEDURES  
ASPR CHANGE No. 50**

**Purpose**

The purpose of this paper is to provide certain background information and the answers to questions which are anticipated in connection with the issuance of the new Section XV, ASPR.

**Background**

The history of cost principles utilized in making cost determinations under defense contracts reveals a continuing search for a uniform, improved, and consistent body of such principles -- satisfactory alike to the Government and the contractor. The World War II period and the years immediately following saw the birth of several sets, each of which was applicable to different departments or different phases of contract administration.

The first of these applicable to World War II contracts was Treasury Decision 5000. Adopted in 1940, this Decision was promulgated for the purpose of recapturing excess profits on certain contracts for vessels and aircraft, but in the absence of a more satisfactory statement of cost principles its use was extended to virtually all cost-type contracts entered into by the War Department (later the Departments of Army and Air Force) until 1949. The Navy Department utilized T. D. 5000 until 1942 when it issued an "Explanation of Principles for Determination of Costs Under Government Contracts" (the so-called "Green Book"). These Principles were employed by the Navy in making cost determinations under

cost-type contracts until 1949. Section XV, "Contract Cost Principles," Armed Services Procurement Regulations, was adopted by the Department of Defense in 1949 and was applicable only to cost-type contracts.

Cost principles employed in contract terminations have likewise varied. Certain cost principles applicable in the event of termination were issued under the authority of the Contract Settlement Act of 1944, and these were subsequently continued in use upon the expiration of that Act. These were superseded by the adoption of Section VIII, "Termination of Contracts," ASPR, Part 4 of which contained a statement of principles applicable to the settlement of fixed-price contracts. These principles were also applicable to negotiated settlements under cost-type contracts.

Despite the apparent wealth of cost principles, the situation was recognized to be unsatisfactory. There was no set of principles applicable to the negotiation and performance of fixed-price contracts -- only to their termination. Section XV, ASPR, has been used to some degree "as a guide only" but even this use went beyond assurances given Government contractors at its adoption and has been a constant source of conflict between contractors and the Government. Sections VIII and XV were not uniform in setting forth which costs were allowable or unallowable, so there existed the anomalous situation of certain costs being unallowable if the contract is completed, but allowable if terminated. Further, a pattern of "implementing" instructions by directive developed to the extent that the mere volume of rules was forbidding, plus the fact that such directives were inconsistent between departments, and they not infrequently altered, through change or restriction, the policy adopted by the Department of Defense. All of these factors pointed to the need

for and desirability of a single set of cost principles to be applicable to all types of contracts and all phases of the contracting process where consideration of costs was involved.

The process of recovery of excessive profits by renegotiation provides, by statute, for cost allowances on defense contracts more liberal than provided by Section XV, ASPR. The renegotiation regulations state specifically that the Renegotiation Board will not recognize cost disallowances pursuant to Section XV or other contractual provisions in contravention of the Renegotiation Act.

Moreover, the statement is frequently made in Government that the cost principles under the Internal Revenue Code have no necessary application to defense contract costs, and no attempt need be made to reconcile them. These general inconsistencies between different programs of the Government are undesirable.

The philosophy underlying the various sets of contract cost principles likewise indicated that a change was in order. Treasury Decision 5008 in defining allowable cost stated: "The cost of performing a particular contract or subcontract shall be the sum of (1) the direct costs .. and (2) the proper portion of any indirect costs ... incident to and necessary for the performance of the contract or subcontract. (Emphasis supplied). The phrase "incident to and necessary for" was interpreted by Government auditors, including those of the General Accounting Office, in such manner as to preclude reimbursement to the contractor of a share of normal business costs where it could not be demonstrated by the contractor that the incurrence of the cost was quite

directly related to the performance of the contract. The "Green Book" referred to above contains the same restrictive language. In consequence numerous indirect costs were disallowed.

Section IV, AEPF, in defining total cost, used the phrase "... incident to the performance of the contract, ..." in an effort to get away from the restrictive interpretation of T.B. 5000; while Section VIII, AEPF, used "... reasonably necessary to the performance of the contract." However, the cost principles contained in each of these Sections included a list of unallowable costs which, in many situations, vitiated the advantages gained from the changed language.

#### Characteristics

Flexibility -- Based upon past experience, it was recognized that the mere statement that a cost was allowable or unallowable, or that every contractor's system and methods for determining cost must be "strait jacketed" into a common pattern, was not the answer. The path chosen was a difficult one. It was followed to achieve the objective of providing a reasonably comprehensive and complete basis for reaching an agreement or understanding between the parties on contract costs for pricing purposes. It also furnished restrictive safeguards and highlights areas where special care must be exercised to assure equity. Adequate details and explanations are incorporated which, it is believed, will provide intelligent users with sufficient philosophy underlying the principles to permit their application to the many varying conditions and circumstances which may be encountered. Thus, for the most part, no formulae or ready-made decisions are provided.



Advance Agreements -- Closely related to the preceding subject of flexibility is the provision for advance agreements contained in Par. 15-107. While the principles do not give specific directions for handling each problem, good contracting requires that the contract reflects a complete meeting of the minds of the contractor and the contracting officer. Thus the admonition is given that specific agreements should be reached as to the handling of any difficult problems before the fact, rather than waiting until after the costs have been incurred. Having both parties aware of the ground rules before the game is started should eliminate many disputes and simplify administration and settlement.

Avoidance of Formula Pricing -- The proposed statement should be read with the clear understanding that it constitutes only one section of the Armed Services Procurement Regulations -- that part confined primarily to establishing cost principles and standards for use where costs are a factor in determining what the Government will pay for contractual supplies or services. It is not intended that it provide all the necessary guidance, regulations, and procedures as to methods of negotiation, pricing, determination of profit margins, choice of the appropriate type of contract, or auditing. There is to be inferred no desire to encourage the greater use of contract forms other than outright fixed-price contracts, or the greater use of cost data in negotiating prices on outright fixed-price contracts. In fact, the use of other factors, such as effective competition or standards established on the basis of prices of other efficient producers or production in our own plants, are to be preferred in negotiated firm prices. Criteria to

serve these purposes are contained in other sections of ASPR, though for emphasis, some of them are repeated in Section XV. Other related sections are those concerned with taxes, patents, and Government furnished property.

The statement should not be looked upon as something which provides a formula which contracting officers can apply mechanically and have the price, or even an aggregate cost figure, appear automatically as a result. It constitutes a middle-of-the-road approach. It attempts to be sufficiently explicit to provide guidance for negotiators and auditors, but must necessarily be broad enough for application to the extremely varied conditions encountered in the contracting process. These varied conditions arise from wide differences in: the nature of contractors' businesses and organizations, the degree of criticalness of need for items being procured, supply of production facilities, and types of contracts used.

Recognizes Generally Accepted Accounting Principles -- Basically, the statement is founded on generally accepted accounting principles and standards (including cost accounting as well as general financial accounting). However, the reader may be able to cite examples in which departures have been made from this basis. These infrequent departures were dictated, in some instances, by public or business policy, and in others by long-standing precedent. The unallowability of entertainment, purely for entertainment's sake, and restrictions on advertising are examples of such departures.

Recognizes Normal Business Practice -- A significant characteristic which is apparent throughout the statement is that the principles will not ordinarily alter a contractor's normal business practices. In fact,



every effort shall be made to follow them. Safeguards have been provided, however, against any abuse of this approach, particularly where defense work constitutes the major part of a contractor's efforts, in that reasonableness of costs such as executive compensation and research development is accorded special scrutiny. Likewise, evidence of arm's length bargaining must be present in determining the allocability of such items as executive compensation, bonuses, and property rentals. Unreasonable deviations from good accounting practices are expected to be corrected by all responsible contractors.

Effect on Defense Procurement Costs -- Some charges have been made that use of the new principles will cause procurement costs to skyrocket. Though no reasons have been advanced, it is possible that this impression may have arisen from the fact that some costs are specifically allowed on which the prior Sec. IV was silent or provided for allowance only as provided for in the contract.

While only experience will provide a firm answer, it is not believed that this charge is valid. First, it is anticipated that the effect on cost-reimbursement type contracts will be minor. The minor possible increases due to changes in allowability of certain elements of costs, such as advertising and research and development, are likely to be offset by greater emphasis on the concepts of reasonableness and allocability.

Second, and more important, a substantial portion of procurement in recent years has been under incentive or fixed-price-type contracts containing price redetermination provisions. It can be safely assumed that part of this increase has been due to the fact that the rather

restrictive cost provisions of Section IV do not apply to those types of contracts, and in practice more liberal allowances have been made in pricing such contracts. In addition to obtaining reimbursement for some of these otherwise unallowable costs by this means, cost to the Government is often increased because the percentage of profit is usually higher on fixed-price contracts containing retroactive price-redetermination clauses than on cost-type contracts. Thus the advent and intelligent application of the guides provided in the proposed statement for appropriate use in fixed-price contracts may well decrease the cost of procurement by the Government.

#### Changes Relating to Selected Cost Elements

As indicated above, no significant changes in allowability of individual elements of cost were made. However, in Par. 15-205, the approach to each element has been changed. Rather than a mere listing as allowable or unallowable, each cost is defined, discussed where appropriate, and then generally classified as to allowability. Secondly, instead of listing certain costs as requiring further consideration as was done in the predecessor Regulation, guidance as to their handling is provided. The following paragraphs highlight and summarize a few of the more important items.

Advertising Costs -- Costs allowable under the present Sec. IV continue to be allowed. In addition costs are made allowable for participation in exhibits under certain circumstances, and for obtaining source material or disposing of scrap or surplus.

Bidding Costs -- While not specifically mentioned in the prior regulation, the new provision is consistent with past practice of making such costs allowable.

Civil Defense Costs -- Costs of such measures as are undertaken on the contractor's premises are allowable. Contributions for off-premises projects are unallowable for purposes consistency with the contributions provision.

Compensation for Personal Services -- The new statement is not inconsistent with the old. However the many forms in which compensation can be paid are specifically covered. This should eliminate inconsistencies in treatment of this cost which have occurred in the past. Generally the new statement makes allowable, compensation in any form, so long as it is reasonable for the services rendered. Special note is made of the necessity for evaluation of reasonableness of compensation and guides are provided for such evaluation.

Stock options are not allowed as a form of compensation.

Contingencies -- Since the new principles relate to forecasting as well as historical costing, certain classes of contingencies are allowable.

Contributions and Donations -- Continue to be unallowable.

Depreciation -- No substantial changes have been made from past practices. However, explanatory material is included stressing the influence of economic factors on depreciation rather than concern exclusively with physical life. In addition, under certain conditions a use charge may be allowed in connection with assets fully depreciated on the books of the contractor.

Interest -- Continues to be unallowable.

Material Costs -- Acceptable bases of charging for materials used are set forth.

Plant Reconversion Costs -- Generally the rule follows past practice of allowing only those costs related to the removal of Government property. However, in special circumstances where equity dictates, additional costs may be allowed if authorized before incurrence of the costs.

Rental Costs -- Factors are provided for evaluating the reasonableness of rent. In the case of sale and leaseback arrangements, rental allowance is made only to the extent that it does not exceed the amount which the contractor would have recovered as a cost had he retained legal title.

Research and Development Costs -- This cost relates to those research and development activities carried on independently by the contractor, which are not sponsored by a contract, grant or other arrangement. The policy treats research separately from development. An allocable share of a contractor's current independent research is allowable against all contracts. Development costs are allowable to the extent they are related to the contract product line, or in the case of exclusively research and development contractors, to the field of effort of research and development contracts.

Amortization of such costs incurred in prior periods are not allowable. This treatment is considered to be equitable in that the Government will pay its share of current costs regardless of any direct benefit derived, but in exchange therefor, will not bear any share of the cost of the contractor's past research even though its contracts



benefit therefrom.

Finally, safeguards are provided to assure reasonableness of costs through approval of the contractors research and development program and cost sharing arrangements under appropriate circumstances.

Selling Costs -- Such costs are allowable but special care is directed to assure consideration of their proper allocability; i.e., reasonable benefit is derived to the Government therefrom.

Severance Pay -- This represents another of the several difficult elements of cost on which guidance has not previously been provided. Costs arising from severance pay in connection with normal employee turnover are allowable. Abnormal or mass severance pay is of such a conjectural nature that any accrual therefor is not allowable. However, the Government recognizes responsibility for its fair share of such costs in the event of occurrence and will consider allowability on a case by case basis.

Termination Costs -- While the aggregate of principles included in Part 2 are applicable to termination situations, such terminations give rise to the incurrence of costs, or the need for special treatment of costs. These special provisions have been eliminated from Sec. VIII, where they appeared previously, and incorporated in Part 2.

Training and Educational Costs -- Costs of routine training and education related to job requirements are allowable. As a means of assuring reasonableness of a contractor's training program, cost of extraordinary programs are shared with the contractor through disallowance of such items as salaries and subsistence paid to full time, post-graduate employee students.

1957

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MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SAL)

SUBJECT: Short History of the Cost Principles Problem

**BACKGROUND:** Within the ASPR there are two sets of cost principles, (i) Section XV, directed for use ONLY for the reimbursement of costs under cost-reimbursement type contracts, and (ii) Part b, Section VIII, Termination, a set slightly different from XV, for the use as a basis for Termination Settlements. Both sets are similar in format, but as indicated above are slightly different in treatment of the elements of cost. The format is one of merely naming the items of cost under three headings:

- (i) examples of items of allowable cost,
- (ii) examples of items of unallowable cost, and
- (iii) examples of subjects requiring special consideration.

The OAS, certain Congressional groups and the Comptrollers (OSD and the military departments), as well as the procurement elements of the Department of Defense have been critical of this format, contending that the principles should be considerably amplified by (i) providing a definition of each of the elements of cost and (ii) such additional guidance as will minimize the need for departmental implementation.

In addition to these, there was a general feeling that the existing principles ought to be reviewed and perhaps adjusted to provide a more equitable coverage of certain items of cost incurred by the contractor.

**REVISION OF SECTION XV:** Over a period of several years, several drafts have been submitted to the TEN industrial associations with whom we customarily coordinate our activities. As might be expected, the various elements of industry reacted differently. In General, the National Security Industrial Association, the National Association of Manufacturers, Machinery and Allied Products Institute, the Radio-Electronics-Television Manufacturers Association and the Automobile Manufacturers Association have provided useful philosophical guidance, which they desire that we substitute for that contained in the draft being criticized and constructive word changes embodying their proposed philosophies. The Aircraft Industries Association INTERESTINGLY DID NOT OFFICIALLY RESPOND AT ALL ON THE MERITS OF ONE SUCH DRAFT. THEIR RESPONSE WAS A SIMPLE ONE PAGE LETTER WHICH SAID IN EFFECT THAT ALL OF THE PHILOSOPHIES INCLUDED IN THE DRAFT WERE WRONG AND THAT CONSEQUENTLY THEY WOULD PREFER



These figures demonstrate conclusively that the new regulations would not only subject cost data to substantially more detailed and lengthy analyses and reviews, with added costs to both Government and contractors, but that the negotiation process would likewise be lengthened. They also show that contractors must expect to recover substantially less of their costs than they have heretofore obtained under cost reimbursement type contracts, and to the extent the proposed regulations are applied to other types of contracts, contractors must expect disallowances of cost equivalent to the new measure of disallowances under cost type contracts. If applied to terminations, the allowable recovery would also be much less than under the provisions of Section VIII of ASPR. It is impossible to predict the measure of such non-recoveries under the new regulation, but they would represent a substantial portion of profits.

1 Incl.  
Cpy memo in Mr. Sculnier

J. M. MALLOY  
Cdr, SC, USN  
Staff Director, ASPR Division  
Office of Procurement Policy

Prepared by: Cdr JM Malloy/rba/  
3/3/59  
3D 774 XT2026

Coordinated by: Mr. Bannerman \_\_\_\_\_

CA

3 March 1959

**MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)**

**SUBJECT: Discussion of Contract Cost Principles Before the Committee on Government Activities Affecting Costs and Prices.**

I am attaching a copy of the memorandum which we have received from Mr. Saulnier, requesting that the contract cost principles be discussed prior to issuance before the Committee on Government Activities Affecting Costs and Prices. I think that it would be most unfortunate if we let the contract cost principles become involved in the anti-inflation exercise. I suspect that none of the individuals on this Committee have the necessary background to evaluate the pros and cons of the proposed contract cost principles. We can only look forward to another delaying action. I strongly recommend that we take whatever informal steps that may be appropriate to allow us to take no action on Mr. Saulnier's request.

As a generality, it is my view that the revised cost principles are slightly more liberal than those currently appearing in Section XV. The research and development principle is potentially the most inflationary, but even here it is not possible to predict the impact of our revision since its impact in actual fact may well be diminished by our administration of the principle. You may be able to use the following quotation from the industry letter of 7 November 1958 in any discussion which you might have with Mr. Saulnier.

"To what extent is the Government, in these proposed regulations, refusing to bear its fair share? It would disallow 23 items entirely, of which only 18 are disallowed by the provisions of the present Section XV of ASFR. It would partially disallow 20 other items, of which only 6 are disallowed by the present ASFR. It would subject 19 other items to special tests or reviews (not "principles") which would, by definition or tests applied, lead to still more partial or total disallowances. Of these 19 items, 3 are disallowed and 7 are subject to "special consideration" under the present ASFR. The proposed regulations also suggest advance negotiation of 9 items of which 7 are on the list for "special consideration" under the present ASFR. Nowhere in the document, however, advance negotiation is stated as a requirement of cost allowances in 6 additional cases. The identification of the above statistics are included in the attachment hereto.

1952



NUMBER 4105.49  
DATE April 8, 1958

## Department of Defense Instruction

ASD(S&L)

SUBJECT

Contractors' Costs for the Recruitment of Engineering  
and Scientific Personnel

### I. PURPOSE

The purpose of this Instruction is to prescribe the basic policy to be followed and the basic criteria to be used in determining reasonableness of costs incurred by contractors in connection with the recruitment of engineering and scientific personnel.

### II. APPLICABILITY

The provisions of this Instruction apply in all cases where the determination of reasonableness of subject costs is a necessary adjunct to proper contract pricing.

### III. GENERAL

There exists a strong nationwide demand for engineering and scientific personnel created by the rapid pace of technological development. This, together with the fact that the supply of such personnel is limited, has brought about an intense competition to recruit and hold qualified personnel and has led to costly recruitment programs and practices. This in turn has pointed up the need for assuring that contractors' recruitment costs are maintained at a reasonable level. Statistical data compiled with respect to selected contractors reveal extremely wide differences in such important conditions affecting recruitment as the nature of operations, the size of engineering and scientific staffs maintained, the amount and nature of recruitment costs incurred, the number of new employees hired, and the rate of employee turnover. In view of these differences, it is clear that the establishment of fixed quantitative standards to measure reasonableness is not practicable and that reasonableness must be judged on a case-by-case basis.

### IV. POLICY

Reasonableness of recruitment costs will be determined on a case-by-case basis, taking into consideration all of the conditions bearing on the particular case, including the magnitude of the recruitment problem, the effectiveness of the control and administration exercised with respect to the formulation, direction and cost of recruitment programs and practices, and the effectiveness of the recruitment programs and practices themselves.

V. CRITERIA

In determining reasonableness of recruitment costs, due weight shall be given to the following criteria:


- (1) Evidence of effective budgetary control of recruitment costs.
- (2) Evidence of effective administrative control and direction in the formulation and operation of recruitment programs.
- (3) Evidence of other effective controls and reviews to detect and prevent indiscriminate, imprudent, and costly recruitment practices.
- (4) Evidence that the size of the engineering and scientific staffs recruited and maintained is in keeping with workload requirements.
- (5) Evidence of effective analysis to determine the cause and effect of the rate of employee turnover.
- (6) Evidence that payments of allowances to new and prospective employees are reasonable and governed by established policy.
- (7) Evidence that salaries and fringe benefits, including educational benefits, offered to new employees are reasonable and governed by established policy.
- (8) Evidence of violations of recruiting ethics in the form of proselyting.


VI. IMPLEMENTATION

Each military department shall take appropriate action to assure that its existing instructions are consistent with this instruction. Four copies of existing or additional Instructions necessary to implement this Instruction will be submitted to the Assistant Secretary of Defense (Supply and Logistics) within 30 days from the date hereof.

VII. EFFECTIVE DATE

This Instruction is effective upon publication.

  
PERKINS MCGUIRE  
Assistant Secretary of Defense  
Supply and Logistics

  
W. J. McNEIL  
Assistant Secretary of Defense  
Comptroller

AUG 4 1958

MEMORANDUM FOR THE SECRETARY OF DEFENSE

SUBJECT: Suggested Language for the Cost Principle Covering Executive Bonuses Based Upon Profit

At the meeting in your office, on the contract cost principles, on August 1, 1958, you asked that we send you the proposed language for inclusion in the principles to make profit sharing payments an allowable part of compensation to the extent total compensation is reasonable.

Since the profit sharing method is simply one portion of the overall treatment of the subject of "compensation" in the principles, there are already general statements under this subject which are applicable. A description of two of these follows:

1. After citing examples of the various methods of compensation, the statement is made that: "Except as otherwise specifically provided in this paragraph, such costs are allowable to the extent that the total compensation of individual employees is reasonable for the services rendered."
2. This is followed by an expansion on the general "reasonableness" provision as follows: "Compensation is reasonable to the extent that the total amount paid or accrued, is commensurate with compensation paid under the contractor's established policy and conforms generally to compensation paid by other contractors of the same size, in the same industry, or in the same geographic area, for similar services. Compensation will be particularly scrutinized to determine whether the compensation is reasonable in amount and is for actual personal services, rather than a distribution of profits, when paid (i) to owners of closely held corporations, (ii) to partners and sole proprietors, (iii) to members of the immediate families of persons within (i) and (ii) above, or (iv) to persons who are committed to acquire a substantial financial interest in the contractor's enterprise. In addition, compensation expenses must be particularly scrutinized in light of the presence or absence of the restraints occurring in the conduct of competitive business."

C D (Bonner)



In discussing this subject in that portion of the cost principles where allowability of specific types of compensation is dealt with in detail, the following language would be used (the portion in brackets is the only new material):

OUT? → Cash Bonuses and Incentive Compensation. [“Incentive compensation for management employees (whether or not dependent upon or measured by profits),” cash bonuses, suggestion awards, and safety awards, based on production, cost reduction or efficient management or performance, are allowable to the extent that the overall compensation is determined to be reasonable and such costs are paid or accrued pursuant to an agreement entered into in good faith between the contractor and the employees before the services were rendered, or pursuant to an established plan followed by the contractor so consistently as to imply, in effect, an agreement to make such payment. (But see ASPR 15-204.1(b).)”]

The reference to ASPR 15-204.1(b) is to that section of the cost principles which we discussed with you, which states that where contractors are predominantly engaged in government work and where the reasonableness of a cost may be difficult to determine, the contractor should arrive at an agreement with the government as to such costs in advance of incurring them.

It is recommended that you approve the above language for inclusion in the cost principles.

SIGNED

W. J. McNEIL  
Assistant Secretary of Defense  
(Comptroller)

SIGNED

PERKINS MCGUIRE  
Assistant Secretary of Defense  
(Supply and Logistics)

Prepared by: GCZannerman and  
KKilgore/kh/4 Aug 58  
73177

0-59

COVERING BRIEF

CR

TO: The Assistant Secretary of Defense (Supply and Logistics)  
FROM: Director for Procurement Policy

Problem: To provide an advance copy of the new Cost Principles to Congressman Hebert for information.

Discussion: The attached letter to Congressman Hebert is designed to afford him with an advance copy of the new Cost Principles. We have no commitment to clear our principles with Congressman Hebert prior to their publication. We feel, however, that we should give him an advance copy as a matter of courtesy in view of his sustained interest in this subject.

Recommendation: That you sign the attached letter.

Concurrence: Assistant Secretary of Defense (Comp) (Mr. Kilgore)  
General Counsel

*Cdr Malloy*



OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON 25, D. C.

SUPPLY AND LOGISTICS

AUG 9 1958

*See Mr  
McElroy's  
Comment on  
page 2.  
gym*

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)

SUBJECT: Contract Cost Principles

We are in the process of changing the 10 September 1957 draft of the Contract Cost Principles to give effect to the recent decisions made by Mr. McElroy as well as certain other changes which were indicated by industry comments. I estimate that we will have a new draft available for forwarding to industry in about two weeks. We are planning to set up our industry meeting for early October. I will provide you with a specific proposal for the conduct of this meeting in the near future.

It is my understanding that the following decisions were made by the Secretary of Defense with respect to the compensation principle at the 6 August 1958 meeting:

1. Incentive compensation of the profit sharing type would be an allowable cost to be considered as a portion of total compensation. Total compensation would, of course, be subject to the overall test of reasonableness.
2. Include a provision in the compensation principle to the effect that we would not allow any part of compensation not deductible for tax purposes.
3. Delete the words "(whether or not dependent upon or measured by profits)" from the paragraph entitled "Cash Bonuses and Incentive Compensation" in your memorandum of 4 August 1958 to the Secretary of Defense.
4. Endeavor, as best we can, to expand our treatment of "reasonableness" as applied to compensation. Additional guidelines or standards to measure the reasonableness of total compensation should be developed to the extent practicable.
5. Provide for joint action by the Departments in those situations where there is a mutual interest and where the determination as to the reasonableness of compensation is difficult.
6. Provide for some type of control over total compensation during the transition period so as to preclude the allowance of increased compensation over that previously paid by the company merely by reason of our action in allowing profit sharing plans as part of total compensation.

7. Submit the new cost principles to the Hebert Committee after we have issued them.

SIGNED  
G. C. BANNERMAN  
Director for Procurement Policy

8/14/58

Look for  
representative  
my understanding  
of the results  
of the meeting  
of the  
Council

McELROY MEETING ON COST PRINCIPLES -- 8/6/58

1. Approved concept of including incentive compensation of the profit sharing type as part of total compensation, subject to reasonableness.

2. Include a caveat that we do not allow any part of compensation not allowed for tax purposes.

3. Delete parentheses (whether or not dependent upon or measured by profits) from suggested treatment in 8/4 memo.

— 4. Consider if we can beef-up definition of "reasonableness" as applied to compensation.

5. Provide procedure for joint consideration of determination of reasonableness by three departments when compensation is large and business is predominately with the Government. This may best be handled separately through an administrative instruction.

— 6. Provide for some type of control of total compensation during transition period so as to preclude increases in total compensation, above that heretofore allowed, merely as a result of our policy change.

— 7. Develop, as best we can, additional guidelines or standards to measure reasonableness of total compensation.

8. Submit entire package to Hébert Committee after issuance.

1/29/58

CONGRESS OF AIRCRAFT INDUSTRIES ASSOCIATION  
STATEMENT TO SECRETARY OF DEFENSE  
22 January 1958

CONTRACT COST PRINCIPLES

Cost principles for use in connection with cost-reimbursement type contracts have existed in one form or another since 1940. However, there has existed no guidance with respect to the handling of costs in connection with other types of negotiated contracts. These "other types," constituting some 67% of our procurement over the past six years, include redeterminable, incentive, and negotiated firm fixed-price contracts in which costs are often a major factor in determining price.

We have long recognized the need for cost principles for use in connection with the various types of so-called fixed-price contracts. More recently considerable pressure has been brought to bear by the Congress, the Comptroller General, and other outside organizations for adoption of cost principles of broader application.

AIA's major point in this connection is that cost principles should apply only to cost-reimbursement type contracts and that a separate set of guidelines should be established for use by auditors in gathering data with respect to fixed-price contracts. This view has received little support, either within or without Government. Costs are costs whatever the nature of the contract. Only the influence of those costs on pricing differs according to the type of contract and the individual conditions surrounding a particular procurement.

Under the existing condition in which there is no guidance relative to costs under fixed-price contracts, there is nonuniformity of treatment between military departments, within departments, and between



contractors. As a result, whether certain costs, such as advertising, profit-sharing, and certain research, are considered in establishing a price depends upon policy of the negotiating agency, or bargaining position or negotiating ability of the contractor. Our position is that we must establish cost principles on a basis that will equalize cost treatment between the several types of contracts so that one type of contract will be neither less nor more attractive to either party by reason only of the cost treatment.

The other specific criticisms of the proposed principles by AXA will be covered in more detail in connection with our analysis of comments received from all of industry.



OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON 25, D. C.

SELDEF MEETING

AUG. 6, 1958

AUG 8 1958

CP

SUPPLY AND LOGISTICS

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)

SUBJECT: Contract Cost Principles

We are in the process of changing the 10 September 1957 draft of the Contract Cost Principles to give effect to the recent decisions made by Mr. McElroy as well as certain other changes which were indicated by industry comments. I estimate that we will have a new draft available for forwarding to industry in about two weeks. We are planning to set up our industry meeting for early October. I will provide you with a specific proposal for the conduct of this meeting in the near future.

It is my understanding that the following decisions were made by the Secretary of Defense with respect to the compensation principle at the 6 August 1958 meeting:

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2. Include a provision in the compensation principle to the effect that we would not allow any part of compensation not deductible for tax purposes.
3. Delete the words "(whether or not dependent upon or measured by profits)" from the paragraph entitled "Cash Bonuses and Incentive Compensation" in your memorandum of 4 August 1958 to the Secretary of Defense.
4. Endeavor, as best we can, to expand our treatment of "reasonableness" as applied to compensation. Additional guidelines or standards to measure the reasonableness of total compensation should be developed to the extent practicable.
5. Provide for joint action by the Departments in those situations where there is a mutual interest and where the determination as to the reasonableness of compensation is difficult.
6. Provide for some type of control over total compensation during the transition period so as to preclude the allowance of increased compensation over that previously paid by the company merely by reason of our action in allowing profit sharing plans as part of total compensation.

7. Submit the new cost principles to the Hébert Committee after we have issued them.

*G. C. Bannerman*

G. C. BANNERMAN  
Director for Procurement Policy

ASD(SVL) has seen & concurs - <sup>8/14</sup> per Jim B

CT

Oct 52

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)

SUBJECT: Contributions and Donations - Armed Services' Associations.

Mr. McNeill's memorandum of 17 September brings up the question of lovability of contributions and donations. He says:

"To my mind it is questionable whether contributions to any of the Armed Services' associations should be recognized as legitimate business expense..."

You will recall that the allowability of contributions and donations one of the issues which is included in the agenda for consideration at a DOD-Industry meeting of 15 October. You will recall also that this is one of the issues which we discussed with the Secretary of Defense in our memorandum of 18 June, 1958 and at the several meetings held with him subsequent thereto. Attached to this letter was the following indication the Industry and Government positions:

Industry Position

The making of contributions is essential to the conduct of a business and the failure to do so adversely affects the contractor's standing in the community and, hence, his employee relations. Such contributions aid in the development of technical education and scientific research. These costs are deductible for tax purposes.

Government Position

The allowance of contributions and donations would put contractors in the position of being able to give away the government's money. They bear no relation to the conduct of government work. As a matter of government policy these costs have never been allowed under any prior cost principles and we feel that we should not change this policy.

The Secretary agreed that our position was proper for the purpose of the conduct of the meeting.

*M. E. L.*

To apply this conclusion to the problem at hand, our position, at this time, is that "ALL CONTRIBUTIONS AND DONATIONS SHOULD NOT BE ALLOWABLE." All contributions would, of course, include contributions made to the Armed Services Associations.

J. J. PHILLAN, JR.  
Acting Director for Procurement Policy

Prepared by TA Pilson/rbs/10Oct58  
3D774 OASD (S&L) X79391

Coordinated by:  
Col. W.A. Pickling

## THE NUMBERS GAME

In presenting its statistical argument about the number of costs disallowed, industry is playing the numbers game. They can (as did NSIA who cited 52 items) list a number of "areas in which there is failure to recognize true costs in whole or in part," and make it appear that we are being more restrictive rather than more liberal. There are several reasons:

(1) We explain the treatment of costs in more detail in the present proposal. Thus whereas "general research unless specifically provided for in the contract" was classed as one unallowable in Sec. XV, NSIA listed several elements of R&D costs as accounting for four items of unallowables. Yet we have liberalized this element substantially. Likewise NSIA lists five such items under compensation, three under depreciation, four under insurance, three under material, three under rental, three under royalties, and four under training. In none of these items is allowability more restricted, and in several it is liberalized.

(2) We provide policy guidance on many items now included in ASPR XV, Part 5, where they are classed as for "Special Consideration."

(3) Many of the items have had to be covered more specifically and their allowability restricted because of abuse by some contractors in the absence of prescribed handling (e.g., sale and leaseback, recruiting, and training).

No doubt the source of much of the attack on this score is the fact that they have been reimbursed in the past for many of the "unallowable" costs through the mechanism of pricing under several of the types of so-called fixed price contracts.

MR. K K KILGORE





OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON 25, D. C.

SUPPLY AND LOGISTICS

OCT 14 1958

CR

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY & LOGISTICS)

SUBJECT: Comparison of Proposed Cost Principles with Current Practices

Messrs. Kilgore and Pilson have undertaken another review of the present cost practices and those proposed under the current draft. The nature of the present ASPR in brevity of the coverage makes it difficult to know precisely what the present coverage is, when subjected to the additional tests of "reasonableness" and "allocability."

The industry statistics presume that reasonableness and allocability are not applied at present and that any specific provision thereof included in the comprehensive set represents a retrogression from current practice. Needless to say this is spurious.

As a matter of fact, we can see only three principles in which there are slight facets which may be less generous than present practices, as follows:

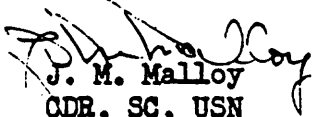
1. Plant reconversion costs. The draft does not allow plant reconversion costs, while at present such costs may be negotiated.
2. Pre-contract costs are narrowly allowable under the current draft, while it is possible that greater allowability may be negotiated under current practices.
3. The Sale and Leaseback aspects of Rental Costs are restricted under the current draft, while greater allowability may be negotiated under current practices.

At the same time, the following costs are MORE GENEROUS:

1. Bidding costs
2. Compensation
3. Food services and dormitory
4. Insurance

5. Interest (allowable in profit or fee)
6. Materials cost
7. Overtime
8. Research and development
9. Selling costs (Government sales aspects)
10. Service and warranty
11. Severance pay
12. Training and education

The remainder of the costs represent no change from current practices.

  
J. M. Malloy  
CDR, SC, USN  
Staff Director, ASPR Division  
Office of Procurement Policy

COVERING BRIEF

CR

JUL 8 1959

TO: The Assistant Secretary of Defense (Supply and Logistics)

FROM: Staff Director, ASPR Division, Office of Procurement Policy

Problem: To provide the Secretary of Defense with an overall status report of the contract cost principles project.

Discussion: During our discussion of the contract cost principles held on 1 July 1959, it was decided that a short overall statement of the current status of the cost principles project should be provided to the Secretary of Defense. This statement was to include information concerning our coordination with industry, a statement of some of the principal issues involved and an indication of the current course of action which we are pursuing. The attached memorandum is designed to accomplish these objectives.

Recommendation: That you sign the attached memorandum.

Concurrence: The Assistant Secretary of Defense (Comptroller).

*Cdr Mallory*  
*AS*

COPY

ASSISTANT SECRETARY OF DEFENSE  
Washington 25, D.C.

Supply and Logistics

CR

21 July 1959

MEMORANDUM FOR THE SECRETARY OF DEFENSE

SUBJECT: Contract Cost Principles

Approximately one year ago, Assistant Secretary McNeil, the Materiel Assistant Secretaries of the Military Departments, and I discussed with you certain issues within Department of Defense and with industry concerning the proposed comprehensive cost principles applicable to all types of negotiated contracts in which costs are a factor in pricing.

Due to the inherently controversial nature of these cost principles, achieving even reasonably close agreement between all parties concerned has been a slow process. We have given industry more than the customary opportunities to present their views. These have included written comment on the 10 September 1957 draft, an open discussion meeting on 15 October 1958 followed by a second written comment, and finally a detailed discussion with four industry representatives on 1-3 April 1959.

Our current proposal is the result of thorough consideration of industry and military department views. Outlined below are its most significant provisions, primarily from the standpoint that they represent a change from present policy or practice, or are opposed by industry.

1. Applicability -- The principles will be incorporated by reference in cost-reimbursement type contracts and will form the basis for determination of costs thereunder. They will also serve as guidance in the evaluation of costs in pricing negotiated fixed-price type contracts where such evaluation is required in the establishment of prices.

2. Advance Agreements -- In order to avoid disagreements with respect to costs during or after performance of a contract, the principles encourage the negotiation of advance agreements as to the handling and the degree of allowability of certain items of cost, particularly in connection with firms or separate divisions thereof whose work is primarily with the Government. Industry has some reservations concerning this provision, but we believe it is entirely reasonable and will work to the benefit of all concerned.

3. Compensation -- As decided in our above-mentioned discussion, compensation of contractor officers and employees is allowable if reasonable. Thus, compensation dependent upon or measured by profits is not, per se, unallowable.

4. Research and Development Costs -- In line with national policy of encouraging research and development, we propose to provide for acceptance as allowable costs, our share of a contractor's independent research. We will treat his independent development costs similarly to the extent that they relate to product lines for which the Government has contracts. Restrictions are provided, however, to limit these costs to reasonable amounts and to prevent unwarranted duplication of efforts in the same area by different contractors. In return for our support of current research programs, we will not accept similar costs incurred by the contractor in the past, even though we may receive some of the benefits thereof.

5. Minor Costs Disallowed -- Industry has long objected to our disallowance of certain items which it considers to be normal and proper costs of doing business. We maintain the position that, for reasons of public policy, equity, or absence of benefit to the Government, we should disallow certain costs. Among these are contributions and donations, interest, bad debts, and product and institutional advertising.

We believe that to try further to resolve the remaining differences with industry would serve only to delay this much needed guidance and deprive us of the benefits which are expected to flow from it. We anticipate that the issuance of these cost principles will result in greater uniformity of treatment of contractors, more effective and economical audit of contractors' costs, and a more orderly procurement process.

One possible hurdle, yet to be overcome, is discussion of the principles with the Comptroller General. While it is within the authority of Department of Defense to issue such regulations without reference to the General Accounting Office, we recognize its interest. Based upon comments of the Comptroller General on earlier drafts and informal staff discussion, we know that he favors a much more rigid application of the principles to all contract pricing -- an approach which industry and many of us fear will remove bargaining from the negotiation process and result in formula pricing. The possibility exists that he may be critical of our effort. However, Mr. McNeil and I plan to discuss the matter with him on 23 July to point out the reasons why we believe we are proposing the best possible solution at this time.

My position, concurred in by Mr. McNeil and the military Departments,

is that the principles should be published in the Armed Services Procurement Regulation immediately, to become effective on 1 January 1960. Barring objection from you, or insurmountable opposition from the Comptroller General, I propose to do so.

(Signed)

PERKINS MCGUIRE  
ASSISTANT SECRETARY OF DEFENSE  
(Supply and Logistics)

Prepared by: KK Kilgore 7/8/59  
30885 X76321

Concurrence:  
Mr. McNeil \_\_\_\_\_  
Cdr Malloy \_\_\_\_\_



September 30, 1959

Jim:

I am very opposed to the issuance of a press release on Cost Principles now. My reasons are, in part:

1. It would reduce our flexibility to make changes in the next 2 weeks.
2. It would or could open up old arguments or pressures which might be effective if the words are not frozen in print.
3. It would induce a flock of inquiries and requests for copies.

I could probably think up others, but my overall feeling is that it would be a tactical blunder. I had planned to get out a press release some time before they hit the street, maybe a week before. At that time, I would have copies available for all, including DOD people.

Another point just occurred to me. We must treat Cong. Hebert carefully here. I plan to transmit him a copy over Mr. McGuire's signature prior to actual publication and prior to any press release. On the other hand, we should not let him know until the package is frozen, i.e. in about 2 weeks.

Pending your consideration of these views I will sit tight. I have discussed this with Ken Kilgore who feels as strongly as I do.

Pete



OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON 25, D. C.

CR

SUPPLY AND LOGISTICS

5 October 1959

MEMORANDUM FOR THE RECORD

SUBJECT: Meeting with Dr. Raymond J. Saulnier on 28 September 1959  
With Respect to Contract Cost Principles.

A meeting was held in Dr. Saulnier's office on 28 September 1959 in connection with the proposed Department of Defense Contract Cost Principles. Those present were:

- Mr. James P. Falvey - Deputy Assistant Secretary of Defense  
(Supply and Logistics)
- Mr. G. C. Bannerman - Director for Procurement Policy  
Office of the Secretary of Defense  
(Supply and Logistics)
- Cdr. J. M. Malloy - Staff Director, ASPR Division, Office  
of Procurement Policy
- Dr. Raymond Saulnier - Chairman, Committee on Government Activities  
Affecting Costs and Prices
- Mr. John Hamlin - Staff Assistant, Committee on Government  
Activities Affecting Costs and Prices

This meeting was held in response to a request from Dr. Saulnier which was transmitted to Assistant Secretary Perkins McGuire by memorandum dated 24 February 1959. Dr. Saulnier had expressed a desire to be advised concerning the Department of Defense efforts in revising the contract cost principles applicable to cost-reimbursement type contracts.

The Department of Defense representatives presented the background of the development of the current set of cost principles and elaborated on the current need within the Department of Defense for the issuance of the principles in the very near future. The Defense representatives advised Dr. Saulnier of their opinion that the revised cost principles would not have an inflationary impact on the national economy. In fact, it was stated that the principles, particularly when used in the area of fixed-price contracts, might well have a deflationary tendency.

Dr. Saulnier expressed appreciation for the background briefing and indicated that no further action need be taken by the Department of Defense in connection with his memorandum of 24 February 1959.

The Defense representatives delivered to Dr. Saulnier a letter dated 25 September 1959 which was responsive to Dr. Saulnier's memorandum of 24 February 1959. A copy of this letter is attached.

J. M. MALLOY  
Cdr., SC, USN  
Staff Director, ASPR Division  
Office of Procurement Policy

1 Incl.  
Ltr. to Dr. Saulnier  
dtd Sept 25, 1959

COPY

February 24, 1959

MEMORANDUM FOR: Mr. Perkins McGuire  
Assistant Secretary of Defense

It has come to my attention that certain revisions in the cost principles of ASPR are under consideration in the Department of Defense, that such revisions are about to be made, and that they are likely to have a significant effect on costs under cost-reimbursement type contracts.

I would appreciate an opportunity to have this matter discussed before the Committee on Government Activities Affecting Costs and Prices, naturally, in advance of the issuance of such revisions. Would you be good enough to suggest an appropriate date for such a discussion? I would appreciate it if you would notify John Hamlin, Executive Secretary of the Committee, of the date you would find agreeable.

(Signed)

Raymond J. Saulnier

CH

Dear Mr. Mahon:

I am inclosing an advance copy of a Revision of the Armed Services Procurement Regulation on the subject of Contract Cost Principles. We expect that this Revision will be distributed officially by the Government Printing Office on 2 November 1959.

I feel certain that you share my feeling that the publication of Contract Cost Principles for use in the evaluation of costs when costs are a factor in Defense contracting represents a substantial forward step in our efforts to improve our procurement activities. We have been in the process of developing this comprehensive set of Cost Principles for a considerable period of time. However, as I am sure you will recognize, this is a highly complicated and controversial subject and one which generates a wide variety of different views as to the treatment which should be afforded each detailed cost element. As a result, the obtaining of a degree of agreement on this set of Cost Principles has been a slow process.

I have decided, however, that further refinements should not be made at this time. After we have gained some experience in the use of this new Regulation, we will be in a position to make such revisions as are deemed necessary or desirable.

Sincerely yours,

**Inclosure**

**ASPR Revision  
Contract Cost Principles**

**Honorable George J. Mahon  
Chairman, Subcommittee on Defense  
Appropriations  
House Appropriations Committee  
House of Representatives**

Copy to: Mr. Kilgore  
Mr. Pilson

Prepared by: JMMalloy/jm/20 Oct 59  
3D774 X-72026

Coordinated with:

Mr. Bannerman \_\_\_\_\_  
LC \_\_\_\_\_  
Mr. Kilgore \_\_\_\_\_

These are the considerations which have prompted me to present this matter to you personally and to explain the urgency which compels us to proceed with publication of our revised regulation at the earliest possible time.

Sincerely yours,

(Signed)

J. P. FALVEY  
Deputy Assistant Secretary of Defense  
(Supply and Logistics)

Honorable Raymond J. Saulnier, Chairman  
Council of Economic Advisers

Prepared by: JMalloy/rbs25Sept59  
3D774 X72026



COPY

ASSISTANT SECRETARY OF DEFENSE  
Washington 25, D.C.

Supply and Logistics  
CR

September 25, 1959

Dear Dr. Saulnier:

In Mr. McGuire's absence, I am responding to your memorandum of 24 February 1959, in which you expressed a desire to be advised concerning the Department of Defense efforts in revising the contract cost principles applicable to cost-reimbursement type contracts. Your interest in this matter stems from the activity of the Committee on Government Activities Affecting Costs and Prices. Your memorandum indicates a belief that our new cost principles "are likely to have a significant effect on costs under cost-reimbursement type contracts."

The Department of Defense has been working on a revision of Section XV of the Armed Services Procurement Regulation with respect to contract cost principles for a considerable period of time. This task has been difficult because of the widely divergent views of all the interests so vitally concerned. We have received the views of industry on numerous occasions and, for the most part, the industry view is that our proposals (now incorporated in the new cost principles) are much too harsh.

We are, I think, approaching the culmination of our efforts in this field. I would like to indicate to you our own appraisal of this project. In the first place, we do not feel that our revised cost principles are significantly different from our present practices with respect to the allowability of costs under cost-reimbursement type contracts. Our revised principles provide more detailed guidelines for both procurement and audit personnel with the end in view of achieving greater uniformity of current practices throughout the Department of Defense. We have, however, provided for the use of these cost principles as a guide in the negotiation of the various types of fixed-type price contracts where costs are an important factor in the establishment of prices. We anticipate that our action in this regard will result in a tightening up of present practices in some areas.

Since, as indicated above, our proposed cost principles will not have a significant effect on costs under cost-reimbursement type contracts, I do not feel that a discussion before the Committee on Government Activities Affecting Costs and Prices would be helpful.

OCT 59

COVERING BRIEF

CR

TO: The Assistant Secretary of Defense (Supply and Logistics)  
FROM: Director for Procurement Policy

Problem: To provide the Atomic Energy Commission with an advance copy of our Contract Cost Principles.

Discussion: The attached letter transmits an advance copy of the Cost Principles to the General Manager of the Atomic Energy Commission for information. We have consulted with Staff elements of the Atomic Energy Commission on several occasions in connection with earlier drafts of the Principles. Representatives of the Commission sat in on our meeting with industry on October 15, 1958. Subsequent to that meeting, we received a letter from the General Manager, Atomic Energy Commission, making certain comments on the then current draft and concluding as follows: "We think it represents an excellent piece of work and that the principles are sound and generally acceptable." Our last discussion with AEC representatives took place a few months ago. The AEC Comptroller acted as spokesman for the AEC representatives. Most of the individual comments which they had were satisfactorily resolved during this discussion. The AEC representatives indicated that the Commission would probably adopt the Principles contained in our Regulation with the exception of 2 or 3 cost elements in which they felt the problems peculiar to Atomic Energy contractors required special treatment somewhat different from our proposals. Basically, however, they are in agreement and will undoubtedly promulgate principles almost identical to our own.

Recommendation: That you sign the attached letter.

Concurrence: Assistant Secretary of Defense (Comp) (Mr. Kilgore)

0-59

COVERING BRIEF

CR

TO: The Assistant Secretary of Defense (Supply and Logistics)

FROM: Director for Procurement Policy

Problem: To provide an advance copy of the new Cost Principles to Congressman Hebert for information.

Discussion: The attached letter to Congressman Hebert is designed to afford him with an advance copy of the new Cost Principles. We have no commitment to clear our principles with Congressman Hebert prior to their publication. We feel, however, that we should give him an advance copy as a matter of courtesy in view of his sustained interest in this subject.

Recommendation: That you sign the attached letter.

Concurrence: Assistant Secretary of Defense (Comp) (Mr. Kilgore)  
General Counsel

*cdw malloy*



OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON 25, D. C.

SUPPLY AND LOGISTICS

AUG

9 1958

*See Mr  
McNeil's  
Comment on  
page 2.  
gmm*

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)

SUBJECT: Contract Cost Principles

We are in the process of changing the 10 September 1957 draft of the Contract Cost Principles to give effect to the recent decisions made by Mr. McElroy as well as certain other changes which were indicated by industry comments. I estimate that we will have a new draft available for forwarding to industry in about two weeks. We are planning to set up our industry meeting for early October. I will provide you with a specific proposal for the conduct of this meeting in the near future.

It is my understanding that the following decisions were made by the Secretary of Defense with respect to the compensation principle at the 6 August 1958 meeting:

1. Incentive compensation of the profit sharing type would be an allowable cost to be considered as a portion of total compensation. Total compensation would, of course, be subject to the overall test of reasonableness.
2. Include a provision in the compensation principle to the effect that we would not allow any part of compensation not deductible for tax purposes.
3. Delete the words "(whether or not dependent upon or measured by profits)" from the paragraph entitled "Cash Bonuses and Incentive Compensation" in your memorandum of 4 August 1958 to the Secretary of Defense.
4. Endeavor, as best we can, to expand our treatment of "reasonableness" as applied to compensation. Additional guidelines or standards to measure the reasonableness of total compensation should be developed to the extent practicable.
5. Provide for joint action by the Departments in those situations where there is a mutual interest and where the determination as to the reasonableness of compensation is difficult.
6. Provide for some type of control over total compensation during the transition period so as to preclude the allowance of increased compensation over that previously paid by the company merely by reason of our action in allowing profit sharing plans as part of total compensation.

Malley

OCT 5-9

COVERING BRIEF

CR

TO: The Assistant Secretary of Defense (Supply and Logistics)  
FROM: Director for Procurement Policy

Problem: To provide an advance copy of the new Cost Principles to Congressman Mahon for information.

Discussion: The attached letter to Congressman Mahon is designed to afford him with an advance copy of the new Cost Principles. We have no commitment to clear our principles with the House Appropriations Committee prior to their publication. We feel, however, that we should give the Committee an advance copy as a matter of courtesy in view of its sustained interest in this subject.

Recommendation: That you sign the attached letter.

Concurrences: Assistant Secretary of Defense (Comp) (Mr. Kilgore)  
General Counsel





OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON 25, D. C.

OCT 21 1959

CR

SUPPLY AND LOGISTICS

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY & LOGISTICS)

SUBJECT: Request for Approval of the Press Release to be Issued on  
the New Contract Cost Principles

I am attaching a draft of the press release which we propose to issue on 2 November 1959 in connection with the issuance of the new Contract Cost Principles. This draft was developed by Commander Malloy and Mr. Kilgore and has been reviewed by staff members of the Office of Public Information.

Our plans now contemplate the issuance of this press release on 2 November 1959, which is the date that we expect the ASPR Revision to be available at the Government Printing Office. The Office of Public Information has recommended that a press interview be granted by a DOD spokesman when the press release is issued. Subject to your approval, I have directed that Commander Malloy undertake this task.

We have several letters prepared to interested Congressional Committees and to other Government Departments which will be released in about one week. These letters will provide the recipients with advance copies of the Regulation. In addition, we are preparing letters to each of the Industrial Associations which have commented on the cost principles. These letters will be released concurrently with the publication of our press release.

A copy of the attached press release is being submitted to the ASD(Comp) for his review and approval concurrently with the forwarding of this memorandum to you.

*G. C. Bannerman*

G. C. BANNERMAN  
Director for Procurement Policy

Incl

Draft - Press Release

11/22  
Approved by EPM.  
*John*



*Mallory*

COVERING BRIEF

CR

TO: The Assistant Secretary of Defense (Supply and Logistics)

FROM: Director for Procurement Policy

Problem: To provide Mr. McGillicuddy of the Preparedness Investigating Subcommittee of the Senate Committee on Armed Services with a copy of the contract cost principles and a copy of the press release in connection with the publication of the cost principles.

Discussion: The attached letter was prepared at the request of the Assistant Secretary of Defense (Supply and Logistics). It is designed to inform Mr. McGillicuddy of the culmination of our efforts in connection with the publication of the contract cost principles.

Recommendation: That you sign the attached letter.

Malloy

Classification: Unclassified

**WHITE HOUSE INFORMATION BRIEF**

**Department of Defense**

**Office of Origin:** Assistant Secretary of Defense (Supply and Logistics)

**Date of Brief:** 23 October 1959

**Subject:** Publication of a Revision of Department of Defense regulations covering cost principles for use in Defense contracts

**Brief:** The Department of Defense will publish an important revision of its procurement regulations on 2 November 1959. This revision covers the subject of cost allowances under Defense contracts. The new regulation provides a single comprehensive set of cost principles which will give more detailed and precise policy guidance in treating cost elements. They apply to all types of contracting situations. The new cost principles will replace similar principles which have been in use for a number of years. They have been adopted after extensive consideration within the Department of Defense and after considering the views of a cross section of industry.

The new regulation does not materially change our current practices when cost-reimbursement type contracts are used. The new feature of the regulation is its use in providing guidance for the treatment of costs under negotiated fixed price type contracts. This new regulation should ultimately lead to more efficient negotiation and administration of Defense contracts.

We expect some adverse comment from industry on this new regulation. Congressional reaction should be favorable. The Comptroller General has long advocated the adoption of comprehensive cost principles. He has recently concurred in the desirability of publication of the new Defense regulation.

A copy of the press release which will announce publication of this regulation is attached.

Attachment  
Press Release

Prepared by: JMMalloy/jm/23 Oct 59  
3D 774 X-72026

Coordinated with: Mr. Bannerman

Dear Mr. McGillicuddy:

I am attaching a copy of a revision to the Armed Services Procurement Regulation dealing with contract cost principles for your information. I recall that you attended our industry meeting on this subject on 15 October 1958 and that you expressed a continuing interest in our efforts to promulgate this important regulation. I am also attaching a copy of our press release on this subject which may be of interest to you.

Sincerely yours,

**Attachments**

1. Contract Cost Principles
2. Press Release

Mr. D. F. McGillicuddy, Jr.  
Assistant Staff Director  
Preparedness Investigating  
Subcommittee of the  
Senate Committee on  
Armed Services  
U. S. Senate

Prepared by: JMMalloy/jm/22 Oct 59  
3D774 X-72026

Coordinated with: Mr. Bannerman

*Druley*

COVERING BRIEF

CH

TO: The Assistant Secretary of Defense (Supply and Logistics)

FROM: Director for Procurement Policy

Problem: To notify the Secretary of Defense of the publication of the contract cost principles and to provide him with a copy of our press release.

Discussion: The attached memorandum has been developed at the request of the Assistant Secretary of Defense (Supply and Logistics). It is designed to notify the Secretary of Defense of the action which we have taken and to provide him with a copy of our press release for his background information.

Recommendation: That you sign the attached memorandum.

COVERING BRIEF

CR

TO: The Assistant Secretary of Defense (Supply and Logistics)  
FROM: Director for Procurement Policy

Problem: To advise the Material Secretaries of our specific plans for publishing the cost principles.

Discussion: It is important that the Military Departments be aware of our specific plans in connection with the publication of the cost principles. The attached memorandum sets forth our plans together with a timetable for each action.

Recommendation: That you sign the attached memorandum.

in reply

*Malley*

COVERING BRIEF

CR

TO: The Assistant Secretary of Defense (Supply and Logistics)

FROM: Director for Procurement Policy

Problem: To advise Mr. Gates of the specific actions which we contemplate in connection with the issuance of our cost principles regulation.

Discussion: The attached memorandum was prepared at the request of the Assistant Secretary of Defense (Supply and Logistics). It is designed to provide Mr. Gates with information as to the current status of this project and to indicate the specific actions which we contemplate.

Recommendation: That you sign the attached memorandum.



CR

**MEMORANDUM FOR THE SECRETARY OF DEFENSE**

**SUBJECT: Publication of Our New Regulation on Contract Cost Principles**

We have now completed our work in connection with the publication of a revision to the Armed Services Procurement Regulation dealing with contract cost principles. The regulation is being printed by the Government Printing Office and will be distributed to the public on 2 November 1959, at which time we plan to issue a press release. A copy of the press release is attached for your information.

You will recall that we discussed this new regulation at some length approximately a year ago. During your recent absence, I provided Mr. Gates with information as to our current plans. We can expect some adverse industry comment. Congressional reaction should be favorable.

**Attachment**  
**Press Release**

Copy to:  
Mr. Gates

Prepared by: JMMalloy/jm/300  
23 Oct 59 3D774 X-72026

Coordinated with: Mr. Bannerman



CR

SUPPLY AND LOGISTICS

ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON 25, D. C.

2-0459

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE ARMY (LOGISTICS)  
THE ASSISTANT SECRETARY OF THE NAVY (MATERIAL)  
THE ASSISTANT SECRETARY OF THE AIR FORCE (MATERIEL)

SUBJECT: Contract Cost Principles

As I indicated at one of our recent meetings, I am anxious that each of you be closely informed of our activities in connection with publication of the new cost principles. I am attaching a schedule of the various actions which we contemplate in this connection. There is also attached a copy of a press release which we expect to issue on 2 November 1959. In addition to the actions listed on the attached schedule, I have instructed Commander Malloy of my staff to be in close touch with his counterpart in each of the services so as to keep him fully informed of our activities.

I am sure that you will agree that the public relations aspects and the timing of our various actions is very important to this exercise. I solicit your assistance in assuring that we will have no breakdown in this regard nor any premature disclosure of either the cost principles or our specific plans in connection with their issuance.

Attachments

1. Action Schedule
2. Press Release

Prepared by: JMMalloy/jm/22 Oct 59  
3D774 X-72026

Coordinated with: Mr. Bannerman

QUESTION AND ANSWER SHEET - COST PRINCIPLES

1. Q. How do these new cost principles change what the Department of Defense has been doing in the past?

A. The Department of Defense has prescribed cost principles for cost reimbursement type contracts for many years. These principles have been prescribed for use only for cost reimbursement contracts. As to this type of contract, the new principles will not materially change our operations although they provide more definite rules and to some extent cover cost elements not previously defined. The new principles will eliminate separate cost principles which we now have for use in negotiating termination settlements. The most significant new feature of the regulation is its use with fixed price contracts. We have not had cost principles for this purpose in the past. The new regulation will be used as a guide in the negotiation of prices under fixed price negotiated contracts to the extent that the evaluation of costs is necessary for the setting of fair and reasonable prices.

2. Q. What will be the affect of the new cost principles with respect to cost recovery be a contractor for (a) cost reimbursement contracts and (b) fixed price contracts?

A. As to cost reimbursement type contracts, contractors generally can expect about the same result under the revised cost rules as they are experiencing under present practices. A definitive answer cannot be given to the question of contractor recovery in the fixed price area since the range of situations here is too complex for generalization. Since we have not provided specific guidance in the past, these new principles will, at least in some instances, result in reduced recovery by contractors for certain particular items of expense. For example, interest has previously been an allowable cost in termination situations. In the future, interest will not be allowed.

3. Q. How much money will these new cost principles cost the Department of Defense or how much will be saved?

A. As indicated previously, about the same result will be experienced in connection with cost reimbursement contracts. In the fixed price area, we expect that the new principles will ultimately result in more efficient procurement and, hence, savings will accrue in the long run. It is not possible to put a dollar sign on any such savings at this time.

4. Q. Why has the Department of Defense not promulgated cost principles for general use in the past? Why has it taken you so long to do this job?

A. The Department of Defense has had cost principles for cost type contracts and for termination settlements. The extension of cost principles to the fixed price area is a very complicated and controversial subject. It has been necessary to take into consideration the strongly held views of the many parties at interest, including those of industry. The resolution of these areas of controversy has been difficult and, hence, progress has been somewhat slow.

5. Q. What are the more important areas of cost disallowance:

A. These would include most advertising costs, bad debts, entertainment, contributions and donations, and interest on borrowings.

6. Q. How do the new cost principles treat research and development expenses?

A. A contractor's independent research costs are allowable. Independent development costs are allowable to the extent that they are related to the product lines for which the Government has contracts. We have provided for certain administrative controls and limitations to insure that these costs are reasonable.

7. Q. Are executive profit sharing plans allowable?

A. We regard compensation measured by profit sharing plans as a portion of an individual's over-all compensation. Such compensation is allowable to the extent that an individual's total compensation is reasonable in amount.

8. Q. What affect do these cost principles have on profit?

A. The cost principles do not cover the subject of profit. Our profit policies are covered fully in Section III, Part 8 of the Armed Services Procurement Regulation.

9. Q. Will this new regulation lead to "formula pricing?"

A. Formula pricing means the resolution of each item of cost by unilateral accounting decisions. We do not anticipate that the new regulation will have this result. Our over-all pricing philosophy remains in effect.

10. Q. What application will these cost principles have to contracts awarded by formal advertising?
- A. The evaluation of costs is not appropriate under contracts awarded by formal advertising. The cost principles will, however, continue to be used as a guide for terminated contracts, including terminated contracts originally awarded after formal advertising.
11. Q. What do you mean by the statement that the cost principles will be used "as a guide" in negotiating fixed price contracts?
- A. We realize that hard and fast rules with respect to costs are not appropriate for many pricing situations encountered under fixed price contracts, particularly in those instances where prices are being established for a future period. Government personnel will be expected to be guided by these principles to the extent appropriate in conducting negotiations in the fixed price contract area to the extent that the pricing action requires the evaluation of costs. Any departure from the basic policies now established will require adequate explanation and justification.
12. Q. Is this new regulation agreeable to industry?
- A. Industry has traditionally opposed any of our regulations which set forth specific costs as unallowable. Industry contends that the Government should allow all normal costs of doing business. For this reason, industry is opposed generally to most of the disallowances we have prescribed. Industry is also opposed to the utilization of cost principles in the fixed price area.
13. Q. Have the Military Departments concurred in this new regulation?
- A. Yes.
14. Q. Has the new regulation been approved by the Secretary of Defense?
- A. Yes.
15. Q. Has the Comptroller General approved this regulation?
- A. The Comptroller General has been in favor of a single comprehensive set of cost principles for some time. He has concurred in the desirability of publishing the new regulation without committing himself as to agreement on all details.

16. Q. What Congressional reaction do you expect?
- A. We expect that our new regulation will be well received by the Congress.
17. Q. How does the new regulation affect Small Business?
- A. We believe it will assist many Small Business concerns in that it is designed to foster an atmosphere of mutual understanding among contractors and contracting officers as well as provide guidance on the handling of many items not previously covered.
18. Q. Why is the new regulation not mandatorily effective until July 1, 1960?
- A. There are many details in this new regulation which will require study for both contractors and Government personnel. A longer period than usual was established in this instance to afford ample opportunity for familiarization with the new rules.
19. Q. Are these cost principles going to be used on a Government-wide basis?
- A. We expect that cost principles substantially similar to our new regulation will be adopted on a Government-wide basis.
20. Q. Will these cost principles mean more negotiated contracts?
- A. No.
21. Q. Will the new cost principles require contractors to establish new accounting systems?
- A. No. The revised cost principles are not an accounting blueprint which will require any appreciable change in the accounting systems of most Government contractors.

Office of the Assistant Secretary of  
Defense (Supply and Logistics)  
26 October 1959





DEPARTMENT OF THE NAVY  
BUREAU OF AERONAUTICS  
WASHINGTON 25, D. C.

IN REPLY REFER TO

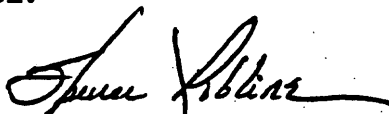
Aer-CT-2

3 November 1959

Dear Pete:

I thought you might be interested in seeing your words in print. Enclosed are a couple of copies of a transcript of your speech taken by a BuAer court reporter at the ONM-sponsored Procurement Lecture Conference on 12 October 1959.

Needless to say, because of the nature of the subject, there has been a very limited and discriminating distribution consisting of several of our procurement people and the BuAer Counsel.

  
S. E. ROBBINS  
CDR, USN



NUMBER 4105.11  
DATE 23 November 1949

## Department of Defense Instruction

SUBJECT

### Price Revision Negotiations

#### I. PURPOSE

The purpose of this instruction is to provide uniform policy guidance in the negotiation in price revision proceedings under fixed-price contracts providing for the redetermination of price.

#### II. CANCELLATION

This instruction cancels that portion of Munitions Board memorandum dated 15 November 1949 to the Secretaries of the Army, Navy and Air Force, wherein it is provided that in negotiating prices under fixed-price contracts, the contract cost principles, as set forth in Section XV of ASPR, may be used "by the contracting officers to the extent that they deem it advisable as a working guide only".

#### III. APPLICABILITY

The policies set forth below shall be applicable to all price revision proceedings under fixed-price contracts providing for the redetermination of price. This instruction is not applicable to fixed-price incentive-type contracts.

#### IV. POLICY

- A. In price revision negotiations, the objective of the Contracting Officer shall be to negotiate a fair and reasonable revised price in which due weight is given to all relevant factors, including those taken into account when the initial contract price was negotiated. By way of illustration, but not limitation, full consideration shall be given to such matters as the contractor's general performance, efficiency, economy and ingenuity displayed in meeting contract requirements, including the delivery schedules, quality of the product, the character and extent of the subcontracting, cost data including questioned costs and the allocability and reasonableness of costs, changes in market conditions, competitive aspects of the original negotiation, as well as the competitive prices

for the same or similar items, extent of contractor's technical, production and financial risk, and Government assistance in the form of facilities, equipment, or financing. All of the above factors shall be considered to the extent pertinent to the specific negotiation and no price revision negotiation shall be based solely on a single factor. The record of the negotiations should be in sufficient detail to reflect the most significant considerations controlling the establishment of the revised price.

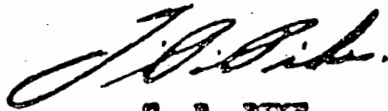
- B. Compliance with the policy stated in paragraph A requires that Contracting Officers rely on educated judgment and not on mechanical rules or mathematical formulas. Compliance further requires that pricing decisions shall not be made solely on the basis of a determination of cost and profit. It follows that the Contracting Officer need not negotiate agreements with contractors as to the individual elements of cost.
- C. In order that the positions of the Government and the Contractor will not be prejudiced in price revision proceedings, such negotiations shall be conducted promptly.

V. EFFECTIVE DATE

This instruction is effective from the date of its receipt.

VI. IMPLEMENTATION

The Military Departments shall promulgate this instruction as soon as possible. Copies of the Departmental implementations pertaining to this instruction will be forwarded to the Assistant Secretary of Defense (Supply and Logistics) for information within thirty (30) days of the date of its issuance.

  
T. P. PIKE  
Assistant Secretary of Defense  
(Supply & Logistics)

<u>Item</u>	<u>Paragraph Number</u>	<u>Allowable Subject to Usual Tests</u>	<u>Allowable if it Meets Special Tests or has Special Approval</u>	<u>Allowable only if Provided for in Contract</u>	<u>Unallowable</u>
<b>Advertising:</b>					
In trade and technical journals valuable for dissemination of technical information within the contractor's industry, provided ads do not offer products or services for sale	15-205.1(a)(i)	X			
Help-wanted	15-205.1(a)(ii)	X			
Costs of participation in exhibits upon invitation of Government or where exhibits are for purpose of disseminating technical information within the contractor's industry and provided specific products or services are not offered for sale	15-205.1(a)(iii)	X			
To obtain scarce materials, plant or equipment or disposing of scrap or surplus materials	15-205.1(a)(iv)	X			
All other	15-205.1(b)				X
<b>Bad Debts</b>	15-205.2				X
<b>Bidding Costs:</b>					
Incurred in current accounting period	15-205.3	X			
" " past periods	15-205.3				X
(Note: Alternative methods permissible)	15-205.3				
<b>Bonding Costs:</b>					
Bonding required by contract	15-205.4(b)	X			
Required in general conduct of business	15-205.4(c)	X			
<b>Civil Defense Costs:</b>					
On contractor's premises pursuant to suggestions or requirements of civil defense authorities	15-205.5(a)	X			
(Notes: Costs of capital assets allowable only as depreciation)	15-205.5(b)				
Contributions to local civil defense funds and projects	15-205.5(c)				X
<b>Compensation for Personal Services:</b>					
To extent the total compensation of individual employees is reasonable for services rendered and not in excess of amounts allowable under Internal Revenue Code	15-205.6(a)(1)		X		
In lieu of salary for services rendered by partners and sole proprietors provided such compensation does not constitute a distribution of profits	15-205.6(a)(3)		X		
Salaries and wages for current services	15-205.6(b)	X			
Premiums for overtime, extra pay shifts and multishift work	15-205.6(b)		X		
Cash bonuses and incentive compensation	15-205.6(c)		X		
Bonuses and incentive compensation paid in stock	15-205.6(d)		X		
Stock options	15-205.6(e)	X			
Deferred compensation for services rendered during current period and for past service pension and retirement costs	15-205.6(f)		X		
Fringe benefits	15-205.6(g)		X		
<b>Contingencies:</b>					
In historical costing, except certain minor items	15-205.7(b)				X
In estimating future costs:	15-205.7(c)				
Where related to known and existing conditions which can be measured with reasonable accuracy		X			
Where related to known or unknown conditions which cannot be measured closely enough to provide equitable results					X
<b>Contributions and Donations</b>	15-205.8				X

Item	Paragraph Number	Allowable Subject to Usual Tests	Allowable if it Meets Special Tests or has Special Approval	Allowable only if Provided for in Contract	Unallowable
<b>Depreciations</b>					
Normal	15-205.9(b)		X		
Emergency facilities	15-205.9(d)		X		
On idle or excess facilities not reasonably necessary for standby purposes	15-205.9(e)				X
Fully depreciated assets:					
Where substantial portion was recovered as a charge to Government contracts or subcontracts	15-205.9(f)				X
Other	15-205.9(f)		X		
<b>Employee Morale, Health, and Welfare Costs and Credits</b>	15-205.10	X			
<b>Entertainment Costs</b>	15-205.11				X
<b>Excess Facility Costs</b>	15-205.12				
Where reasonably necessary for standby purposes		X			
Other					X
<b>Fines and Penalties</b>	15-205.13				
Incurred in compliance with contract or written instructions from contracting officer		X			
Other					X
<b>Food Service and Dormitory Costs and Credits</b>	15-205.14				
Allocation of reasonable losses to all activities served		X			
Profits to be credited, unless used for employee welfare		(X) Credit			
<b>Insurance and Indemnifications</b>					
Required or approved pursuant to contract	15-205.16(a)(1)	X			
Other insurance maintained for general conduct of business	15-205.16(a)(2)		X		
Actual losses which could have been covered by permissible insurance:	15-205.16(a)(3)				
Result of nominal deductible insurance coverage		X			
Minor losses such as spoilage, breakage, and disappearance of small hand tools		X			
Other such losses					X
<b>Indemnifications</b>	15-205.16(b)				X
Result of nominal deductible coverage		X			
Minor losses such as spoilage, breakage and disappearance of small hand tools		X			
Other indemnification					X
<b>Interest and Other Financial Costs</b>	15-205.17				
Interest on borrowings					X
Bond discounts					X
Costs of financing and refinancing operations					X
Legal and professional fees paid for preparation of prospectuses					X
Preparation and issuance of stock rights					X
Interest assessed by State or local taxing authorities because of non-payment of tax at the direction of contracting officer or because of failure of contracting officer to assure timely direction after prompt request therefor	(See also 15-205.A1)	X			
<b>Labor Relations Costs</b>	15-205.18	X			
<b>Losses on Other Contracts</b>	15-205.19				X
<b>Maintenance and Repair Costs</b>	15-205.20(a)				
Normal		X			
Extraordinary costs, provided such are allocated to periods to which applicable		X			
<b>Manufacturing and Production Engineering Costs</b>	15-205.21	X			

Item	Paragraph Number	Allowable Subject to Usual Tests	Allowable if it Meets Special Tests or has Special Approval	Allowable only if Provided for in Contract	Unallowable
<b>Material Costs</b>					
Reasonable overruns, spoilage, or defective work	15-205.22(a)	X			
Cash discounts not taken because of reasonable circumstances	15-205.22(b)	X			
Adjustments for differences between physical and book inventories related to period of contract performance	15-205.22(c)	X			
Interplant, interdivision or interorganization transfers; Ordinarily allowable at lower of cost to transferor or market	15-205.22(e)	X			
On a price basis	15-205.22(f)		X		
<b>Organization Costs:</b>					
Incorporation fees, attorneys' fees, accountants' fees, brokers' fees and fees to promoters and organizers, for organization, reorganization or raising capital	15-205.23				X
<b>Other Business Expenses:</b>					
Registry and transfer charges resulting from changes in ownership of securities issued by contractor	15-205.24	X			
Cost of shareholders' meetings	15-205.24	X			
Normal proxy solicitations	15-205.24	X			
Preparation and publication of reports to shareholders	15-205.24	X			
Preparation and submission of required reports and forms to taxing and other regulatory bodies	15-205.24	X			
Incidental costs of directors and committee meetings	15-205.24	X			
Overtime, Extra-Pay Shift and Night-Shift Premiums	15-205.25		X		
<b>Patent Costs:</b>					
Preparing disclosures, reports and other documents required by the contract	15-205.26	X			
Searching the art as necessary to make invention disclosures	15-205.26	X			
Preparing documents and other costs in connection with filing patent applications where title is conveyed to Government in accordance with contract clauses	15-205.26	X			
<b>Plant Protection Costs:</b>					
Wages, uniforms and equipment of personnel	15-205.28	X			
Depreciation on plant protection capital assets	15-205.28	X			
Necessary compliance with military security requirements	15-205.28	X			
<b>Plant Reconstruction Costs:</b>					
Cost of removing Government property and related restoration rehabilitation costs	15-205.29	X			
Additional costs to extent agreed upon before incurrence	15-205.29	X			
All other reconstruction costs	15-205.29				X
<b>Precontract Costs:</b>					
To extent allowable if incurred after date of contract	15-205.30	X			
<b>Professional Service Costs - Legal, Accounting, Engineering, and Others:</b>					
Rendered by members of a profession who are not employees of the contractor	15-205.31(a)		X		
Retainer fees supported by evidence of bona fide services available or rendered	15-205.31(b)		X		
Legal, accounting, and consulting services, and related costs, in connection with organizations and reorganizations, defense of anti-trust suits and the prosecution of claims against the Government	15-205.31(c)				X
Legal, accounting, and consulting services, and related costs, incurred in connection with patent infringement litigation	15-205.31(e)				X
<b>Profits and Losses on Disposition of Plant, Equipment or Other Capital Assets</b>					
	15-205.32				X
<b>Recruiting Costs:</b>					
Help-wanted advertising	15-205.33	X			
Operating costs of employment office	15-205.33	X			
Operating and upfitting and educational testing program	15-205.33	X			
Travel costs of employees while engaged in recruiting personnel	15-205.33	X			
Travel costs of applicants for interviews for prospective employment	15-205.33	X			



Item	Paragraph Number	Allowable Subject to Usual Tests	Allowable if it Meets Special Tests or has Special Approval	Allowable only if Provided for in Contract	allocable
<b>Recruiting Costs (Cont'd.)</b>					
Employment agency charges at not in excess of standard commercial rates	15-205.33	X			
Special benefits or emoluments beyond the standard practice in the industry	15-205.33				X
<b>Rental Costs (Including Sale and Leaseback of Facilities):</b>					
Land, building and equipment and other personal property	15-205.34(a)		X		
Interplant, interdivisional and interorganization charges	15-205.34(b)		X		
Sale and leaseback agreements	15-205.34(c)			X*	
Under unexpired leases in connection with terminations	15-205.34(d)				
	15-205.42(e)		X		
<b>Research and Development Costs:</b>					
Costs of independent research	15-205.35(d)		X		
Costs of independent development	15-205.35(e)		X		
Incurring in accounting periods prior to the award of contract:					
Where allowable as precontract costs	15-205.35(g)	X			
All other	15-205.35(g)				X
<b>Royalties and Other Costs for Use of Patents:</b>					
Royalties or amortization of patent purchase costs	15-205.36(a)		X		
In case of patents formerly owned by contractor - amounts not in excess of costs which would have been allowed had the contractor retained title	15-205.36(c)		X		
<b>Selling Costs:</b>					
To extent reasonable and allocable to Government business	15-205.37(b)		X		
Salesmen's or agents' compensation, fees, commissions, percentages or brokerage fees contingent upon award of contracts - paid to bona fide employees or commercial or selling agencies maintained to secure business	15-205.37(c)		X		
<b>Service and Warranty Costs</b>					
	15-205.38		X		
<b>Severance Pay:</b>					
Normal turnover severance payments	15-205.39(b)(1)		X		
Abnormal or mass severance pay:					
Accruals	15-205.39(b)(11)				X
Recognition of Government's obligation to pay its fair share on a case-by-case basis	15-205.39(b)(11)		X		
<b>Special Tooling Costs</b>					
	15-205.40		X		
<b>Taxes:</b>					
Federal income and excess profits taxes	15-205.41(a)				X
Taxes in connection with financing, refinancing or refunding operations	15-205.41(a)				X
Taxes from which exemptions are available to the contractor	15-205.41(a)				X
Special assessments on land which represent capital improvements	15-205.41(a)	X			
Where claims of illegal or erroneous assessment exists	15-205.41(b)		X		
Reasonable costs of action undertaken by contractor, in cooperation with the contracting officer, to determine legality of tax assessment or secure a refund in cases where claims of illegal or erroneous assessment exists	15-205.41(b)	X			
Interest and penalties incurred because of nonpayment of any tax at the direction of the contracting officer or by reason of failure of contracting officer to assure timely direction after prompt request therefor	15-205.41(b)	X			
Any refund of taxes, interest, or penalties and any payment to the contractor of interest thereon attributable to items allowed as contract costs	15-205.41(c)	(X) Credit			
<b>Termination Costs:</b>					
<b>Common items:</b>					
Reasonably usable on contractor's other work	15-205.42(a)				X
Not usable on other work	15-205.42(a)	X			
Costs continuing after termination except where due to negligent or willful failure to discontinue such costs	15-205.42(b)	X			
Initial costs, including starting load and preparatory costs	15-205.42(c)		X		

\* Allowance without contract provision limited to amount which the contractor would have received had it retained title to facilities

Item	Paragraph Number	Allowable Subject to Usual Tests	Allowable if it Meets Special Tests or has Special Approval	Allowable only if Provided for in Contract	Unallowable
<b>Termination Costs: (Cont'd.)</b>					
Loss of useful value of special tooling, special machinery and equipment	15-205.42(d)		X		
Rental costs under unexpired leases	15-205.42(e)		X		
Cost of alterations of leased property	15-205.42(e)		X		
Reasonable restoration to leased property required by provisions of lease	15-205.42(e)	X			
Accounting, legal, clerical, and similar costs reasonably necessary for preparation and presentation of settlement claims, and the termination and settlement of sub-contracts	15-205.42(f)	X			
Storage, transportation, protection and disposition of property acquired or produced for the contract	15-205.42(f)	X			
Subcontractor claims, including the allocable portion of claims which are common to the contract and to other work of the contractor	15-205.42(g)	X			
<b>Trade, Business, Technical and Professional Activity Costs:</b>					
Memberships in trade, business, technical, and professional organizations	15-205.43(a)	X			
Subscriptions to trade, business, professional, or technical periodicals	15-205.43(b)	X			
Meetings and conferences, including cost of meals, transportation, rental of facilities for meetings, and costs incidental thereto	15-205.43(c)		X		
<b>Training and Educational Costs:</b>					
Programs of instruction at noncollege level designed to increase the vocational effectiveness of bona fide employees	15-205.44(a)	X			
Part-time education at an under-graduate or post-graduate college level relating to the job requirements of bona fide employees:					
Training materials, text books, and fees charged by education institutions	15-205.44(b)	X			
Tuition charged by educational institutions	15-205.44(b)	X			
In lieu of tuition, instructors' salaries and emoluments share of indirect cost of the institution not in excess of the tuition which would have been paid	15-205.44(b)	X			
Straight time compensation to employees for time spent attending classes during working hours not in excess of 156 hours per year	15-205.44(b)		X		
Tuition, fees, training materials and textbooks in connection with full time scientific and engineering education at a post-graduate level related to job requirements of bona fide employees - not to exceed one year for each employee trained	15-205.44(c)	X			
Subsistence, salary or other emoluments in connection with full time scientific and engineering education at post-graduate level	15-205.44(c)				X
Tuition, fees, training materials, text books, subsistence, salary or other emoluments in connection with full time education at an under-graduate level	15-205.44(c)				X
Maintenance expense and normal depreciation or fair rental on facilities owned or leased by the contractor for training purposes	15-205.44(d)	X			
Grants to educational or training institutions including the donation of facilities or other properties, scholarships or fellowships	15-205.44(e)				X
<b>Transportation Costs:</b>					
Freight, express, cartage and postage charges on goods purchased, in process, or delivered	15-205.45	X			
Outbound freight	15-205.45				X - As a direct cost only
<b>Travel Costs:</b>					
On an actual basis or on a per diem or mileage basis incurred in the normal course of over-all administration of the business	15-205.46(e)	X			
Directly attributable to performance of a specific contract	15-205.46(d)	X			
Necessary, reasonable costs of family movements and personnel movements of a special or mass nature	15-205.46(e)		X		
			X - Special allocation required where appropriate		

Office Memorandum • UNITED STATES GOVERNMENT

DATE: 27 November 1959

TO : CDR J. M. Malloy, OSD

FROM : E. T. Cook, CAD, NavCompt

SUBJECT:

Dear Pete:

Enclosed for your information is a copy of the article as sent to the Journal on the new cost principles. I will let you know when I hear whether they are interested in publishing it.

Sincerely,

Ed.

OFFICE OF THE NAVY COMPTROLLER  
CONTRACT AUDIT DIVISION  
WASHINGTON 25 D C

Page 1 of 5

Analysis of Treatment Accorded Specific Categories, Items, or Subitems in  
Revised Part 2, Section XV, ASPR, dated 2 November 1959

Item	Paragraph Number	Allowable Subject to Usual Tests	Allowable if it Meets Special Tests or has Special Approval	Allowable only if Provided for in Contract	Unallow- able
<b>Advertising:</b>					
In trade and technical journals valuable for dissemination of technical information within the contractor's industry, provided ads do not offer products or services for sale	15-205.1(a)(i)	X			
Help-wanted	15-205.1(a)(ii)	X			
Costs of participation in exhibits upon invitation of Government or where exhibits are for purpose of disseminating technical information within the contractor's industry and provided specific products or services are not offered for sale	15-205.1(a)(iii)	X			
To obtain scarce materials, plant or equipment or disposing of scrap or surplus materials	15-205.1(a)(iv)	X			
All other	15-205.1(b)				X
Bad Debts	15-205.2				X
<b>Bidding Costs:</b>					
Incurred in current accounting period	15-205.3	X			
"    "    past    "    periods	15-205.3				X
(Note: Alternative methods permissible)	15-205.3				
<b>Bonding Costs:</b>					
Bonding required by contract	15-205.4(b)	X			
Required in general conduct of business	15-205.4(c)	X			
<b>Civil Defense Costs:</b>					
On contractor's premises pursuant to suggestions or requirements of civil defense authorities	15-205.5(a)	X			
(Note: Costs of capital assets allowable only as depreciation)	15-205.5(b)				
Contributions to local civil defense funds and projects	15-205.5(c)				X
<b>Compensation for Personal Services:</b>					
To extent the total compensation of individual employees is reasonable for services rendered and not in excess of amounts allowable under Internal Revenue Code	15-205.6(a)(1)		X		
In lieu of salary for services rendered by partners and sole proprietors provided such compensation does not constitute a distribution of profits	15-205.6(a)(3)		X		
Salaries and wages for current services	15-205.6(b)	X			
Premiums for overtime, extra pay shifts and multishift work	15-205.6(b)		X		
Cash bonuses and incentive compensation	15-205.6(c)		X		
Bonuses and incentive compensation paid in stock	15-205.6(d)		X		
Stock options	15-205.6(e)	X			
Deferred compensation for services rendered during current period and for past service pension and retirement costs	15-205.6(f)		X		
Fringe benefits	15-205.6(g)		X		
<b>Contingencies:</b>					
In historical costing, except certain minor items	15-205.7(b)				X
In estimating future costs:	15-205.7(c)				
Where related to known and existing conditions which can be measured with reasonable accuracy		X			
Where related to known or unknown conditions which cannot be measured closely enough to provide equitable results					X
Contributions and Donations	15-205.8				X

Item	Paragraph Number	Allowable Subject to Usual Tests	Allowable if it Meets Special Tests or has Special Approval	Allowable only if Provided for in Contract	Unallowable
Depreciations:					
Normal	15-205.9(b)		X		
Emergency facilities	15-205.9(d)		X		
On idle or excess facilities not reasonably necessary for standby purposes	15-205.9(e)				X
Fully depreciated assets:					
Where substantial portion was recovered as a charge to Government contracts or subcontracts	15-205.9(f)				X
Other	15-205.9(f)		X		
Employee Morale, Health, and Welfare Costs and Credits	15-205.10	X			
Entertainment Costs	15-205.11				X
Excess Facility Costs:	15-205.12				
Where reasonably necessary for standby purposes		X			
Other					X
Fines and Penalties:	15-205.13				
Incurred in compliance with contract or written instructions from contracting officer		X			
Other					X
Food Service and Dormitory Costs and Credits:	15-205.14				
Allocation of reasonable losses to all activities served		X			
Profits to be credited, unless used for employee welfare		(X) Credit			
Insurance and Indemnification:					
Required or approved pursuant to contract	15-205.16(a)(1)	X			
Other insurance maintained for general conduct of business	15-205.16(a)(2)		X		
Actual losses which could have been covered by permissible insurance:	15-205.16(a)(3)				
Result of nominal deductible insurance coverage		X			
Minor losses such as spoilage, breakage, and disappearance of small hand tools		X			
Other such losses					X
Indemnification:	15-205.16(b)				X
Result of nominal deductible coverage		X			
Minor losses such as spoilage, breakage and disappearance of small hand tools		X			
Other indemnification					X
Interest and Other Financial Costs:	15-205.17				
Interest on borrowings					X
Bond discounts					X
Costs of financing and refinancing operations					X
Legal and professional fees paid for preparation of prospectuses					X
Preparation and issuance of stock rights					X
Interest assessed by State or local taxing authorities because of non-payment of tax at the direction of contracting officer or because of failure of contracting officer to assure timely direction after prompt request therefor	(See also 15-205.41)	X			
Labor Relations Costs	15-205.18	X			
Losses on Other Contracts	15-205.19				X
Maintenance and Repair Costs:	15-205.20(a)				
Normal		X			
Extraordinary costs, provided such are allocated to periods to which applicable		X			
Manufacturing and Production Engineering Costs	15-205.21	X			

Item	Paragraph Number	Allowable Subject to Usual Tests	Allowable if it Meets Special Tests or has Special Approval	Allowable only if Provided for in Contract	Unallowable
<b>Material Costs</b>					
Reasonable overruns, spoilage, or defective work	15-205.22(a)	X			
Cash discounts not taken because of reasonable circumstances	15-205.22(b)	X			
Adjustments for differences between physical and book inventories related to period of contract performance	15-205.22(c)	X			
Interplant, interdivision or intraorganization transfers:					
Ordinarily allowable at lower of cost to transferor or market	15-205.22(e)	X			
On a price basis	15-205.22(e)		X		
<b>Organization Costs:</b>					
Incorporation fees, attorneys' fees, accountants' fees, brokers' fees and fees to promoters and organizers, for organization, reorganization or raising capital	15-205.23				X
<b>Other Business Expenses:</b>					
Registry and transfer charges resulting from changes in ownership of securities issued by contractor	15-205.24	X			
Cost of shareholders' meetings	15-205.24	X			
Normal proxy solicitations	15-205.24	X			
Preparation and publication of reports to shareholders	15-205.24	X			
Preparation and submission of required reports and forms to taxing and other regulatory bodies	15-205.24	X			
Incidental costs of directors and committee meetings	15-205.24	X			
<b>Overtime, Extra-Pay Shift and Multi-Shift Premiums</b>	15-205.25		X		
<b>Patent Costs:</b>					
Preparing disclosures, reports and other documents required by the contract	15-205.26	X			
Searching the art as necessary to make invention disclosures	15-205.26	X			
Preparing documents and other costs in connection with filing patent applications where title is conveyed to Government in accordance with contract clauses	15-205.26	X			
<b>Plant Protection Costs:</b>					
Wages, uniforms and equipment of personnel	15-205.28	X			
Depreciation on plant protection capital assets	15-205.28	X			
Necessary compliance with military security requirements	15-205.28	X			
<b>Plant Reconversion Costs:</b>					
Cost of removing Government property and related restoration rehabilitation costs	15-205.29	X			
Additional costs to extent agreed upon before incurrence	15-205.29	X			
All other reconversion costs	15-205.29				X
<b>Precontract Costs:</b>					
To extent allowable if incurred after date of contract	15-205.30	X			
<b>Professional Service Costs - Legal, Accounting, Engineering, and Others:</b>					
Rendered by members of a profession who are not employees of the contractor	15-205.31(a)		X		
Retainer fees supported by evidence of bona fide services available or rendered	15-205.31(b)		X		
Legal, accounting, and consulting services, and related costs, in connection with organizations and reorganizations, defense of anti-trust suits and the prosecution of claims against the Government	15-205.31(c)				X
Legal, accounting, and consulting services, and related costs, incurred in connection with patent infringement litigation	15-205.31(c)			X	
<b>Profits and Losses on Disposition of Plant, Equipment or Other Capital Assets</b>	15-205.32				X
<b>Recruiting Costs:</b>					
Help-wanted advertising	15-205.33	X			
Operating costs of employment office	15-205.33	X			
Operating and aptitude and educational testing program	15-205.33	X			
Travel costs of employees while engaged in recruiting personnel	15-205.33	X			
Travel costs of applicants for interviews for prospective employment	15-205.33	X			



Item	Paragraph Number	Allowable Subject to Usual Tests	Allowable if it Meets Special Tests or has Special Approval	Allowable only if Provided for in Contract	Unallowable
<b>Recruiting Costs: (Cont'd.)</b>					
Employment agency charges at not in excess of standard commercial rates	15-205.33	X			
Special benefits or emoluments beyond the standard practice in the industry	15-205.33				X
<b>Rental Costs (Including Sale and Leaseback of Facilities):</b>					
Land, building and equipment and other personal property	15-205.34(a)		X		
Interplant, interdivisional and interorganization charges	15-205.34(b)		X		
Sale and leaseback agreements	15-205.34(c)			X*	
Under unexpired leases in connection with terminations	15-205.34(d)				
	15-205.42(e)		X		
<b>Research and Development Costs:</b>					
Costs of independent research	15-205.35(d)		X		
Costs of independent development	15-205.35(e)		X		
Incurrd in accounting periods prior to the aware of contract:					
Where allowable as precontract costs	15-205.35(g)	X			
All other	15-205.35(g)				X
<b>Royalties and Other Costs for Use of Patents:</b>					
Royalties or amortization of patent purchase costs	15-205.36(a)		X		
In case of patents formerly owned by contractor - amounts not in excess of costs which would have been allowed had the contractor retained title	15-205.36(c)		X		
<b>Selling Costs:</b>					
To extent reasonable and allocable to Government business	15-205.37(b)		X		
Salesmen's or agents' compensation, fees, commissions, percentages or brokerage fees contingent upon award of contracts - paid to bona fide employees or commercial or selling agencies maintained to secure business	15-205.37(c)		X		
<b>Service and Warranty Costs</b>					
	15-205.38		X		
<b>Severance Pay:</b>					
Normal turnover severance payments	15-205.39(b)(i)		X		
Abnormal or mass severance pay:					
Accruals	15-205.39(b)(ii)				X
Recognition of Government's obligation to pay its fair share on a case-by-case basis	15-205.39(b)(ii)		X		
<b>Special Tooling Costs</b>					
	15-205.40		X		
<b>Taxes:</b>					
Federal income and excess profits taxes	15-205.41(a)				X
Taxes in connection with financing, refinancing or refunding operations	15-205.41(a)				X
Taxes from which exemptions are available to the contractor	15-205.41(a)				X
Special assessments on land which represent capital improvements	15-205.41(a)	X			
Where claims of illegal or erroneous assessment exists	15-205.41(b)		X		
Reasonable costs of action undertaken by contractor, in cooperation with the contracting officer, to determine legality of tax assessment or secure a refund in cases where claims of illegal or erroneous assessment exists	15-205.41(b)	X			
Interest and penalties incurred because of nonpayment of any tax at the direction of the contracting officer or by reason of failure of contracting officer to assure timely direction after prompt request therefor	15-205.41(b)	X			
Any refund of taxes, interest, or penalties and any payment to the contractor of interest thereon attributable to items allowed as contract costs	15-205.41(c)		(X) Credit		
<b>Termination Costs:</b>					
<b>Common items:</b>					
Reasonably usable on contractor's other work	15-205.42(a)				X
Not usable on other work	15-205.42(a)	X			
Costs continuing after termination except where due to negligent or wilful failure to discontinue such costs	15-205.42(b)	X			
Initial costs, including starting load and preparatory costs	15-205.42(c)		X		

\* Allowance without contract provision limited to amount which the contractor would have received had it retained title to the facilities

Item	Paragraph Number	Allowable Subject to Usual Tests	Allowable if it Meets Special Tests or has Special Approval	Allowable only if Provided for in Contract	Unallowable
<b>Termination Costs: (Cont'd.)</b>					
Loss of useful value of special tooling, special machinery and equipment	15-205.42(d)		X		
Rental costs under unexpired leases	15-205.42(e)		X		
Cost of alterations of leased property	15-205.42(e)		X		
Reasonable restoration to leased property required by provisions of lease	15-205.42(e)	X			
Accounting, legal, clerical, and similar costs reasonably necessary for preparation and presentation of settlement claims, and the termination and settlement of sub-contracts	15-205.42(f)	X			
Storage, transportation, protection and disposition of property acquired or produced for the contract	15-205.42(f)	X			
Subcontractor claims, including the allocable portion of claims which are common to the contract and to other work of the contractor	15-205.42(g)	X			
<b>Trade, Business, Technical and Professional Activity Costs:</b>					
Memberships in trade, business, technical, and professional organizations	15-205.43(a)	X			
Subscriptions to trade, business, professional, or technical periodicals	15-205.43(b)	X			
Meetings and conferences, including cost of meals, transportation, rental of facilities for meetings, and costs incidental thereto	15-205.43(c)		X		
<b>Training and Educational Costs:</b>					
Programs of instruction at noncollege level designed to increase the vocational effectiveness of bona fide employees	15-205.44(a)	X			
Part-time education at an under-graduate or post-graduate college level relating to the job requirements of bona fide employees:					
Training materials, text books, and fees charged by education institutions	15-205.44(b)	X			
Tuition charged by educational institutions	15-205.44(b)	X			
In lieu of tuition, instructors' salaries and related share of indirect cost of the institution not in excess of the tuition which would have been paid	15-205.44(b)	X			
Straight time compensation to employees for time spent attending classes during working hours not in excess of 156 hours per year	15-205.44(b)		X		
Tuition, fees, training materials and textbooks in connection with full time scientific and engineering education at a post-graduate level related to job requirements of bona fide employees - not to exceed one year for each employee trained	15-205.44(c)	X			
Subsistence, salary or other emoluments in connection with full time scientific and engineering education at post-graduate level	15-205.44(c)			X	
Tuition, fees, training materials, text books, subsistence, salary or other emoluments in connection with full time education at an under-graduate level	15-205.44(d)			X	
Maintenance expense and normal depreciation or fair rental on facilities owned or leased by the contractor for training purposes	15-205.44(d)	X			
Grants to educational or training institutions including the donation of facilities or other properties, scholarships or fellowships	15-205.44(e)				X
<b>Transportation Costs:</b>					
Freight, express, cartage and postage charges on goods purchased, in process, or delivered	15-205.45	X			
Outbound freight	15-205.45			X- As a direct cost only	
<b>Travel Costs:</b>					
On an actual basis or on a per diem or mileage basis	15-205.46(b)	X			
Incurred in the normal course of over-all administration of the business	15-205.46(c)		X- As an indirect cost		
Directly attributable to performance of a specific contract	15-205.46(d)	X			
Necessary, reasonable costs of family movements and personnel movements of a special or mass nature	15-205.46(e)		X- Special allocation required where appropriate		



## P R O C E E D I N G S

[The meeting convened at 8:25 o'clock, a.m.,  
Monday, 12 October 1959, GSA Auditorium, Washington, D. C.]

CAPT. FAGAN: Good morning. This is the fourth of our procurement talks, and the first three--the first two particularly--we have called quite controversial subjects. The third one was on auditing, and the use of auditors.

This morning, we are going to hear about cost principles. I got exposed to procurement from BuShips beginning in 1948, and one of the hottest subjects at that time was cost principles.

I had heard of Section 15 before I got there, but I had no idea what it was. I thought it was a revenue code, and then I got to BuShips and found that Section 15 had to do with cost type contracts, and that sort of thing, but there was considerable debate as to whether or not it was theoretical; whether it applied to fixed type contracts as well as cost type contracts.

In 1948, some ten or eleven years ago, cost principles were quite a discussion, quite an issue. I got back in Washington, here, in 1956 and found out that the subject hasn't changed a bit or had the solution apparently toward the subject.

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We have got a man with us this morning who knows about cost principles, being the Chairman of the ASPR Committee. He has been with cost principles ever since he has begun procurement some 10 or 15 years ago. He is actually the most knowledgeable one on cost principles, and the development of them, and where they stand today.

You all know Commander John M. "Pete" Malloy, soon to be Captain Malloy, and with this short introduction I will introduce Commander Malloy.

CDR. MALLOY: Thank you, Captain Fagan. Of course, it is a pleasure for me to come back to the Navy after my current exile in the Office of the Secretary of Defense. There has always been a question in my mind as to whether the Navy would take me back. You can see they have already taken my uniform away.

I'd like to talk to you today about the contract cost principle exercise. Somebody asked me this morning was I in a position to tell all this morning and I said, "Well, No, not really but I am in a position and do intend to tell more than I should."

So, although I don't have a completely free hand to talk as to the complete contents of this document and the exact current status of it, I will give you as much as I absolutely can. I am under some wraps since

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among other things my boss has told me to keep my mouth shut and such other direct admonitions.

I would like to take up with you today, and try to describe, some of the objectives which we are trying to accomplish by putting out a so-called comprehensive set of contract cost principles. I will give you some of the important highlights of the new principles themselves.

I think some of the history of this exercise might be of interest to most of you. I don't think that too many of you realize the number, the great number, of people in government outside of the Navy Department--if you will--who are interested in and have a voice in what kind of contract cost principles we will have, and I think maybe I can give you a little on that.

I also would like to give you my own personal evaluation as to these principles as a set of contract cost principles, and as to the effect they will have when published for what they are worth, and then after lunch to the extent we have time I would be glad to tell you the current status of the project.

First of all, I think that you have to be in the proper frame of mind to consider objectively this very controversial kind of a regulation, and because I think--and I speak with some actual degree of experience with respect to this--we sometimes think emotionally



about this subject.

One of the things I have found out, incidentally, over in the Pentagon is--it was a great shock to me, too--but I found out that the Navy wasn't necessarily right on every matter. This you find out in the Pentagon. These are some of the plus factors, too few that there are, but you do have to put yourself in the proper frame of mind and the frame of mind that I would suggest to you this morning would be to consider this project from the standpoint of top managers of the procurement function of the Department of Defense rather than your own little niche, and when I speak of top management I am really talking about the people who have the ultimate responsibility which would have to be the Secretariat level, including if you will the Secretary of Defense.

I would like to make before I go on any further, before I forget it, one observation. I would ask you not to discuss freely with any industry friends whom you have the contents of my remarks this morning, and that I only ask out of an abundance of caution. There will be nothing classified in what I have to say, but we are trying to handle the public relations aspect of this exercise rather closely. Any premature disclosure of some of the things that I have to say this morning would not help us one little bit.

Let's get into it then, and try to set forth some of the objectives which we are seeking to obtain by putting out a comprehensive set of cost principles; that is, a set of principles which will be used in one way or another as the basic groundrules whenever costs are a factor in procurement, and you will notice that my words are rather carefully chosen--whenever costs are a factor in procurement--and that is not to say that costs always should be a factor. But, first, we have I think the obligation to up-date the contract cost principles which we have in the book now.

These were published in 1948. They are rather sketchy. A lot of new things have come on the horizon since these were published. We have been in the process of revising them for the past six years, and so you'd expect that we would need some up-dating and this, of course, has to be one of the objectives.

We are also seeking to obtain some uniformity of treatment of these various elements of cost, and this uniformity of treatment has to do with uniformity within the Department of Defense first among the three Services, and then--if you will--sometimes a little uniformity among the Navy bureaus doesn't hurt, and that is one of the things that might be accomplished here with these contract cost principles.

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Also, we are trying to put out a blueprint, if you will, which will set forth Department of Defense policy so that a cost can be treated policy-wise at least the same way regardless of the type of contract that is used. In other words, we are trying to get over the hurdle of the selection of a contract type so that no one contract type will be more desirable than another merely by reason of the cost treatment which is accorded.

This is not trying to upset, and to make all the types of contracts the same, but you know yourselves that contractors and we ourselves often select a particular type of contract not because it is the best type of contract for the particular application, but because it has a more liberal cost treatment involved in it, and we think lastly that this exercise will get us better administration of many of our important programs in the Department of Defense.

We think it will get us better procurement. We think it will get us better auditing. We think it will save some money and we are not--as one of our objectives--we are not out to write a set of cost principles merely to save money. You could do that very easily. Just increase your unallowables. This was not one of the major objectives, but we think that we will have some savings as a by-product of this exercise.

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Now, a few things that this is not designed to do. It is not designed to be an accounting blueprint. It has many, many, references in it indicating that there is no need for any major revision of a contractor's accounting system to accommodate these cost principles.

Now, there will be some but not very major for a contractor who is already doing business with the Government. Some of our definitions will cause a kind of tightening up for some contractors, and for others who have a very loose arrangement there would be more practical effects, but it was not set out to be an accounting blueprint and we don't believe that that will be the effect of these principles we published; that is, that there will be any accounting revolution, you might say, on the part of our contractors.

We are not seeking here to throw into the Potomac the pricing philosophy which we hold so dearly. You will see somewhat later our attempt to emphasize our pricing philosophy, and maybe some of the reasons why we feel that this emphasis is necessary at this time.

Now, another thing that this is not designed to be is it is not designed to be a document which will guarantee to contractors a certain recovery of costs just because we have a list of contract cost principles that are listed as allowable. It is no guarantee that we

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should not allow it to be a guarantee that the contractor will automatically recover these costs.

Now here, of course, our procurement principles come into play. The question of reasonableness, allocability, but more important the question of the contractor's efficiency and our pressures to make him more efficient.

Let's look at the situation as we have it today. We have contract cost principles for terminated contracts. We have--excuse me, I was reading ahead of myself here--we have contract cost principles for terminations, a separate set. We have a separate set for cost type contracts, and as to fixed price contracts insofar as policy direction is concerned we have nothing. We have a void.

Some of you are familiar with the abortive attempt a few years ago to prescribe the current Section 15 for fixed price contracts, and you know that this was--it was prescribed as a guide. You know that less than a year later that particular Department of Defense directive was cancelled. We know that today, in these sets of cost principles that are printed and published, the one for cost type contracts and one for terminations, that there are some rather significant differences.

Interest, for example, is allowable under our termination cost principles and it is unallowable in our cost type contract situation and where it is in the fixed

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price contract situation depends on a lot of things including the power and strength of the negotiating parties and what not.

Now, what should be the Department of Defense policy on anything like interest, and is there any difference in the situation where you meet the problem of interest? Now, that is one of the things we are trying to come upon. There are differences in application of such things as interest and any other cost, individual costs, research if you will, training if you will, contributions and donations. There are differences existing today as between Navy Bureaus, Army, technical services, individual offices in the Air Force. There are different philosophies, actually, in the military departments and I can cite you one specific case which is known maybe to a lot of you, and this was hammered home to me by Congressman Bates one day when he was then a member of the Hebert Committee, and he was saying that he--and, incidentally, he was one of the greatest friends we had down there--and I say had because he is no longer on the Committee.

He said, "I can't understand for the life of me, sympathetic as I am with the Department of Defense, I can't understand for the life of me why the Air Force says that a profit sharing plan, or a bonus if you will,



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based on a profit sharing plan, is automatically unallowable and the Navy comes here the next day to our Committee and says 'We see nothing wrong with compensation based on profit sharing planning.' A profit sharing plan is merely a way of measuring a man's compensation, and if the overall compensation is reasonable. This is the way we look at it."

Now, there is a lot of money riding here, thousands and thousands, and even millions of dollars, and two Departments come down before a committee of Congress and one says, "Our policy is so and so," and another says, "Our policy is exactly the opposite," and they obviously look to the Department of Defense and say, "What is the Department of Defense policy, make up your mind."

Now, shouldn't this be so? This, of course, is one of the things we are trying to do with our comprehensive set of contract cost principles. Now, what is in this set? Well, it represents a lot of work, I can assure you for one thing. It has been going on for the past six years. It represents a rather delicate balance at the moment, because we have opinions which run from one extreme to the other, with people saying there should be no cost principles except for cost type contracts, and others saying they should be made mandatory for all

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contractual situations, and that they should be incorporated into contracts in all but fixed price situations.

So, what we have in the package today is a rather delicate balance of the conflicting points of view and, of course, you have industry who like no part of anything unallowable. Industry, strangely enough, if you read their material closely, can be said to be very much in favor of a comprehensive set of contract cost principles.

Now, that may cause some raised eyebrows on the part of the more sophisticated and experienced with this exercise in the audience, but I maintain that it is so. Industry would love to have a comprehensive set of cost principles. Under certain conditions, of course, they have expressed themselves as being in favor of this but what they want is a set of cost principles not near as detailed as we have which, in effect, would have everything allowable. They won't like any unallowable. This is almost tantamount to being un-American to have an unallowable. They would like to have everything allowable, and industry as a whole with their trained negotiators they start from up here in order to get here. They argue for everything being allowable so that they can get a better cost recovery, and some people think that

what they are after is a guaranteed cost base with the cost guaranteed to them through a single set of cost principles and if everything were allowable maybe this would be a good result from their point of view.

Anyway, the set that we have today I think in considering it you would have to start with the roughest part; that is, the applicability. How are you going to use them? We have it set up, first, starting with the obvious. They would be used as the contractual basis for reimbursement--for cost reimbursement type contracts which is not much different from the situation today. For fixed price contracts, the cost principles would be used. Boiling the whole thing down to its key clutch word, they would be used as a guide.

Now, in the contract termination setup, they would be used also as a guide. The Section 8, today, suggests the use of cost principles as a guide and some of the language that is in Section 8 of ASPR with respect to the use of cost principles and the termination situation that language was so good we thought, some of us, that we lifted it. If you will check it, you will see we have lifted somewhat the good language, and have put it in the applicability section of these new principles.

We have the problem, here, a very real problem of the spectrum that we are trying to cover. The cost

situation where we traditionally feel that we should be very conservative, moving down the line to the re-determinable contract, redeterminable after the fact. Now, we don't use many of those in the Navy but I am rather surprised at the extent of their use in some of the other Services particularly in the Army.

If you have an after the fact re-determinable contract of \$100,000,000, do you have a situation pretty close to a cost reimbursement type contract? Yes, and how about the next one down the line our old friend and incentive contract, fixed price incentive contract? The contract clause, itself, says there will be a negotiation of costs, and this is done after the fact. This is a retrospective application. We know what has been incurred; what is the Department of Defense policy here. You don't have to be guessing, you do have a negotiation but not something that is out in the wild blue yonder, a situation that calls for and requires a certain degree of precision, not a completely boxed in type of precision, but precision nonetheless, and as you move down the spectrum you come to the other family--the other wrinkles in the family--of redeterminable contracts and in many of these you need contract cost principles.

You need something. Anyway, we start off with that, you need something and we hope that we are providing

you with the something in these principles.

I think I might profitably spend a little time on this particular section, the applicability, and I am going to read you something which is substantially accurate as to the way it will be published, and this will come out as a part 6 of section 15 which will be headed "Guidelines for Application in the Negotiation and Administration of Fixed Price Type Contracts, and in the Negotiation of Termination Settlements."

Incidentally, you will notice that we have treated the termination situation quite similarly to the other situation that you meet in the retrospective costing or pricing. Your termination is a situation in which you use cost principles as a guide for a negotiated settlement at a point where costs have been incurred, and there are parallels in the negotiation situation which I have already mentioned--after the fact re-determinable; your incentive contracts, and some of your other re-determinables so your terminations are mixed here so this part provides guidance for the parts 2 and 3, and for evaluation of costs in pricing of negotiated fixed price contracts and subcontracts in those instances where such evaluation is required to establish prices for subcontracts and in the negotiation of

termination situations.

Under fixed price type contracts, the negotiated price is the basis for payment to a contractor whereas allowable costs are the basis for reimbursement under cost reimbursement contracts. Accordingly, the policies and procedures of ASPR, Section 3, part 8, and that is of course the specific ASPR containing our pricing policies, are governing and shall be followed in the negotiation of fixed price type contracts.

Cost and accounting data may provide guides for ascertaining fair compensation but are not rigid measures of it. Other types of data or criteria, or standards, may furnish reliable guides to fair compensation.

The ability to apply standards of business judgment as distinct from strict accounting principles is at the heart of a negotiated price or settlement.

You see, there, our attempt to remove ourselves from any potential straightjacket which may be forced on us as a result of publication of a comprehensive set of contract cost principles. Here, we have specifically referred back to the policies, our pricing policies. We have said they will be controlled, and we have put in some of the language from the termination section that I at least thought was pretty good.

Now, we have still the problem of differentiating



between retrospective pricing and prospective pricing, where you are looking back to a cost that you have incurred. It seems to me you have one situation where you are looking ahead, and guessing that you have another situation, so we try to get at that kind of a break in this fashion.

First, as to these two among the different types of fixed price type contracts, the need for consideration of course varies considerably as indicated below. First, retrospective pricing and settlements in negotiating firm fixed price or settlements for work which has been completed at the time of negotiation; that is, final negotiations under fixed price incentive contracts, re-determination of price at the completion of work, or negotiation of a settlement under a contract terminated for the convenience of the Government.

The treatment of cost is a major factor in arriving at the amount of the price of settlement. However, even in these situations the finally agreed price or settlement may represent something other than the sum total of acceptable costs plus profit, since the final price accepted by each party does not necessarily reflect agreement on the evaluation of each element of cost but rather a final resolution of all issues in the

negotiation process.

If you were to sit down, yourself, in all honesty and try to attack that problem I wonder what you'd write. That is what we wrote. The type of language was written some three years ago, and I take no personal credit whatsoever for it. The section on forward pricing:

"The extent to which costs influence forward pricing varies greatly from case to case. In negotiations covering future work, actual costs can not be known and the importance of cost estimates depends on the circumstances.

The contracting officer must consider all the factors affecting the reasonableness of the total proposed price, such as the technical production or financial risk assumed; the complexity of the work; the extent of competitive pricing, and the contractor's record for efficiency, economy, and ingenuity.

Available cost estimates must be present to bargain for total price, to equitably distribute a risk between the contractor and the Government and provide incentive for efficiency and cost reduction.

In negotiating such a price, it is not possible to identify the treatment of specific cost elements since bargaining is on a total price basis. Thus, while cost data

is often a valuable aid it will not control the negotiation of prices for work to be performed or a target price under an incentive contract."

Does that, I wonder, give you enough room to operate in in the manner in which you have become accustomed, and in the manner in which you would prefer to remain accustomed? I think it does.

Now, we come to the punch line of the document which goes on this way:

"When, pursuant to ASPR 15-6 or 2, costs are to be considered in the negotiation of fixed price type contracts."

If I might stop there, that is rather important. "When costs are to be considered." Now, this doesn't intend to say, doesn't mean to say, and I hope won't be construed to say, that costs are always a factor in negotiating prices. Very often, under the right competitive situation as we all know we don't care what the man has in his cost. We are not interested. We don't want any breakdown. We, I think, all believe quite sincerely that the very best price that we can obtain is one which is established in the marked place under competitive conditions.

That is how the water gets out, and when we are satisfied that competitive conditions are correct and that they have taken the water out, we don't care

anything further and shouldn't care anything further about the use of cost principles and that is not intended to prescribe the use of these principles when you would not, yourself, even today want to look at the breakdown of costs. So, to go on:

"When, pursuant to ASPR so and so costs are to be considered in the negotiation of fixed price type contracts, the appropriate part of this Section 15 shall be used as a guide in evaluation of cost data required to establish a fair and reasonable price in conjunction with other pertinent considerations as set forth more fully in ASPR Section 3, part 8."

Again, a throwback to pricing and an abundance of caution if you will and to go on:

"In the case of negotiated termination settlements, Section 8 Part 3."

So that, then becomes the punch line for the use of cost principles in the fixed price contract area. Now, what do you do; how are you guided in a case where you are in an argument with the contractor over a specific item of cost?

Now, we sometimes talk rather loosely--we procurement people--about how we use costs in negotiating price and you sometimes get the idea that we really are not much interested, that we go through no real approach and get a price that is real tight and close, and that we

get it out of the air, and you and I know that we sometimes do it that way, but more often than not we are in there pitching with some detail, and we are looking at the cost and you can't look at costs plural, you look at costs singular, those that are of any magnitude.

Now, suppose you under this set of contract principles are in an argument with a contractor on an individual item of cost, and you know what this document says, that the principles will be used as a guide, and our guide says they are unallowable. What happens in an individual case? We have tried to write it in a retrospective situation; that is, where you are in an argument as to cost that has been incurred, and we have tried our hand this way:

"In retrospective pricing, wherever an occasion arises in which the acceptability of a specific item of cost becomes an issue, the appropriate part of this Section 15 will serve as a guide for the contracting officer in his conduct of negotiations."

This particular little paragraph is one of the most important in the entire document, and six or eight months ago--I guess as short as six months ago--that paragraph read considerably different. It read something like this that whenever an individual item of cost becomes an issue, the contracting officer will serve--the contract

cost principles--will serve as a basis for the resolution of the issue. You see the difference?

In the latter instance, you would be pretty well bound in an argument with a contractor to resolve it the way the book says. As here written, there is obviously a need to follow the policy laid down by your bosses. They say you will use these as a guide. They didn't say, however, that you will have to use it every time. They didn't say that you have to throw common sense out the window. They didn't say that you would abandon overall bargaining. You can, I think, depart from these but when you do, when you depart from the guidance that has been laid down by your superiors, it is only right that you have a pretty good story.

You shouldn't depart on some whim of your own. You ought to be willing to stand up and be counted. We have other language here which will, I hope, not get us into the straightjacket of having to examine each and every minor item of cost and where we don't follow the blueprint exactly have to fill the file with that much justification. We don't intend this, and I think that there is enough flexibility here to prevent it, absent some bad approach--if you will--by those who might be looking over your shoulder including the procurement types who do that sort of work, and the audit types. But, absent



the wrong approach from that standpoint I do not think we have built a straightjacket for you.

We have tried to describe this somewhat along these lines:

"In applying Section 15 to fixed price contracts, contracting officers will, one, not be expected to negotiate agreements on every individual element of cost. Two, will be expected to use their judgment as to the degree of detail in which they consider the individual element of cost in arriving at their evaluation of total cost where such evaluation is appropriate.

However, the negotiation record should fully substantiate and justify the reasoning leading to any negotiated price."

Now, that last sentence is no more than you have today as a requirement. Now, how are these going to be used by our contractors? Are they bound by these principles in preparing their cost breakdowns? This is a very touchy area, a very difficult one, one in which we obviously don't see eye to eye with the contractors.

We have tried our hand on it this way, bearing in mind that regardless of what we said that no contractor, or I should say prospective contractor, would be bound by anything we say here because this is a document--well he would in certain situations possibly--but by and large these will be used before the man is a contractor. He is a prospective contractor and, hence, is not legally

contractually bound.

Well, we tried our hand at expressing this and this is some change from earlier drafts, some loosening up if you will.

"In order to permit the proper evaluation of cost data submitted by contractors for use in negotiating prices, it may be necessary to obtain breakdowns or account analysis in respect to some cost elements particularly those whose treatment may be dependent upon special circumstances as stated in the principles.

Contractors will be expected to be responsive to reasonable requests for data of this kind."

It is a little weak, I think. Will it do any good at all, that kind of language? I think it will. Will it do the most good? You have a difference of opinion. Some, of course, feel the contractor should be required to the maximum extent we can, using all of our powers, to prepare his account analysis, and cost breakdowns, strictly in accordance with the contract cost principles because this makes the audit job easier; makes the consideration of costs and pricing easier. We have not adopted, here, the rather stringent approach.

Well, I have spent a great deal of time on the applicability because they are really at the heart of this whole exercise. I recall speaking with Jim Bannermann the other day, and he was recalling this whole

exercise which started in about 1953, when a gentleman on the Staff of the Office of the Secretary of Defense had in his hand a document which he had developed called "A Comprehensive Set of Contract Cost Principles", and they had a meeting of the three Services to find out what this was all about, and it was announced as being something that was all ready to go, and should go right away.

Here was a new blueprint of cost. This would save us all kinds of money, and Jim relates the story of how he was sitting in as the Navy representative on that meeting, and how he came back and he says, "Actually, before I even left the Pentagon I was on the phone. I was ringing bells all over the Navy building, and all over everywhere that I could ring them," and he succeeded in getting enough people exercised about this whole scheme that it was delayed somewhat, about six years. Bannermann had good Navy training.

But, Jim went on and said that this early draft had not a word on how are you going to use them, and this of course was at the crux of the whole exercise and so they set about drafting how to use or, as we call it, the applicability and some two or three years later they had an applicability not in basic substance too much

different from that which I have described to you this morning.

We have made it more flexible. We have fixed it up here and there, but in its basic elements it is not too different from that which was developed about three years ago, and which the majority of procurement types decided was then a feasible project having described the use to which these principles would be put.

Well, now, let's get into the principles in slightly more detail. We, of course, have here much more detail than we have in the book today. I think the present Section 15 has what, five or six pages, something like that. I would guess that the new cost principles in terms of pages--which is a rather bad way to measure--but in terms of pages maybe 25 or 30 pages. That gives you some idea. You have considerably more guidelines in many, many, areas.

We have, for example, tried our hand at defining reasonableness, and allocability.. Sort of foundation words, wouldn't you say? Foundation words with respect to the current Section 15, and yet not defined in the ASPR today. They are probably not susceptible of precise definition, particularly the one on reasonableness. But I think you will find that they

will be helpful in certain situations. We have provided for a gimmick known as "advanced understanding."

Now, an advanced understanding is something that takes place obviously in advance of the signing of the contract, in situations in which the question of reasonableness or allocability are quite difficult to determine, and these advanced understandings are particularly important when dealing with contractors who do a very large volume of business the great majority of which is with the Government, and where the competitive forces of the market place do not control their activities in a very elaborate fashion.

So, we provided that advance understandings should be reached in these instances. We have a difficult problem with respect to the reasonableness of executive compensation. Now, we don't have this all the time, but we have it sometimes particularly now since the new principles will have as the guideline the man's total compensation no matter how he gets it. Shouldn't you sit down in difficult situations before the contract is placed, and figure out with respect to a particular contractor what the salary scale is going to be so far as what we pick up?

You have some real substantial problems with respect to overhead, research, expenses. Shouldn't you

sit down and do these things in advance? Mass movement of personnel; pre-contract costs; there are a list of seven or eight areas which are suggestive in this new set of cost principles, suggestive of advance understandings and when you have reached advanced understandings in the cost reimbursement area they will be incorporated into the contract.

In the fixed price area, this will be put in the contract file. Now, others would have us put-- others meaning, more specifically, the General Accounting Office--would have us put these advanced understandings as a part of the contract regardless of the type of contract, but as now set up it would be in the contract file except in cost reimbursement type situations as to the individual items of cost that are, we will say, in the allowable category.

I have indicated that compensation will include all facets of compensation regardless of how determined, which really boils down to the real severe argument within the Department of Defense as to whether bonuses based on profit sharing plans would be allowable. That one reached the level of the Secretary of Defense himself last year about this time, and he decided that the total compensation was the key.

Research is a particularly difficult individual



cost element. Probably absolutely the most difficult. Here, we are caught in the horns of a dilemma. The research people want to stimulate research, independent research, by contractors. Non-sponsored research, on the theory that these contractors can break a lot of research barriers on their own, and can do it often cheaper.

So, how to provide the incentive through reimbursement of overhead for independent contractor-- independent research-- and avoid the runaway situation which some of our contractor friends obviously indulge in? We know that contractors, today, get ahead primarily on their technical excellence. They have to get themselves that posture of being better technically than the other fellow, and if they can get themselves in that posture on our money isn't that lovely. How to prevent that in a situation where you don't have the competitive restraints of a mix of commercial and military business. There is the dilemma.

We had an approach before an industry meeting of last year, which would lump the three kinds of research this way. It would lump basic research, or blue sky research, or general research, whatever you want to call it, and applied research together, or rather in our previous one we split basic research and applied research

with the applied following the pattern for development and we have become rather substantially convinced that any attempt to draw the line between basic research and applied research is fraught with all kinds of complications, so we have dropped that concept.

We have, now, lumped applied research and basic research together and we have said--and we call this, then, independent research, so independent contractor's research is a reimbursable element of cost through overhead.

Now, subject to what? Subject to these advance agreements that I indicated that we would agree with them in advance on these things, which provides one check on it and provided in the principles themselves also are several methods by which we can come at the problem of paying less than what the contractor wants to put into it.

This could be a dollar sharing. For every dollar he puts, we will put a dollar in. This can take the form of a review of individual research programs and decisions as to which one we will support; things that we are doing today for the most part, and we have an agreement to have a three Services approach to the research expenses to be reimbursed through overhead for the major big large contractors.

We have not figured out how to do this yet. I

hate to think of how to do it, but I suppose we have got to but this is a realization that some of these expenses get so big that there must be some coordination as between the three Services and, obviously, there are from a contractor point of view and they have let us hear this loud and clear.

They say we obviously can not sit down with 500 individual different contracting officers and argue about how much of our research will be reimbursed for overhead. They won't be capable of these decisions. We will be put through a terrible nightmare.

So, we will try to do it centrally by departments, and then we will try to get the department to work together pretty much the same approach that we use in negotiated overhead rates.

Time is running; if I might skip along and mention some of the individual unallowable costs that are in this package. As you can imagine, some advertising costs are unallowable. Our old friend the institutional and product advertising will stay unallowable, but by and large the principle will look something like the current principle on advertising with some additions to it, some liberality, some reimbursement for exhibits and things of that kind that we don't even treat today.

Interest will be unallowable; you can have some

fun debating that one if you like. I don't have the time to develop it here. Let me say only that most people agree that interest should be unallowable. Whether they are right or not is another question, but even in industry the feeling of the people who have tried to analyze this concept abstractly differ. We have it as unallowable.

Contributions and donations, another friend, unallowable; bad debts, unallowable; stock options, unallowable; just a few. These I don't think are of any surprise. Now, about the final package with respect to cost reimbursement type contracts. Is it more liberal? Will a fellow get more under these new principles than under the old? That is rather important when we start worrying about whether we can amend current contracts or not.

We can not provide a completely definite answer on this. I will give you my personal opinion. Contractors have been giving us the business saying when you publish those terrible new contract cost principles don't forget that you have got to provide a mechanism to give us an equitable adjustment as to increase in prices, to make these things equal--the old versus the new.

I don't think this is factual, however, my

own view is that the new principles--and before I indicate that view--let me merely hedge further by indicating that as I have described the research principle and the advance agreement idea, that a lot depends on the actual administration of these principles. The man doesn't automatically get reimbursed just because you put out principles.

But, this concept, I have the personal opinion that as to cost reimbursement type contracts substantively there will not be a great deal of difference. I feel that there is a slightly more liberal set of cost principles that will be coming out, more liberal than today, more liberal than the principles that are published. Not quite so much more liberal if you consider together the principles that are published, plus our practices under them.

Our practices meaning what we are doing to fill in the gaps that exist today, so I think slightly more liberal in the cost reimbursement type situation.

In the termination situation, and in the fixed price situation, well in the fixed price situation we have no guidelines today prescribed. I have the idea that the new principles will require, and certainly they are intended to require, more precision in the negotiation of prices and, hence, I think that the

overall result will be advantageous in the fixed price area. I don't think it will make a hoot and a damn's worth of difference in the termination area.

Sure, the new principles for termination contracts may be a little bit tighter in that, for example, I have indicated interest is allowable today in terminated contracts and not allowable in the new principles. By and large, I don't think it will have a very great effect in termination.

We have had six years' history of this exercise. We have met with industry innumerable times. We had a rather unique meeting in October of last year where the twelve industry associations interested in this exercise got together and nominated a spokesman who came before a meeting which I am sure a lot of you attended, which was primarily for the benefit of the decision making Assistant Secretaries of the military departments, and in the Pentagon, to listen to both sides of the controversial items.

The industry spokesman said his piece, and he didn't pull any punches, and the Government spokesman said his piece, and there was a verbatim transcript of that. Incidentally, I think there are still a few copies of that available for any students in the audience, but subsequent to that meeting we received further written comments. The written comments on that, and I am not

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exaggerating, are about this much paper. Subsequent to the October meeting, we received some more written comments. After that, in April of this year, a small group of us sat down with four very experienced industry spokesmen and went over the document again, page by page, word by word, not necessarily as to substance but to clear up ambiguities in the meanings of the words.

One of those industry people, for example, was a senior partner of one of the best known accounting firms in this country. Others were some of the more experienced contractor negotiators that I know.

Industry, of course, doesn't like the applicability to fixed price contracts. They are afraid that this will lead to formula pricing. They want the all-cost concept. That is the concept which I think they expressed in the following comprehensive set of cost principles:

"Should allow all the legitimate costs of doing business provided they are reasonable and allocable to the contract involved."

Would you buy that? Would you buy that? I buy it, with a hedge. That is not a bad premise; that is almost a statement of what we started off with ourselves, but what we have done is pre-determine some of these reasonable situations as a matter of policy. We have pre-determined that it is not reasonable to have contributions and donations

and interest, and these other things, allocated to our contract. This is what really departs us from industry.

Other people have an interest. The General Accounting Office, they have been hammering us for years to get out a set of cost principles applicable across the board. They have written very strong letters. They are, as you know, a very potent force. They could well get the Congress so excited that they would hold hearings, and try to develop contract cost principles by law. This has been threatened, but I have never considered it to be a very serious matter. It is something, though, that is on the horizon.

We have met with the Comptroller himself within the past month, have discussed this with him, and we have just a few days ago received his written comment. Our approach to him was that it is better, we think, to get out something now than to spend any further time in refinements and hence we are going to publish his comments. It was about two and a half pages, but really it was in the nature of a nit-pick. He says:

"It isn't abundantly clear that your test of reasonableness which you have over in the front of your document, and which you speak of two or three, or four times elsewhere, it isn't absolutely clear that the test of reasonableness applies to each and every individual element of cost."

We certainly intend, in this business, that it is best if everybody is a winner so we make the Comptroller General a winner by putting in a sentence which says, "Don't forget that reasonableness does apply to each individual element of cost." So we are, I think, passing the hurdle of the Comptroller General.

The Congress has threatened us with hearings on several occasions. It is my feeling that we are probably going to have hearings in the next session whether we publish the principles or whether we don't publish the principles, and I think that we'd be better off if we published them.

We had an interest from the White House from a fellow named Mr. Saulnier, who is the Chairman of the President's Council of Economic Advisors, who was worrying about the inflationary potential effects of this exercise. We have met with him. Other government agencies are involved. AEC, we have been discussing it with AEC and by and large they are in agreement with the set that we have. They have about four specific principles that they will have some departure from.

I think we have been discussing it with NASA, the Space Agency, and they buy it. We will make this available to the General Services Administration, and

it will undoubtedly appear in the Federal Procurement Regulations.

Well, as to a personal evaluation of this whole thing, the following are at least my views for what they are worth. I think that this whole exercise is necessary. I think that the present set could be improved. It isn't the way I would personally write it in all respects. I suppose anybody could say that, however. This is such a controversial area.

The thing that bothers me is that we started with a good premise, and we varied from it. We started with a good premise that we would say all costs are allowable unless there is a damn good reason why they shouldn't be, some overriding public policy reason like entertainment. We couldn't have a set of cost principles that said entertainment was an allowable cost because of public reasons, but we shouldn't make certain costs across the board unallowable because they are hard to administer. We have done some of that. I think this isn't good.

I think that we have, in the package we have now, the best results that we could hope to get. I think that, as I have said, that it is essential that we have a comprehensive set of cost principles. It is management's duty to provide guidance in this area. I can't, myself, quarrel with the basic theory that a cost is a cost

regardless of the type of contract, and I don't think that we should be selecting a contract type merely because of the difference in reimbursement cost; reimbursements that might come under it. We should select our contract type for other reasons.

I think that we do need uniform guidance. I think we must recognize that the forces of the market place and competitive restraints are not present in a substantial part of our procurement, and I'd like to quote from a very capable gentleman from the Secretarial level who had this to say:

"I wonder how soon some very sincere people in this business will recognize that whether we like it or not more and more of the contract dollar volume is based on cost regardless of the label of the contract."

Not a bad observation. Now, there are some dangers in the exercise that we will have to watch very closely. There is a danger to our pricing philosophy. We have tried to build in safeguards. If you don't worry about this whole exercise, and the effect of it, I say you are not knowledgeable in procurement. You must worry about it. We are worrying about it. We are worrying about its use in the hands of inexperienced personnel. We are worrying about its use by people, some people, mostly inexperienced, who will use these principles as

a crutch to avoid criticism rather than doing a good job of overall bargaining.

We are worried, sincerely, about the possibilities of misuse of these contract cost principles by certain audit elements and by the General Accounting Office. I said certain audit elements and, of course, didn't mean the Navy audit elements. But, if you will be honest in your own evaluation, I think you must have as a basic worry the use to which those who have the job of criticizing us, of second guessing us, what use will they put to this document.

You might say, "Sure, it is helpful to me, but in the long run it isn't going to help me if the other fellow can beat me over the head with it on and off so badly that I don't get my work done, so it forces me to go to cost price contracts or price all my negotiations on a formula basis."

I don't think that the dangers inherent here are insurmountable. I think they can be overcome, and we will try to insure that they won't take place. I think that the principles will, at times, give industry a handle against us. I think that it will be sometimes more difficult to negotiate an individual element of cost if industry can point to a set of principles that says allowable and now allow it when you are trying to



pick up a piece of it. Maybe the research principle will be in this category.

This set is not a cure-all. It has got compromises in it. I don't think that it will have a great impact on your negotiation process. I don't think there will be a ground swell of resentment from industry which will be important or effective enough to give you insurmountable negotiation difficulties with major contractors refusing to take contracts. I do not see this implication.

Now, what is the present status of this exercise, and here I have to be less than completely forthright because they have not been finally approved for the final printing, but I say to you that they are getting close. We have in mind that they will be published in, say, within a few weeks. This could, as you know, be within three weeks to let's say fifteen weeks, so I will say within weeks they will be published-- I think.

I see my old buddy and friend Harry Christenat down there who would dearly love to meet me after this talk and bet me another cigar that they won't be published in this fiscal year, and this time I will probably take him up again, and the only thing that I can say is that I have paid off my friend over ten Corona Corona cigars already. But, I will estimate that this is weeks away.

Procurement Lecture Conference

12 Oct 1959

"Revised ASPR Section XV -

Contract Cost Principles"

Speaker, CDR John M. Malloy (OSD)

I think it is the closest that it has ever been. We have in mind that even when it is published it will not be mandatorily effective until the first of January--excuse me--until the first of July next year. We obviously don't want to have something that has the potentially disruptive effect of these to come in, we will say, in April or May, or March for that matter and so we have skipped over into the first of July for mandatory use. They will, of course, be for use as a guide in the interim period.

We will be issuing, when these are published, there will be an official Department of Defense press release issued. There will be a lot of yakety-yak about it. We will attempt to distribute advanced copies throughout the military so that you don't first see these principles in the hands of the contractors, a situation which sometimes happens.

Well, I have covered a lot of territory here this morning. I hope that I have given you at least some food for thought, and at least I have exposed some of my own personal views; whether you like them or not is beside the point, and I will say it has been a pleasure to talk to you and I will be glad to duck your questions as best I can. Thank you.

[Applause]

DEPARTMENT OF THE NAVY  
OFFICE OF THE COMPTROLLER OF THE NAVY  
CONTRACT AUDIT DIVISION  
WASHINGTON, D. C.

Page 1 of 5

Analysis of Treatment Accorded Specific Categories, Items, or Subitems in  
Revised Part 2, Section XV, ASPR, dated 2 November 1959

Item	Paragraph Number	Allowable Subject to Usual Tests	Allowable if it Meets Special Tests or has Special Approval	Allowable only if Provided for in Contract	Unallow- able
<b>Advertising:</b>					
In trade and technical journals valuable for dissemination of technical information within the contractor's industry, provided ads do not offer products or services for sale	15-205.1(a)(i)	X			
Help-wanted	15-205.1(a)(ii)	X			
Costs of participation in exhibits upon invitation of Government or where exhibits are for purpose of disseminating technical information within the contractor's industry and provided specific products or services are not offered for sale	15-205.1(a)(iii)	X			
To obtain scarce materials, plant or equipment or disposing of scrap or surplus materials	15-205.1(a)(iv)	X			
All other	15-205.1(b)				X
<b>Bad Debts</b>	15-205.2				X
<b>Bidding Costs:</b>					
Incurred in current accounting period	15-205.3	X			
"    "    past    "    periods	15-205.3				X
(Note: Alternative methods permissible)	15-205.3				
<b>Bonding Costs:</b>					
Bonding required by contract	15-205.4(b)	X			
Required in general conduct of business	15-205.4(c)	X			
<b>Civil Defense Costs:</b>					
On contractor's premises pursuant to suggestions or requirements of civil defense authorities	15-205.5(a)	X			
(Note: Costs of capital assets allowable only as depreciation)	15-205.5(b)				
Contributions to local civil defense funds and projects	15-205.5(c)				X
<b>Compensation for Personal Services:</b>					
To extent the total compensation of individual employees is reasonable for services rendered and not in excess of amounts allowable under Internal Revenue Code	15-205.6(a)(1)		X		
In lieu of salary for services rendered by partners and sole proprietors provided such compensation does not constitute a distribution of profits	15-205.6(a)(3)		X		
Salaries and wages for current services	15-205.6(b)	X			
Premiums for overtime, extra pay shifts and multishift work	15-205.6(b)		X		
Cash bonuses and incentive compensation	15-205.6(c)		X		
Bonuses and incentive compensation paid in stock	15-205.6(d)		X		
Stock options	15-205.6(e)				X
Deferred compensation for services rendered during current period and for past service pension and retirement costs	15-205.6(f)		X		
Fringe benefits	15-205.6(g)		X		
<b>Contingencies:</b>					
In historical costing, except certain minor items	15-205.7(b)				X
In estimating future costs:	15-205.7(c)				
Where related to known and existing conditions which can be measured with reasonable accuracy		X			
Where related to known or unknown conditions which cannot be measured closely enough to provide equitable results					X
<b>Contributions and Donations</b>	15-205.8				X



Item	Paragraph Number	Allowable Subject to Usual Tests	Allowable if it Meets Special Tests or has Special Approval	Allowable only if Provided for in Contract	Unallow- able
Depreciations:					
Normal	15-205.9(b)		X		
Emergency facilities	15-205.9(d)		X		
On idle or excess facilities not reasonably necessary for standby purposes	15-205.9(e)				X
Fully depreciated assets:					
Where substantial portion was recovered as a charge to Government contracts or subcontracts	15-205.9(f)				X
Other	15-205.9(f)		X		
Employee Morale, Health, and Welfare Costs and Credits	15-205.10	X			
Entertainment Costs	15-205.11				X
Excess Facility Costs:	15-205.12				
Where reasonably necessary for standby purposes		X			
Other					X
Fines and Penalties:	15-205.13				
Incurred in compliance with contract or written in- structions from contracting officer		X			
Other					X
Food Service and Dormitory Costs and Credits:	15-205.14				
Allocation of reasonable losses to all activities served		X			
Profits to be credited, unless used for employee welfare		(X) Credit			
Insurance and Indemnifications:					
Insurance required or approved pursuant to contract	15-205.16(a)(1)	X			
Other insurance maintained for general conduct of business	15-205.16(a)(2)		X		
Actual losses which could have been covered by permissible insurance:	15-205.16(a)(3)				
Result of nominal deductible insurance coverage		X			
Minor losses such as spoilage, breakage, and dis- appearance of small hand tools		X			
Other such losses				X	
Indemnifications:					
Result of nominal deductible coverage		X			
Minor losses such as spoilage, breakage and dis- appearance of small hand tools		X			
Other indemnification				X	
Interest and Other Financial Costs:	15-205.17				
Interest on borrowings					X
Bond discounts					X
Costs of financing and refinancing operations					X
Legal and professional fees paid for preparation of prospectuses					X
Preparation and issuance of stock rights					X
Interest assessed by State or local taxing authorities because of non-payment of tax at the direction of con- tracting officer or because of failure of contracting officer to assure timely direction after prompt request therefor	(See also 15-205.41)	X			
Labor Relations Costs	15-205.18	X			
Losses on Other Contracts	15-205.19				X
Maintenance and Repair Costs:	15-205.20(a)				
Normal		X			
Extraordinary costs, provided such are allocated to periods to which applicable		X			
Manufacturing and Production Engineering Costs	15-205.21	X			



Item	Paragraph Number	Allowable Subject to Usual Tests	Allowable if it Meets Special Tests or has Special Approval	Allowable only if Provided for in Contract	Unallowable
<b>Material Costs</b>					
Reasonable overruns, spoilage, or defective work	15-205.22(a)	X			
Cash discounts not taken because of reasonable circumstances	15-205.22(b)	X			
Adjustments for differences between physical and book inventories related to period of contract performance	15-205.22(c)	X			
Interplant, interdivision or intraorganization transfers:					
Ordinarily allowable at lower of cost to transferor or market	15-205.22(e)	X			
On a price basis	15-205.22(e)		X		
<b>Organization Costs:</b>					
Incorporation fees, attorneys' fees, accountants' fees, brokers' fees and fees to promoters and organizers, for organization, reorganization or raising capital	15-205.23				X
<b>Other Business Expenses:</b>					
Registry and transfer charges resulting from changes in ownership of securities issued by contractor	15-205.24	X			
Cost of shareholders' meetings	15-205.24	X			
Normal proxy solicitations	15-205.24	X			
Preparation and publication of reports to shareholders	15-205.24	X			
Preparation and submission of required reports and forms to taxing and other regulatory bodies	15-205.24	X			
Incidental costs of directors and committee meetings	15-205.24	X			
<b>Overtime, Extra-Pay Shift and Multi-Shift Premiums</b>	15-205.25		X		
<b>Patent Costs:</b>					
Preparing disclosures, reports and other documents required by the contract	15-205.26	X			
Searching the art as necessary to make invention disclosures	15-205.26	X			
Preparing documents and other costs in connection with filing patent applications where title is conveyed to Government in accordance with contract clauses	15-205.26	X			
<b>Plant Protection Costs:</b>					
Wages, uniforms and equipment of personnel	15-205.28	X			
Depreciation on plant protection capital assets	15-205.28	X			
Necessary compliance with military security requirements	15-205.28	X			
<b>Plant Reconversion Costs:</b>					
Cost of removing Government property and related restoration or rehabilitation costs	15-205.29	X			
Additional costs to extent agreed upon before incurrence	15-205.29	X			
All other reconversion costs	15-205.29				X
<b>Precontract Costs:</b>					
To extent allowable if incurred after date of contract	15-205.30	X			
<b>Professional Service Costs - Legal, Accounting, Engineering, and Other:</b>					
Rendered by members of a profession who are not employees of the contractor	15-205.31(a)		X		
Retainer fees supported by evidence of bona fide services available or rendered	15-205.31(b)		X		
Legal, accounting, and consulting services, and related costs, in connection with organizations and reorganizations, defense of anti-trust suits and the prosecution of claims against the Government	15-205.31(c)				X
Legal, accounting, and consulting services, and related costs, incurred in connection with patent infringement litigation	15-205.31(c)			X	
<b>Profits and Losses on Disposition of Plant, Equipment or Other Capital Assets</b>	15-205.32				X
<b>Recruiting Costs:</b>					
Help-wanted advertising	15-205.33	X			
Operating costs of employment office	15-205.33	X			
Operating and aptitude and educational testing program	15-205.33	X			
Travel costs of employees while engaged in recruiting personnel	15-205.33	X			
Travel costs of applicants for interviews for prospective employment	15-205.33	X			

Item	Paragraph Number	Allowable Subject to Usual Tests	Allowable if it Meets Special Tests or has Special Approval	Allowable only if Provided for in Contract	Unallowable
<b>Recruiting Costs: (Cont'd.)</b>					
Employment agency charges at not in excess of standard commercial rates	15-205.33	X			
Special benefits or emoluments beyond the standard practice in the industry	15-205.33				X
<b>Rental Costs (Including Sale and Leaseback of Facilities):</b>					
Land, building and equipment and other personal property	15-205.34(a)		X		
Interplant, interdivisional and interorganization charges	15-205.34(b)		X		
Sale and leaseback agreements	15-205.34(c)			X*	
Under unexpired leases in connection with terminations	15-205.34(d)				
	15-205.42(e)		X		
<b>Research and Development Costs:</b>					
Costs of independent research	15-205.35(d)		X		
Costs of independent development	15-205.35(e)		X		
Incurring in accounting periods prior to the award of contract:					
Where allowable as precontract costs	15-205.35(g)	X			
All other	15-205.35(g)				X
<b>Royalties and Other Costs for Use of Patents:</b>					
Royalties or amortization of patent purchase costs	15-205.36(a)		X		
In case of patents formerly owned by contractor - amounts not in excess of costs which would have been allowed had the contractor retained title	15-205.36(c)		X		
<b>Selling Costs:</b>					
To extent reasonable and allocable to Government business	15-205.37(b)		X		
Salesmen's or agents' compensation, fees, commissions, percentages or brokerage fees contingent upon award of contracts - paid to bona fide employees or commercial or selling agencies maintained to secure business	15-205.37(c)		X		
<b>Service and Warranty Costs</b>					
	15-205.38		X		
<b>Severance Pay:</b>					
Normal turnover severance payments	15-205.39(b)(i)		X		
Abnormal or mass severance pay:					
Accruals	15-205.39(b)(ii)				X
Recognition of Government's obligation to pay its fair share on a case-by-case basis	15-205.39(b)(ii)		X		
<b>Special Tooling Costs</b>					
	15-205.40		X		
<b>Taxes:</b>					
Federal income and excess profits taxes	15-205.41(a)				X
Taxes in connection with financing, refinancing or refunding operations	15-205.41(a)				X
Taxes from which exemptions are available to the contractor	15-205.41(a)				X
Special assessments on land which represent capital improvements	15-205.41(a)				X
Where claims of illegal or erroneous assessment exists	15-205.41(b)		X		
Reasonable costs of action undertaken by contractor, in cooperation with the contracting officer, to determine legality of tax assessment or secure a refund in cases where claims of illegal or erroneous assessment exists	15-205.41(b)	X			
Interest and penalties incurred because of nonpayment of any tax at the direction of the contracting officer or by reason of failure of contracting officer to assure timely direction after prompt request therefor	15-205.41(b)	X			
Any refund of taxes, interest, or penalties and any payment to the contractor of interest thereon attributable to items allowed as contract costs	15-205.41(c)	(X) Credit			
<b>Termination Costs:</b>					
Common items:					
Reasonably usable on contractor's other work	15-205.42(a)				X
Not usable on other work	15-205.42(a)	X			
Costs continuing after termination except where due to negligent or wilful failure to discontinue such costs	15-205.42(b)	X			
Initial costs, including starting load and preparatory costs	15-205.42(c)				X

\* Allowance without contract provision limited to amount which the contractor would have received had it retained title to the facilities

Item	Paragraph Number	Allowable Subject to Usual Tests	Allowable if it Meets Special Tests or has Special Approval	Allowable only if Provided for in Contract	Unallowable
<b>Termination Costs: (Cont'd.)</b>					
Loss of useful value of special tooling, special machinery and equipment	15-205.42(d)		X		
Rental costs under unexpired leases	15-205.42(e)		X		
Cost of alterations of leased property	15-205.42(e)		X		
Reasonable restoration to leased property required by provisions of lease	15-205.42(e)	X			
Accounting, legal, clerical, and similar costs reasonably necessary for preparation and presentation of settlement claims, and the termination and settlement of sub-contracts	15-205.42(f)	X			
Storage, transportation, protection and disposition of property acquired or produced for the contract	15-205.42(f)	X			
Subcontractor claims, including the allocable portion of claims which are common to the contract and to other work of the contractor	15-205.42(g)	X			
<b>Trade, Business, Technical and Professional Activity Costs:</b>					
Memberships in trade, business, technical, and professional organizations	15-205.43(a)	X			
Subscriptions to trade, business, professional, or technical periodicals	15-205.43(b)	X			
Meetings and conferences, including cost of meals, transportation, rental of facilities for meetings, and costs incidental thereto	15-205.43(c)		X		
<b>Training and Educational Costs:</b>					
Programs of instruction at noncollege level designed to increase the vocational effectiveness of bona fide employees	15-205.44(a)	X			
Part-time education at an under-graduate or post-graduate college level relating to the job requirements of bona fide employees:					
Training materials, text books, and fees charged by education institutions	15-205.44(b)	X			
Tuition charged by educational institutions	15-205.44(b)	X			
In lieu of tuition, instructors' salaries and related share of indirect cost of the institution not in excess of the tuition which would have been paid	15-205.44(b)	X			
Straight time compensation to employees for time spent attending classes during working hours not in excess of 156 hours per year	15-205.44(b)		X		
Tuition, fees, training materials and textbooks in connection with full time scientific and engineering education at a post-graduate level related to job requirements of bona fide employees - not to exceed one year for each employee trained	15-205.44(c)	X			
Subsistence, salary or other emoluments in connection with full time scientific and engineering education at post-graduate level	15-205.44(c)				X
Tuition, fees, training materials, text books, subsistence, salary or other emoluments in connection with full time education at an under-graduate level	15-205.44(c)				X
Maintenance expense and normal depreciation or fair rental on facilities owned or leased by the contractor for training purposes	15-205.44(d)	X			
Grants to educational or training institutions including the donation of facilities or other properties, scholarships or fellowships	15-205.44(e)				X
<b>Transportation Costs:</b>					
Freight, express, cartage and postage charges on goods purchased, in process, or delivered	15-205.45	X			
Outbound freight	15-205.45				X- As a direct cost only
<b>Travel Costs:</b>					
On an actual basis or on a per diem or mileage basis	15-205.46(b)	X			
Incurred in the normal course of over-all administration of the business	15-205.46(c)		X- As an indirect cost		
Directly attributable to performance of a specific contract	15-205.46(d)	X			
Necessary, reasonable costs of family movements and personnel movements of a special or mass nature	15-205.46(e)		X- Special allocation required where appropriate		

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Issue

8. Contributions and Donations.

Industry Position

Industry objects strenuously to our proposed disallowance of contributions and donations. Industry claims that expenditures for contributions and donations are normal and legitimate costs which they must incur. Industry feels that the possible problem of excessive gifts can be solved by the establishment of certain tests of reasonableness which are acceptable to both industry and government.

10 Sept 1957 - 8/21/58 Draft

(h) Contributions and Donations. Contributions and donations are unallowable.

Issue

9. Interest

Industry Position

Industry argued strongly that interest on borrowings made necessary by our contracts should be allowed as a cost against our contracts. Industry contends that the fluctuating nature of government business precludes availability of equity capital in many instances.

Issue

10. Training and Education.

Industry Position

Industry did not make a strong case against our proposed cost principle at the 15 October meeting. Subsequent written comments failed to mention this item.

Issue

11. Plant Reconversion Cost.

Industry Position

Industry contends that there are circumstances wherein equity requires the payment of plant reconversion cost on a mutually acceptable basis. Industry contends that our prior draft precluded any such negotiation on a case by case basis.

Issue

12. Overtime.

Industry Position

Industry's recommendations here are limited to requesting a clarification between overtime premium pay and fixed premium pay, but in ASFR Section XII and the proposed Cost Principles.

We do not feel that all contributions and donations should be allowable. However, we propose an extensive change in this principle to allow the costs of reasonable contributions to establish non-profit charitable organizations. The Air Force representative does not concur in this change from the 21 August draft. The following addition to the 21 August draft is proposed:

"Reasonable contributions and donations to established non-profit charitable organizations are allowable provided they are expected of the contractor by the community and it can reasonably be expected that the prestige of the contractor in the community would suffer through the lack of such contributions.

"The propriety of the amount of particular contributions and the aggregate thereof for each fiscal period must ordinarily be judged in the light of the pattern of past contributions, particularly those made prior to the placing of Government contracts. The amount of each allowable contribution must be deductible for purposes of Federal income tax, but this condition does not, in itself, justify allowability as a contract cost."

#### Latest Suggested Revision

Reasonable contributions and donations to established nonprofit charitable organizations are allowable provided they are expected of the contractor by the community and it can reasonably be expected that the prestige of the contractor in the community would suffer through the lack of such contributions.

The propriety of the amount of particular contributions and the aggregate thereof for each fiscal period must ordinarily be judged in the light of the pattern of past contributions, particularly those made prior to the placing of Government contracts. The amount of each allowable contribution must be deductible for purposes of Federal income tax, but this condition does not, in itself, justify allowability as a contract cost.

#### Government Position

We do not feel that Industry has made a case for allowance of interest as a cost. We feel that such allowance would provide a preference for one method of obtaining capital requirements over other methods, and therefore would provide an incentive for borrowing for the performance of our contracts.

#### Government Position

In view of the lack of further industry comment on this item, we feel that our proposal, as contained in the 21 August draft, is correct.

#### Government Position

While retaining the substance of our previous draft of this principle, we recognize the industry argument that the payment of reconversion cost on a case by case basis should not be precluded by the cost principles.

#### Government Position

We do not feel that any further clarification is required on this subject.

#### Current Proposal

While we propose that interest remain an allowable cost, we are recommending a revision in our profit policy appearing in ASPR 3-808.4 by adding a new subparagraph (d) which would read:

"d. Extent of the Contractor's Investment. The extent of the contractor's total investment in the performance of the contract will be taken into consideration in the fixing of the amount of the fee of profit."

#### Current Proposal

No change from the 21 August draft.

#### Current Proposal

We propose that the following provision be added to the principles: "However, in special circumstances where equity so dictates, additional costs may be allowed to the extent mutually agreed upon."

#### Current Proposal

No change from our 21 August draft.



1959

THE NUMBERS GAME

In presenting its statistical argument about the number of costs disallowed, industry is playing the numbers game. They can (as did NSIA who cited 52 items) list a number of "areas in which there is failure to recognize true costs in whole or in part," and make it appear that we are being more restrictive rather than more liberal. There are several reasons:

(1) We explain the treatment of costs in more detail in the present proposal. Thus whereas "general research unless specifically provided for in the contract" was classed as one unallowable in Sec. XV, NSIA listed several elements of R&D costs as accounting for four items of unallowables. Yet we have liberalized this element substantially. Likewise NSIA lists five such items under compensation, three under depreciation, four under insurance, three under material, three under rental, three under royalties, and four under training. In none of these items is allowability more restricted, and in several it is liberalized.

(2) We provide policy guidance on many items now included in ASPR XV, Part 5, where they are classed as for "Special Consideration."

(3) Many of the items have had to be covered more specifically and their allowability restricted because of abuse by some contractors in the absence of prescribed handling (e.g., sale and leaseback, recruiting, and training).

No doubt the source of much of the attack on this score is the fact that they have been reimbursed in the past for many of the "unallowable" costs through the mechanism of pricing under several of the types of so-called fixed price contracts.

QUESTION AND ANSWER SHEET - COST PRINCIPLES

1. Q. How do these new cost principles change what the Department of Defense has been doing in the past?

A. The Department of Defense has prescribed cost principles for cost reimbursement type contracts for many years. These principles have been prescribed for use only for cost reimbursement contracts. As to this type of contract, the new principles will not materially change our operations although they provide more definite rules and to some extent cover cost elements not previously defined. The new principles will eliminate separate cost principles which we now have for use in negotiating termination settlements. The most significant new feature of the regulation is its use with fixed price contracts. We have not had cost principles for this purpose in the past. The new regulation will be used as a guide in the negotiation of prices under fixed price negotiated contracts to the extent that the evaluation of costs is necessary for the setting of fair and reasonable prices.

2. Q. What will be the affect of the new cost principles with respect to cost recovery be a contractor for (a) cost reimbursement contracts and (b) fixed price contracts?

A. As to cost reimbursement type contracts, contractors generally can expect about the same result under the revised cost rules as they are experiencing under present practices. A definitive answer cannot be given to the question of contractor recovery in the fixed price area since the range of situations here is too complex for generalization. Since we have not provided specific guidance in the past, these new principles will, at least in some instances, result in reduced recovery by contractors for certain particular items of expense. For example, interest has previously been an allowable cost in termination situations. In the future, interest will not be allowed.

3. Q. How much money will these new cost principles cost the Department of Defense or how much will be saved?

A. As indicated previously, about the same result will be experienced in connection with cost reimbursement contracts. In the fixed price area, we expect that the new principles will ultimately result in more efficient procurement and, hence, savings will accrue in the long run. It is not possible to put a dollar sign on any such savings at this time.

4. Q. Why has the Department of Defense not promulgated cost principles for general use in the past? Why has it taken you so long to do this job?
- A. The Department of Defense has had cost principles for cost type contracts and for termination settlements. The extension of cost principles to the fixed price area is a very complicated and controversial subject. It has been necessary to take into consideration the strongly held views of the many parties at interest, including those of industry. The resolution of these areas of controversy has been difficult and, hence, progress has been somewhat slow.
5. Q. What are the more important areas of cost disallowance:
- A. These would include most advertising costs, bad debts, entertainment, contributions and donations, and interest on borrowings.
6. Q. How do the new cost principles treat research and development expenses?
- A. A contractor's independent research costs are allowable. Independent development costs are allowable to the extent that they are related to the product lines for which the Government has contracts. We have provided for certain administrative controls and limitations to insure that these costs are reasonable.
7. Q. Are executive profit sharing plans allowable?
- A. We regard compensation measured by profit sharing plans as a portion of an individual's over-all compensation. Such compensation is allowable to the extent that an individual's total compensation is reasonable in amount.
8. Q. What affect do these cost principles have on profit?
- A. The cost principles do not cover the subject of profit. Our profit policies are covered fully in Section III, Part 8 of the Armed Services Procurement Regulation.
9. Q. Will this new regulation lead to "formula pricing?"
- A. Formula pricing means the resolution of each item of cost by unilateral accounting decisions. We do not anticipate that the new regulation will have this result. Our over-all pricing philosophy remains in effect.

10. Q. What application will these cost principles have to contracts awarded by formal advertising?
- A. The evaluation of costs is not appropriate under contracts awarded by formal advertising. The cost principles will, however, continue to be used as a guide for terminated contracts, including terminated contracts originally awarded after formal advertising.
11. Q. What do you mean by the statement that the cost principles will be used "as a guide" in negotiating fixed price contracts?
- A. We realize that hard and fast rules with respect to costs are not appropriate for many pricing situations encountered under fixed price contracts, particularly in those instances where prices are being established for a future period. Government personnel will be expected to be guided by these principles to the extent appropriate in conducting negotiations in the fixed price contract area to the extent that the pricing action requires the evaluation of costs. Any departure from the basic policies now established will require adequate explanation and justification.
12. Q. Is this new regulation agreeable to industry?
- A. Industry has traditionally opposed any of our regulations which set forth specific costs as unallowable. Industry contends that the Government should allow all normal costs of doing business. For this reason, industry is opposed generally to most of the disallowances we have prescribed. Industry is also opposed to the utilization of cost principles in the fixed price area.
13. Q. Have the Military Departments concurred in this new regulation?
- A. Yes.
14. Q. Has the new regulation been approved by the Secretary of Defense?
- A. Yes.
15. Q. Has the Comptroller General approved this regulation?
- A. The Comptroller General has been in favor of a single comprehensive set of cost principles for some time. He has concurred in the desirability of publishing the new regulation without committing himself as to agreement on all details.

16. Q. What Congressional reaction do you expect?
- A. We expect that our new regulation will be well received by the Congress.
17. Q. How does the new regulation affect Small Business?
- A. We believe it will assist many Small Business concerns in that it is designed to foster an atmosphere of mutual understanding among contractors and contracting officers as well as provide guidance on the handling of many items not previously covered.
18. Q. Why is the new regulation not mandatorily effective until July 1, 1960?
- A. There are many details in this new regulation which will require study for both contractors and Government personnel. A longer period than usual was established in this instance to afford ample opportunity for familiarization with the new rules.
19. Q. Are these cost principles going to be used on a Government-wide basis?
- A. We expect that cost principles substantially similar to our new regulation will be adopted on a Government-wide basis.
20. Q. Will these cost principles mean more negotiated contracts?
- A. No.
21. Q. Will the new cost principles require contractors to establish new accounting systems?
- A. No. The revised cost principles are not an accounting blueprint which will require any appreciable change in the accounting systems of most Government contractors.

Office of the Assistant Secretary of  
Defense (Supply and Logistics)  
26 October 1959



ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON 25, D. C.

*CR*  
*Cdr. Malloy*

November 24, 1959

SUPPLY AND LOGISTICS

Dear Dan:

I met with your boys yesterday and was very appreciative of their attitude. I am not so sure we can accomplish this as of December first, but we are striving to work it out to their satisfaction.

Best regards,

*(S)*  
PERK

Mr. Dan A. Kimball  
President,  
Aerojet-General Corporation  
6352 North Irwindale Avenue  
Azusa, California

*AB*  
cc: Mr. Bannerman

**AEROJET-GENERAL CORPORATION**

6352 NORTH IRWINDALE AVENUE  
AZUSA, CALIFORNIA

DAN A. KIMBALL  
PRESIDENT

November 17, 1959

Hon. E. Perkins McGuire  
Assistant Secretary (Supply and Logistics)  
Office of the Secretary of Defense  
Washington 25, D. C.

Dear Perk,

I would like to have E. S. Reichard, Jr., our Director of Contracts come in to chat with you about applying the new Cost Principles to all of our contracts beginning December 1, 1959.

I hope it will be convenient for Mr. Reichard to meet with you early in the week of November 23.

Sincerely,





cc: E. Perkins McGuire

**DAN A KIMBALL**  
President

November 17, 1959

Hon. Thomas S. Gates, Jr.  
The Deputy Secretary of Defense  
Washington 25, D. C.

Dear Tom.

Aerjet-General Corporation believes the recently revised Contract Cost Principles, Section XV, could be applied to all of our Defense work beginning with our fiscal year starting December 1, 1959.

In this connection, we would like our people to discuss our thoughts with Mr. Perkins McGuire in the very near future.

We think beginning the uniform application of the revised Cost Principles to all of our contracts will provide the Government consistent methods of handling costs throughout our operations, rather than gradually incorporating the new regulations when new procurements take place.

Sincerely,

AEROJET-GENERAL CORPORATION

6332 NORTH IRWINDALE AVENUE  
AZUSA, CALIFORNIA

DAN A. KIMBALL  
PRESIDENT

November 17, 1959

Hon. Thomas S. Gates, Jr.  
The Deputy Secretary of Defense  
Washington 25, D. C.

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Sincerely,



*See McGuire to  
arrange  
Bf.*

MISS DIETZ (Mr. Kimball's Secretary)  
District 7-1005

050 29 1959

Dear Mr. Reichardt:

I have your letter of 17 December 1959 in which you have provided me with considerable background information in connection with your request to have all of your contracts cite the new cost principles as of 1 December 1959. This information will be very helpful in our effort to resolve the basic problems which are involved in amending existing contracts.

At the present time, we are actively studying this problem. I would like to accept your offer of Aerojet-General's services as a pilot company in our consideration of this matter. Accordingly, I have requested the Navy, as the cognizant audit agency of your home office plant, to be in touch with you as soon as possible for the purpose of evaluating the impact of the new cost principles on your existing contracts. The Air Force, which has audit cognizance of your Sacramento plant, will assist the Navy in its evaluation.

As mentioned during your recent visit to the Pentagon, the problem of securing an amendment from your prime contractor, in those instances where Aerojet-General is acting as a subcontractor, may present some substantial difficulties. You can be of further assistance to us if you would contact a few of your prime contractors to ascertain their reaction to amending their subcontracts to you, even if they themselves were not at the time cut over to the new cost principles.

While we are initiating the action indicated above as soon as possible, I am sure that you appreciate that we are not yet in a position to give you positive assurance that your existing contracts will be amended as of 1 December to incorporate the new cost principles. We will, however, seek to resolve this matter at the earliest possible time. Again, may I express my appreciation for your helpful assistance in this matter.

Sincerely yours,

(Signed) Philip LeBoutillier, Jr.

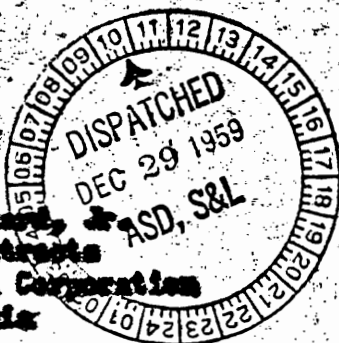
PHILIP LeBOUTILLIER, JR.  
Acting Assistant Secretary of Defense

Prepared by: 30774 X72026/12a/28Dec59

Coordinated with:

Mr. Bannerman

Mr. E. S. Reichardt, Jr.  
Director of Contracts  
Aerojet-General Corporation  
Azusa, California



COVERING BRIEF

CR

TO: The Assistant Secretary of Defense (Supply and Logistics)

FROM: Director for Procurement Policy

**Problem:** To respond to a letter dated 17 December 1959 from the Aerojet-General Corporation which offered the services of Aerojet-General as a pilot company to work out the problems of cutting over companies across the board to the new contract cost principles.

**Discussion:** The Aerojet-General letter requested that all of its contracts, including those in which the company is a subcontractor to other prime contractors, be cut over to the new contract cost principles as of 1 December 1959 (the beginning of a new fiscal year). The Company offered its services as a pilot company and provided a detailed listing of contracts which total approximately 805 million dollars. The Company also furnished an analysis of the effect of the new cost principles on their existing contracts, indicating that "Based on the preceding analysis, Aerojet-General Corporation concurs in the opinion of the Department of Defense, as expressed in the questions and answers published in connection with publication of the new contract cost principles, to the effect that operating under the new set of rules is not expected to result in increased costs to the Department of Defense."

*P. L. Malloy*

We have had a group from the Military Department studying the difficult problems involved in the amendment of existing contracts to incorporate the new cost principles. This group will meet again on 5 January. Some of our people have met informally with representatives of the General Accounting Office and further discussions are contemplated. We think that a quick look at the Aerojet-General situation will provide us with valuable information in our overall consideration of this problem. We contemplate issuing an amplifying memorandum to the Military Department on this subject as soon as possible.

In the meantime, we have requested the audit elements of the Army and Air Forces to make an immediate appraisal of Aerojet-General's contention that the application of the new cost principles to existing contracts will have no material effect.

**Recommendation:** That you sign the attached letter.

**Conclusion:** ASD Comptroller (Mr. Kigore).

COVERING BRIEF

CR

MAR 31 1960

TO: The Assistant Secretary of Defense (Supply and Logistics)

FROM: The Director for Procurement Policy

**Problem:** To advise the Aerojet-General Corporation that we have decided not to try to amend existing cost-reimbursement type contracts so as to incorporate the new cost principles.

**Discussion:** By letter of December 17, 1959, the Aerojet-General Corporation requested that all of its contracts including those in which the company is a subcontractor to another prime contractor, be cut over to the new contract cost principles as of 1 December 1959 (the beginning of a new Fiscal Year). The company offered its services as a pilot company and provided a detailed list of contracts which totaled approximately 505 million dollars. This Aerojet request was received at the time we were in the midst of working out our over-all policy with respect to the amendment of existing cost-reimbursement type contracts. We took advantage of the Aerojet offer to act as a pilot company and requested the field audit organizations of the Navy and Air Force to provide us with an advisory report as to the impact of the new cost principles. We also requested that Aerojet investigate the feasibility of getting its contracts amended when Aerojet was acting as a subcontractor to another prime contractor.

The audit report mentioned above indicates that, aside from research and development expense, there is no practical difference between the return to Aerojet under the old cost principles and under the new cost principles. The auditors however could draw no sound over-all conclusions since they were unable to measure the impact of the new cost principles down the subcontract chain nor could they evaluate the impact of the new research and development cost principle. Aerojet-General, by letter dated 7 March 1960, advised that they had contacted the Douglas Aircraft Company and the Lockheed Missile Systems Division of Lockheed Aircraft Company. Both companies agreed to the modification of their contracts with Aerojet. However, Lockheed conditioned their agreement on the promise that "no adverse cost impact arose." This type of condition is not easily disposed of and raises many legal problems, all of which influenced our decision not to amend existing contracts as a matter of general policy.

*Copy Melloy*

*091*

In sum, the situation faced by Aerojet-General appears to be similar to that faced by all large companies holding substantial Government contracts. We see no basis for distinguishing the Aerojet-General situation from the others. Hence, we feel it necessary to deny the Aerojet request and provide for this company in a manner consistent with others. Since the initiation of the Aerojet request, we have issued a general policy on this subject, including a press release. Informal contact with the local Aerojet-General representative indicates a realization on the part of the company that our action would undoubtedly correspond with our general policy issuance.

Recommendations: That you sign the attached letter.

Comments: OASD (Comptroller) (Mr. Kilgore)  
Army (Lt. Col. W. W. Thybony, DCM LOG)  
Navy (Mr. M. E. Jones, CMC)  
Air Force (Mr. George Vecchiotti, AFMPT)



CR

APR 1 1960

Dear Mr. Reichardt:

I appreciate the information forwarded by Mr. E. A. Krist on 7 March 1960 in connection with establishing a procedure for amending existing cost-reimbursement type contracts with your company to incorporate the new contract cost principles.

We have given this information careful consideration. In addition, we have received and analyzed a report from our field auditors which commented on the feasibility of amending your existing contracts. It appears to us that the administrative problems which would be encountered in endeavoring to make an accurate appraisal of the practical effect of the new cost principles on your existing contracts would be very great. This is particularly true with respect to attempting an analysis of the impact of the principles down the subcontract chain. For these reasons, we regret that it is not feasible to grant your request for amendment of existing cost-reimbursement type contracts to incorporate the new cost principles. We have recently established a uniform policy for use throughout the Department of Defense in this area. I am attaching a copy of this policy for your information. While this overall policy was adopted because of the administrative and legal problems involved, we intend to review the situation in about one year. We are hopeful that it will be practical to issue additional guidelines at that time so as to minimize the problem of complying with two different sets of cost principles for an extended period of time.

I would like to take this opportunity to express my appreciation to you for your assistance in our study of this matter.

Sincerely yours,

Signed

PHILIP LeBOUTILLIER, JR.

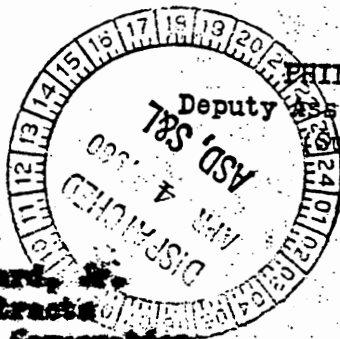
Deputy Assistant Secretary of Defense  
(Supply and Logistics)

Attachment

Mr. E. E. Reichardt, Jr.  
Director of Contracts  
Aerojet-General Corporation  
Azusa, California

Prepared by: JMMalloy/rbs/30Mar60  
3D774 X72026

Coordinated with:  
Mr. Bannerman \_\_\_\_\_





# *Aerojet-General* CORPORATION

AZUSA, CALIFORNIA • TELEPHONES: LOS ANGELES, CUMBERLAND 3-6111 • AZUSA, EDGEWOOD 4-6211

A. SUBSIDIARY OF THE GENERAL TIRE & RUBBER COMPANY



IN REPLY REFER TO:

920:2290

MAR -7 1960

**The Honorable Philip LeBoutillier, Jr.**  
**Acting Assistant Secretary of Defense**  
**(Supply and Logistics)**  
**The Pentagon**  
**Washington 25, D. C.**

**Subject: Amending Contracts to Incorporate New Contract Cost Principles Issued November 2, 1959**

**Reference:** (a) Letter from Aerojet-General Corporation to the Assistant Secretary of Defense (Supply and Logistics), dated December 17, 1959, Serial 920:1424 ESR:lh.  
(b) Letter from Assistant Secretary of Defense to Aerojet-General Corporation, dated December 29, 1959, Serial: CR

**My dear Mr. LeBoutillier:**

In connection with Aerojet-General Corporation's offer, reference (a), to serve as a pilot company in establishing a procedure for amending contracts to incorporate the new Contract Cost Principles and in response to the request contained in reference (b), we have contacted prime contractors to ascertain their reaction to amending their subcontracts with this company to incorporate the new Contract Cost Principles.

To date, this matter has been discussed with the Lockheed Missile Systems Division and the Douglas Aircraft Company, Inc. At the Lockheed company, the matter was discussed with Mr. Roy Anderson, Manager of Finance, and Mr. Harry Kahl, Materiel Director. It was their opinion that there would be no objection by the Lockheed company to amending its subcontracts to incorporate the new Contract Cost Principles provided no adverse cost

The Honorable Philip LeBeauillier, Jr.

impact areas. Aerojet-General Corporation was advised to submit formal written requests for such amendments which could be expected to receive a favorable action by the Lockheed company.

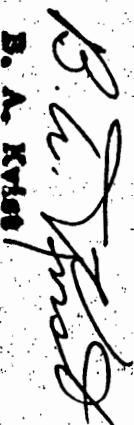
The Douglas company representative with whom the matter was discussed is Mr. J. R. Shelton, Manager - Major Subcontracts. This gentleman stated that the Douglas company has no objection to incorporating the new Contract Cost Principles in its subcontracts. Such amendments as issued would be subject to the customary review and approval by resident government personnel under the terms of the prime contracts held by the Douglas company.

The significance of the viewpoints of these two major prime contractors is highlighted by the dollar magnitude of subcontracts which Aerojet-General Corporation is performing for them. As of January 31, 1960, the total dollar value of subcontracts being performed for the Lockheed company by Aerojet-General Corporation was \$122,114,784 while, subcontracts in performance for the Douglas company by Aerojet-General Corporation at that date totaled \$14,898,881. While these figures include some fixed-price subcontracts, the vast preponderance of the amounts stated are on a CPFF basis. Although comparable figures for the period ending February 29, 1960 are not yet available, any deviation from those reported above would be most likely to increase the amounts involved.

Aerojet-General Corporation appreciates the opportunity to report this information for your consideration and we are hopeful of rendering further assistance in your efforts to establish a procedure for amending existing contracts to include the new Contract Cost Principles.

Very truly yours,

AEROJET-GENERAL CORPORATION



B. A. Kvist  
Director of Contract Administration



DEPARTMENT OF THE NAVY  
OFFICE OF THE COMPTROLLER  
WASHINGTON 25, D.C.

IN REPLY REFER TO  
NCF 11  
7560/Aerojet-Ge  
18 FEB 1960

MEMORANDUM FOR K. K. KILGORE, Office of Assistant Secretary of Defense  
(Comptroller)

Subj: Aerojet-General Corporation - Report setting forth results of review of contractor's request for amendment of existing cost-reimbursement type contracts to incorporate new contract Cost Principles

- Encl: (1) Two copies of NAAO, LA ltr, OCL, 7560/Aerojet-Gen'l of 12 Feb 1960  
(2) Two copies of NAAO, Wash. ltr, SO, A6-7, Aerojet Gen. Corp., Atlantic Div. of 28 Jan 1960

1. The enclosures are forwarded in response to the addressee's request for a report on the subject contractor's proposal to amend its existing cost-reimbursement type contracts to incorporate the new contract Cost Principles (ASPR, Sect. XV, Part 2, as revised by ASPR Revision No. 50).

J B KACKLEY  
Assistant, Comptroller

OC1  
7560/Aerojet-Gen'l  
12 Feb 1960

From: Officer in Charge, U. S. Navy Area Audit Office, Los Angeles  
To: Comptroller of the Navy (NCT)

Subj: Aerojet-General Corporation, Azusa, California - Review of contractor's request for amendment of existing cost reimbursement type contracts to incorporate new contract cost principles

Ref: (a) NavCompt ltr NCT11, L10-4, Ser: 02958 of 28 Dec 1959  
(b) Aerojet-General ltr 920:1424, ESR:1k of 17 Dec 1959 to Asst. Secy. Def. (S&L)

1. In accordance with request in reference (a) a review has been made of the contractor's contentions that only a negligible difference in reimbursable costs would result from the use of the new cost principles (ASPR Revision No. 50) rather than those cost principles currently incorporated in cost reimbursement type contracts. This review was conducted in conjunction with the Air Force auditor cognizant of the contractor's Sacramento divisions.

2. In reference (b) the contractor presented considerable detail concerning the contracts and subcontracts under which it is performing work for the Government. Based on the year ended 30 November 1959 the contractor's business may be summarized as follows:

	<u>Cost-Type</u>	<u>Cost of Sales</u> <u>Fixed-Price</u> <u>(000 omitted)</u>	<u>Total</u>
<b>Prime contracts</b>			
Navy	\$ 29,666	\$ 7,564	\$ 37,230
Air Force	163,246	469	163,715
Army	4,951	2,504	7,455
Other Government	7,196	793	7,989
<b>Subcontracts under Government primes</b>	<u>116,533</u>	<u>12,233</u>	<u>128,766</u>
<b>Total Government</b>	<u>\$321,592</u>	<u>\$ 23,563</u>	<u>\$345,155</u>
<b>Commercial</b>	<u>          </u>	<u>203</u>	<u>203</u>
<b>Total</b>	<u>\$321,592</u>	<u>\$ 23,766</u>	<u>\$345,358</u>

3. No sound conclusions could be reached as to the effect of the new cost principles on the reimbursement of costs to Aerojet because (a) it was not practicable to determine the effect of the new principles on the reimbursable costs of Aerojet's subcontractors, and (b) the extent and cost of the independent research and development program which Aerojet might pursue in 1960 and subsequent years is not presently known.

4. With respect to subcontractors' costs, it was determined that Aerojet now has ninety-two subcontracts issued to approximately forty subcontractors in the aggregate amount of \$38,831,700. Since the new principles appear to be somewhat more liberal than the old principles, particularly in the areas of research and development and selling costs, it would appear reasonable to assume that the subcontractors' reimbursable cost would increase. The extent of any such potential increase could not be determined unless a survey was made of all Aerojet's subcontractors.

5. With respect to Aerojet's own costs, a review of the provisions of ASPR Revision No. 50 reveals that the only area of potential significant difference in reimbursable costs involves the contractor's independent research and development costs. In order to test the contractor's contention that the effect of the use of the new cost principles would be negligible, a comparison was made of the effect of the old and new cost principles on overhead reimbursable under cost-type contracts for the fiscal year ended 30 November 1958. The contractor's 1958 fiscal year was used because it is the most recent year for which all the information needed to make the comparison was available. The results of this comparison are summarized as follows:

Total Aerojet overhead that would be reimbursable under CPFF contracts and subcontracts for the 1958 fiscal year if costs were determined in accordance with the new cost principles	\$64,656,000
Total Aerojet overhead determined to be reimbursable under CPFF contracts and subcontracts for the 1958 fiscal year in accordance with the old cost principles	<u>64,624,000</u>
Increase in reimbursable overhead resulting from the application of the new principles - all CPFF work performed by Aerojet	\$ 32,000
Less - applicable to prime contracts with Government agencies other than Department of Defense and subcontracts	<u>9,000</u>
Increase applicable to prime contracts with the Department of Defense	<u>\$ 23,000</u>



It is believed that the 1959 fiscal year would yield comparable results except that a greater proportion of the increase would be applicable to prime contracts with other Government agencies and to subcontracts under Government primes.

6. The foregoing tabulation appears to support the contractor's contentions, since the increase in reimbursable overhead cost under Department of Defense prime contracts is negligible, i.e. approximately .05 percent. In all probability the increased cost to both this office and the contractor incident to administering contracts under two sets of cost principles simultaneously would be greater than the estimated increase in overhead cost in 1958. However, it should be noted that the increase is due entirely to the difference in the reimbursability of independent research and development costs under the new principles as compared to the old principles. In 1958 the contractor incurred \$291,000 of direct costs in its independent research and development program. In a supplement to reference (b) the contractor has proposed an independent research and development program of over \$7,000,000. This proposal was submitted by the contractor for the purpose of executing an advance agreement in accordance with the new ASPR cost principles, paragraph 15-205.35(h). Until it is known how much of this program will be approved or what cost sharing arrangements will be worked out, no conclusion can be reached as to probable effect of the new cost principles on Aerojet's reimbursable costs for the 1960 fiscal year.

7. The Director, Western District, Auditor General USAF, concurs.

L. A. COFFY

U. S. NAVY AREA AUDIT OFFICE

WASHINGTON 25. D. C.

IN REPLY REFER TO

SO

A6-7

Aerojet Gen. Corp.  
Atlantic Division

28 JAN 1960

From: Officer in Charge, U.S. Navy Area Audit Office, Washington, D. C.  
To : Comptroller of the Navy (NCT)

Subj: Aerojet-General Corporation - Atlantic Division, Frederick, Maryland -  
Review of Contractor's Request for Amendment of Existing Cost  
Reimbursement Type Contracts to Incorporate New Contract Cost  
Principles

Ref : (a) NavCompt (NCT) ltr NCT11, L10-4, Ser:02958 dated 28 December 1959  
w/encl

1. In accordance with the reference, a review has been made of the subject Contractor's books and records for the purpose of evaluating the Contractor's contention that the difference would be negligible between costs reimbursable under the new cost principles (as published in ASPR Revision No. 50) as compared with those currently incorporated in contracts.

2. The operations of the Atlantic Division Aerojet-General Corporation are limited to research and development work and involve only five cost-type contracts with the Department of Defense. Annual sales for the fiscal year ended 30 November 1959, of \$588,870.02, are classified as follows:

Cost Reimbursable-Type Contracts

Department of Defense	\$185,378.14
U.S. Post Office Department	321,047.66
Total Cost-Type	\$506,425.80
<u>Fixed Price</u>	82,444.22
Total Sales	<u>\$588,870.02</u>

3. Review of the Atlantic Division claim, as presented under each set of costs principles, disclosed no differences in the amounts claimed, based on the Contractor's interpretation of reimbursable costs under Revision No. 50 to ASPR. The Contractor has also expressed an opinion that no change or advantage is to be found in the application of the revised cost principles.

4. Based on the foregoing review and audit of the Atlantic Division's books and records, the Auditor concurs with the opinion of the Contractor.

Copy to:  
OinC, NAAO, Los Angeles

  
T. W. HAGLUND  
ACTING

ENC(2)



# *Aerojet-General* CORPORATION

AZUSA, CALIFORNIA • TELEPHONES: LOS ANGELES, CUMBERLAND 3-6111 • AZUSA, EDGEWOOD 4-6211

A SUBSIDIARY OF THE GENERAL TIRE & RUBBER COMPANY



IN REPLY REFER TO:

920:3005

MAY -3 1960

The Honorable Philip LeBoutillier, Jr.  
Deputy Assistant Secretary of Defense  
(Supply and Logistics)  
The Pentagon  
Washington 25, D. C.

Subject: Amending Contracts to Incorporate New Contract  
Cost Principles Issued November 2, 1959

Reference: (a) Letter from Deputy Assistant Secretary of  
Defense to Aerojet-General Corporation,  
dated April 1, 1960, Serial: CR

My dear Mr. LeBoutillier:

On behalf of Aerojet-General Corporation, I wish to thank you and your staff for the effort and consideration given to our offer to serve as a pilot company in establishing a procedure for amending contracts to incorporate the new Contract Cost Principles.

While we share your regret that the new Cost Principles cannot be incorporated in all cost-reimbursement type contracts simultaneously, we appreciate the difficulties which you may have encountered in applying such a procedure to the multitude of contractors within the industry. Viewed in this light, the strength of the policy adopted seems evident since it is sufficiently broad to allow inclusion of the Cost Principles in existing contracts when precautionary conditions are met. We are still hopeful of completing the change-over to the new Cost Principles at an early date, for it appears desirable, in light of the fact that the old principles will phase out eventually, to establish uniform operations under current regulations at the earliest possible time.

You may be interested that Aerojet-General Corporation is presently availing itself of the important provision in the new Cost Principles covering advance understandings. We are currently in the process of reaching an advance understanding concerning allowability of independent research and development costs,

The Honorable Philip LeBoutillier, Jr.

920:3005

an area which has provided a fruitful source of dissension in the past. Our program for the current year is presently under consideration by the Tri-Departmental Committee, established to review such programs as a result of the provisions contained in the new Cost Principles.

Your letter, referenced in (b) above, indicated that a review of the present policy on incorporating the new Cost Principles into existing contracts is planned in about a year. If this company can assist you at that time, we will be pleased to do so. Of course, in the interim, if we can be of service to you or your staff, please call upon us.

Very truly yours,

AEROJET-GENERAL CORPORATION

A handwritten signature in dark ink, appearing to read "B. A. Kvist", is written over the typed name.

B. A. Kvist  
Director of Contracts

*Approved & P*  
*Approved & signed to by Joint Office*

001 2 9 1959

MEMORANDUM FOR MR. JAMES P. FAULK, DMSD (SUPPLY AND LOGISTICS)

SUBJECT: Mr. Moore's suggestion re Research and Development Treatment in New Cost Principles

To counter-balance the criticism made of the Administration that enough is not being done to encourage research and development, *vis-à-vis* recent Russian achievements such as Sputnik, Mr. Moore suggests that the treatment of research and development costs in the new Cost Principles should be emphasized to the press.

In this connection, it is necessary to bear in mind that we are on record */your letter of 25 September 1959 to Dr. Saulnier/* that "we do not feel that our revised Cost Principles are significantly different from our present practices with respect to the allocability of costs under cost-reimbursement type contracts." You also advised, in the same letter, that "our proposed cost principles will not have a significant effect on costs under cost reimbursement type contracts." Moreover, in regard to Question 2 in the Question and Answer Sheet we have stated that, as to cost reimbursement type contracts, contractors generally can expect about the same result under the revised cost rules as they are experiencing under present practices. And in response to Question 3, we state that the new Cost Principles are not going to cost us any money nor will we save any.

To adopt Mr. Moore's suggestion that the new treatment of research and development is a significant step in encouraging efforts in those areas, we would have to be prepared to come up with an item or items where we have significantly cut back on costs previously allowable, otherwise our statements to Dr. Saulnier and in response to the questions referred to above are insupportable. I do not know of any significant areas in cost type contracts where we propose to disallow items of cost that previously were allowable.

Therefore, there is a real danger in emphasizing, as Mr. Moore suggests, the significance of the new treatment of research and development costs.

As a compromise or middle-of-the-road approach, we could insert the following sentence at the beginning of the answer now prepared for Question 6:

"The new Cost Principles are in line with the national policy of encouraging research and development."



This sentence would appear sufficiently general as to avoid the danger referred to above. At the same time, it is at least questionable whether it is sufficient to accomplish anything Mr. Moore suggests be achieved.

In these circumstances, and in view of the further fact that copies of the press release and the Question and Answer Sheet have already been distributed to the military departments, I recommend that no change now be made in either document.

SIGNED

J. J. FHELAN, JR.  
Acting Director for Procurement Policy

Prepared by: JJPhelan/mt/29Oct59  
30774 X79391



U. S. NAVY AREA AUDIT OFFICE

WASHINGTON 25, D. C.

IN REPLY REFER TO

SO

A6-7

Aerojet Gen. Corp.

Atlantic Division

28 JAN 1960

From: Officer in Charge, U.S. Navy Area Audit Office, Washington, D. C.

To : Comptroller of the Navy (NCT)

Subj: Aerojet-General Corporation - Atlantic Division, Frederick, Maryland -  
Review of Contractor's Request for Amendment of Existing Cost  
Reimbursement Type Contracts to Incorporate New Contract Cost  
Principles

Ref : (a) NavCompt (NCT) ltr NCT11, L10-4, Ser:02958 dated 28 December 1959  
w/encl

1. In accordance with the reference, a review has been made of the subject Contractor's books and records for the purpose of evaluating the Contractor's contention that the difference would be negligible between costs reimbursable under the new cost principles (as published in ASPR Revision No. 50) as compared with those currently incorporated in contracts.

2. The operations of the Atlantic Division Aerojet-General Corporation are limited to research and development work and involve only five cost-type contracts with the Department of Defense. Annual sales for the fiscal year ended 30 November 1959, of \$588,870.02, are classified as follows:

Cost Reimbursable-Type Contracts

Department of Defense	\$185,378.14
U.S. Post Office Department	321,047.66
Total Cost-Type	\$506,425.80
<u>Fixed Price</u>	82,444.22
Total Sales	<u>\$588,870.02</u>

3. Review of the Atlantic Division claim, as presented under each set of costs principles, disclosed no differences in the amounts claimed, based on the Contractor's interpretation of reimbursable costs under Revision No. 50 to ASPR. The Contractor has also expressed an opinion that no change or advantage is to be found in the application of the revised cost principles.

4. Based on the foregoing review and audit of the Atlantic Division's books and records, the Auditor concurs with the opinion of the Contractor.

Copy to:  
OinC, NAAO, Los Angeles

  
T. W. HAGLUND  
ACTING

ENC1(2)





CR

3 November 1959

**MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)**

**SUBJECT: Contract Cost Principles**

The program for launching the contract cost principles was carried out on schedule. The press release was distributed on Monday afternoon at 1430. We held a press interview at 1500 at which time Mr. Falvey, Commander Malloy and Mr. Kilgore answered press inquiries and supplied additional background information for over one hour. We also distributed copies of our question and answer sheet.

The press interview commenced on somewhat of a sour note in that Mr. Saythe demanded to know why Mr. McElroy was not present. He then inquired as to why Mr. McGuire was not on hand. At several stages, Mr. Saythe interjected caustic comments or asked leading questions such as "Does this mean that the Department of Defense will continue to allow the high cost of memberships in lobbying organizations such as AIA." The questions from the remainder of the press corps (almost exclusively from the business press) were legitimate and to the point. They were particularly interested in those particular cost elements which were new or which represented a change from the past principles. Upon the conclusion of this interview, it appeared to us that the press was well satisfied with the explanations given. A check with Mr. Odom of our office of Public Affairs this morning elicited the comment that the press interview went off very well.

I have ascertained that our announcement did not appear on either the AP or UP wire. We have not seen any press coverage on the cost principles today.

15/  
J. M. MALLOY  
Cdr, SC, USN  
Staff Director, ASFR Division  
Office of Procurement Policy

*Cdr Malloy*

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OCT 59

SCHEDULE OF ACTION - COST PRINCIPLES

<u>Action</u>	<u>Timing</u>	<u>Responsibility</u>
1. Issue Revision 50 of ASPR (Cost Principles)	2 Nov 59	ASD (S&L)
2. Issue Press Release	2 Nov 59	ASD (PA)
3. Press Interview by DOD Spokesman	2 Nov 59	ASD (S&L) and ASD (PA)
4. Advise Secretary of Defense and Deputy Secretary of Defense	28 Oct 59	ASD (S&L)
5. Advise White House	28 Oct 59	ASD (S&L)
6. Provide Advance Copy of new regulation to Congressman Hebert and Congressman Mahon	29 Oct 59	ASD (S&L)
7. Advise Departmental Assistant Secretaries (Materiel) of complete schedule	28 Oct 59	ASD (S&L)
8. Distribute Advance Copies to key offices in each Military Department	30 Oct 59	Military Depts.
9. Provide Advance Copy to GSA, AEC, and NASA	30 Oct 59	ASD (S&L)
10. Advise Industry Consultants	2 Nov 59	ASD (S&L)
11. Advise Trade Associations	2 Nov 59	ASD (S&L)

*to arrive  
on  
2 Nov  
possibly  
air mail*

- A. 50 copies of the principles provided to each military dept.
- B. Procedures for the tri-departmental administration of the R&D principle were started 22 Oct. and basic approaches were tentatively agreed to.

*10/27  
week of decision  
to merge the Elroy  
and Gates  
on 10/28*



CR

**MEMORANDUM FOR THE DEPUTY SECRETARY OF DEFENSE**

**SUBJECT: Publication of Our New Regulation on Contract Cost Principles**

We are now in the final stages of publication of our new procurement regulation dealing with cost principles which we recently discussed with you. It will be published on 2 November 1959, at which time we also plan to issue a rather comprehensive press release. I have separately forwarded a memorandum to Mr. McElroy (Tab A attached) to alert him to our plans and to provide him with a copy of the press release. A copy of the press release (Tab B) is attached for your information. In addition, I am providing you with a copy of our Action Schedule (Tab C) which indicates the important corollary actions which we are taking.

**Attachments**

Tab A  
Tab B  
Tab C

Prepared by: JMMalloy/jm/23 Oct 59  
3D774 X-72026

Coordinated with: Mr. Bannerman







CR

SUPPLY AND LOGISTICS

ASSISTANT SECRETARY OF DEFENSE  
WASHINGTON 25, D. C.

22 Oct 59

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE ARMY (LOGISTICS)  
THE ASSISTANT SECRETARY OF THE NAVY (MATERIAL)  
THE ASSISTANT SECRETARY OF THE AIR FORCE (MATERIEL)

SUBJECT: Contract Cost Principles

As I indicated at one of our recent meetings, I am anxious that each of you be closely informed of our activities in connection with publication of the new cost principles. I am attaching a schedule of the various actions which we contemplate in this connection. There is also attached a copy of a press release which we expect to issue on 2 November 1959. In addition to the actions listed on the attached schedule, I have instructed Commander Malloy of my staff to be in close touch with his counterpart in each of the services so as to keep him fully informed of our activities.

I am sure that you will agree that the public relations aspects and the timing of our various actions is very important to this exercise. I solicit your assistance in assuring that we will have no breakdown in this regard nor any premature disclosure of either the cost principles or our specific plans in connection with their issuance.

Attachments

1. Action Schedule
2. Press Release

Prepared by: JMMalloy/jm/22 Oct 59  
30774 X-72026

Coordinated with: Mr. Bannerman \_\_\_\_\_





DEPARTMENT OF THE NAVY  
BUREAU OF AERONAUTICS  
WASHINGTON 25, D. C.


IN REPLY REFER TO

Aer-CT-2  
3 November 1959

Dear Pete:

I thought you might be interested in seeing your words in print. Enclosed are a couple of copies of a transcript of your speech taken by a BuAer court reporter at the ONM-sponsored Procurement Lecture Conference on 12 October 1959.

Needless to say, because of the nature of the subject, there has been a very limited and discriminating distribution consisting of several of our procurement people and the BuAer Counsel.

  
S. E. ROBBINS  
CDR, USN



OCT 59

CR

COVERING BRIEF

TO: The Assistant Secretary of Defense (Supply and Logistics)  
FROM: Director for Procurement Policy

Problem: To provide an advance copy of our Contract Cost Principles to the National Aeronautics and Space Administration for information.

Discussion: We have been providing NASA with a copy of each new draft of the Cost Principles as they were being developed. NASA has been waiting for us to take the lead in this effort. They feel that our Principles as currently developed will be completely satisfactory to NASA. We have had one meeting with NASA representatives at which time they recommended that we change our research and development principle to eliminate the definition of basic research and applied research. The affect of this revision would not change the substance of our research and development principle. They were concerned more with the precedent that our definitions would have in fields beyond contract cost principles. After a full discussion, it was agreed that the definitions were necessary to enable DOD personnel to completely understand this cost principle. NASA representatives indicated that their suggestion was, from their point of view, desirable although not essential. We feel that our present proposal will be completely satisfactory to NASA and will be used by them upon publication.

Recommendation: That you sign the attached letter.

Concurrence: Assistant Secretary of Defense (Comp) (Mr. Kilgore)

summary



CR

Dear Mr. Inedecke:

I am inclosing an advance copy of a Revision of the Armed Services Procurement Regulation on the subject of Contract Cost Principles. We expect that this Revision will be distributed officially by the Government Printing Office on 2 November 1959.

I am aware of the fact that our respective Staffs have been working together on many of the earlier drafts of this Regulation. I am advised that the new Cost Principles which we have adopted, after an extended period of review and consultation with the many interests involved, are, with few exceptions, agreeable to the Atomic Energy Commission. I think it very desirable that the many Government agencies with a primary interest in this project be substantially in agreement as to the treatment of costs under Government contracts.

Sincerely yours,

Inclosure

ASPR Revision

Contract Cost Principles

Prepared by: JMMalloy/jm/19 Oct 59  
3D774 X-72026

Mr. A. R. Inedecke  
General Manager  
Atomic Energy Commission

Coordinated with:

Mr. Bannerman \_\_\_\_\_

Mr. Kilgore \_\_\_\_\_

Copyh to:

Mr. Pilson

Mr. Kilgore



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JUL 2 1958

**MEMORANDUM FOR THE SECRETARY OF DEFENSE**

**SUBJECT: Contract Cost Principles**

Approximately one year ago, Assistant Secretary McCall, the Material Assistant Secretaries of the Military Departments, and I discussed with you certain issues within Department of Defense and with industry concerning the proposed comprehensive cost principles applicable to all types of negotiated contracts in which costs are a factor in pricing.

Due to the inherently controversial nature of these cost principles, achieving even reasonably close agreement between all parties concerned has been a slow process. We have given industry more than the customary opportunities to present their views. These have included written comment on the 10 September 1957 draft, an open discussion meeting on 15 October 1957 followed by a second written comment, and finally a detailed discussion with four industry representatives on 1-3 April 1958.

Our current proposal is the result of thorough consideration of industry and military department views. Outlined below are its most significant provisions, primarily from the standpoint that they represent a change from present policy or practice, or are opposed by industry.

1. Applicability -- The principles will be incorporated by reference in cost-reimbursement type contracts and will form the basis for determination of costs thereunder. They will also serve as guidance in the evaluation of costs in pricing negotiated fixed-price type contracts where such evaluation is required in the establishment of prices.

2. Advance agreements -- In order to avoid disagreements with respect to costs during or after performance of a contract, the principles encourage the negotiation of advance agreements as to the handling and the degree of allowability of certain items of cost, particularly in connection with firms or separate divisions thereof whose work is primarily with the Government. Industry has some reservations concerning this provision, but we believe it is entirely reasonable and will work to the benefit of all concerned.



3. Compensation — As decided in our above-mentioned discussion, compensation of contractor officers and employees is allowable if reasonable. Thus, compensation dependent upon or measured by profits is not, per se, unallowable.

4. Research and Development Costs — In line with national policy of encouraging research and development, we propose to provide for acceptance as allowable costs, our share of a contractor's independent research. We will treat his independent development costs similarly to the extent that they relate to product lines for which the Government has contracts. Restrictions are provided, however, to limit these costs to reasonable amounts and to prevent unwarranted duplication of efforts in the same area by different contractors. In return for our support of current research programs, we will not accept similar costs incurred by the contractor in the past, even though we may receive some of the benefits thereof.

5. Minor Costs Disallowed — Industry has long objected to our disallowance of certain items which it considers to be normal and proper costs of doing business. We maintain the position that, for reasons of public policy, equity, or absence of benefit to the Government, we should disallow certain costs. Among these are contributions and donations, interest, bad debts, and product and institutional advertising.

We believe that to try further to resolve the remaining differences with industry would serve only to delay this much needed guidance and deprive us of the benefits which are expected to flow from it. We anticipate that the issuance of these cost principles will result in greater uniformity of treatment of contractors, more effective and economical audit of contractors' costs, and a more orderly procurement process.

One possible hurdle, yet to be overcome, is discussion of the principles with the Comptroller General. While it is within the authority of Department of Defense to issue such regulations without reference to the General Accounting Office, we recognize its interest. Based upon comments of the Comptroller General on earlier drafts and informal staff discussion, we know that he favors a much more rigid application of the principles to all contract pricing — an approach which industry and many of us fear will remove bargaining from the negotiation process and result in formula pricing. The possibility exists that he may be critical of our effort. However, Mr. McNeil and I plan to discuss the matter with him on 23 July to point out the reasons why we believe we are proposing the best possible solution at this time.

My position, concurred in by Mr. McNeil and the military departments,



is that these principles should be published in the Armed Services Procurement Regulation immediately, to become effective on 1 January 1960. Barring objection from you, or insurmountable opposition from the Comptroller General, I propose to do so.

(Signed) Perkins McGuire  
PERKINS McGUIRE  
Assistant Secretary of Defense  
(Supply and Logistics)

DISPATCHED  
JUL 22 1959  
ASST. SEC.

Prepared by: KK Kilgore 7/8/59  
3C885 I76321

Concurrence:

Mr. McNeil \_\_\_\_\_





CR

**MEMORANDUM FOR THE SECRETARY OF DEFENSE**

**SUBJECT: Publication of Our New Regulation on Contract Cost Principles**

We have now completed our work in connection with the publication of a revision to the Armed Services Procurement Regulation dealing with contract cost principles. The regulation is being printed by the Government Printing Office and will be distributed to the public on 2 November 1959, at which time we plan to issue a press release. A copy of the press release is attached for your information.

You will recall that we discussed this new regulation at some length approximately a year ago. During your recent absence, I provided Mr. Gates with information as to our current plans. We can expect some adverse industry comment. Congressional reaction should be favorable.

Attachment  
Press Release

Copy to:  
Mr. Gates

Prepared by: JMMalloy/jm/~~307~~  
23 Oct 59 3D774 X-72026

Coordinated with: Mr. Bannerman \_\_\_\_\_



OFFICE OF THE SECRETARY OF DEFENSE  
Munitions Board

15 November 1949

MEMORANDUM FOR THE SECRETARY OF THE ARMY

THRU: The Assistant Secretary of the Army

MEMORANDUM FOR THE SECRETARY OF THE NAVY

THRU: The Assistant Secretary of the Navy

MEMORANDUM FOR THE SECRETARY OF THE AIR FORCE

THRU: The Under Secretary of the Air Force

SUBJECT: Contract Cost Principles.

References: (a) Section XV, Armed Services Procurement Regulation.  
(b) Joint Letter No. 12 dtd 5 Aug 49 re Use of Contract Cost Principles, Sec. XV, ASPR, by Audit Personnel.

1. Your attention is invited to the provisions of Paragraph 15-101 of reference (a), wherein it is provided that the Contract Cost Principles "shall be followed in connection with all cost-reimbursement type contracts..."

2. During the development of these principles, industry took the strong position that they must not be applied to contracts other than those of the cost-reimbursement type, and was assured that they would not be so applied.

3. However, in the absence of more suitable cost principles, and in order to provide uniformity from an auditing viewpoint, all auditors under the jurisdiction of the Army Audit Agency, of the Navy Cost Inspection Service, and of the Air Force Office of the Auditor General have been instructed by reference (b) to use, except in certain special circumstances set forth therein, the Contract Cost Principles as cost standards for the preparation of advisory reports to Contracting Officers in connection with fixed-price type contracts.

4. All Contracting Officers and others involved should be specifically advised that there has been no change in the application of the cost principles for purposes of determining allowable costs from that set forth in Paragraph 15-101 of reference (a), and that, therefore, the Contract Cost Principles shall not be used in negotiating prices under fixed-price contracts other than (1) for the purpose of preparing advisory reports as referred to in paragraph 3 above and (2) by the Contracting Officers to the extent they deem it advisable, as a working guide only.

C  
OPY



Mailing

OCT 59

COVERING BRIEF

CR

**TO: The Assistant Secretary of Defense (Supply and Logistics)**

**FROM: Director for Procurement Policy**

**Problem:** To provide an advance copy of the new Cost Principles to Congressman Mahon for information.

**Discussion:** The attached letter to Congressman Mahon is designed to afford him with an advance copy of the new Cost Principles. We have no commitment to clear our principles with the House Appropriations Committee prior to their publication. We feel, however, that we should give the Committee an advance copy as a matter of courtesy in view of its sustained interest in this subject.

**Recommendation:** That you sign the attached letter.

**Concurrence:** Assistant Secretary of Defense (Comp) (Mr. Kilgore)  
General Counsel



CR

Dear Mr. Floete:

I am inclosing an advance copy of a Revision of the Armed Services Procurement Regulation on the subject of Contract Cost Principles. We expect that this Revision will be distributed officially by the Government Printing Office on 2 November 1959.

The Department of Defense has been developing a revision to our Procurement Regulations with respect to Contract Cost Principles for a considerable period of time. However, as I am sure you will recognize, this is a highly complicated and controversial subject and one which generates a wide variety of different views as to the treatment which should be afforded each detailed cost element. As a result, the obtaining of a degree of agreement on this set of Cost Principles has been a slow process.

The Department of Defense has been under considerable pressure from several Congressional Committees to promulgate a comprehensive set of Cost Principles without further delay. For my own part, I am convinced that it is more important for us to promulgate our current proposals without further refinement. We will, of course, look forward to any changes which may be necessary after we have had experience with these Principles.

We have afforded ample opportunity for Industry to provide comments and suggestions with respect to this new Regulation. While we expect that Industry will remain quite critical of the new Cost Principles, it is my feeling that our present effort is the proper course of action for us to take. I feel sure that you will desire to incorporate these Contract Cost Principles into the Federal Procurement Regulation. In this connection, we have been in consultation at the Staff level with the Atomic Energy Commission and the National Aeronautics and Space Administration who have both indicated substantial agreement with our new Regulation.

Sincerely yours,

Inclosure

Contract Cost Principles

Honorable Franklin G. Floete  
Administrator  
General Services Administration

Prepared by: JMMalloy/jm/19 Oct 59  
3B774 X-72026

Coordinated with:

Mr. Bannerman \_\_\_\_\_

Mr. Kilgore \_\_\_\_\_

Copy to: Mr. Pilson  
Mr. Kilgore





OCT 59

Malloy

COVERING BRIEF

CR

TO: The Assistant Secretary of Defense (Supply and Logistics)

FROM: Director for Procurement Policy

Problem: To provide an advance copy of the Cost Principles to the General Services Administration for information and for possible use in connection with the Federal Procurement Regulation.

Discussion: The General Services Administration has been aware of our continuing efforts over the past several years to resolve the problems which have accompanied our efforts to promulgate a comprehensive set of Cost Principles. They have not taken an active part in this project, preferring to await the outcome of our efforts. The Department of Defense is the primary user of Cost Principles in Government although both AEC and NASA will have use for Cost Principles. Use by other Government agencies, including GSA, will be insignificant. The purpose of this letter is to advise Mr. Floete of the results of our efforts.

Recommendation: That you sign the attached letter.

Concurrence: Assistant Secretary of Defense (Comp) (Mr. Kilgore)

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Dear Mr. Johnson:

I am inclosing an advance copy of a Revision of the Armed Services Procurement Regulation on the subject of Contract Cost Principles. We expect that this Revision will be distributed officially by the Government Printing Office on 2 November 1959.

I am advised that members of the NASA staff have reviewed earlier drafts of our new Regulation and have expressed the view that these Cost Principles could be used by NASA. In view of the fact that both NASA and the Department of Defense have many common contractors, purposes, and interests, I think it very desirable that our approach to costs under Government contracts be parallel to the maximum practicable extent.

Sincerely yours,

**Inclosure**

ASPR Revision  
Contract Cost Principles

Mr. John A. Johnson  
General Counsel  
National Aeronautics and  
Space Administration  
1520 H Street, NW

Copy to:  
Mr. Pilson  
Mr. Kilgore

Prepared by:  
JMMalloy/jm/19 Oct 59  
3D774 X-72026

Coordinated with:  
Mr. Bannerman \_\_\_\_\_  
Mr. Kilgore \_\_\_\_\_



ARTICLE ON THE DEPARTMENT OF DEFENSE  
REVISION OF THE CONTRACT COST PRINCIPLES CONTAINED  
IN THE ARMED SERVICES PROCUREMENT REGULATION  
SECTION XV, PARTS 1, 2 AND 6

27 November 1959

By Edward T. Cook  
Contract Audit Division  
Office of the Comptroller  
of the Navy  
Washington, D. C.

DEPARTMENT OF DEFENSE PUBLISHES REVISED CONTRACT COST PRINCIPLES

By the publication of Revision No. 50 dated 2 November 1959 to the Armed Services Procurement Regulation, the Department of Defense has issued a new set of contract cost principles for use in connection with supply and research contracts with commercial organizations. The new principles will replace those now in the Armed Services Procurement Regulation and while they may be technically described as a revision of the former cost principles, they are, for all practical purposes, a new and quite different document. However, insofar as application to cost reimbursement type contracts <sup>is</sup> ~~are~~ concerned, they appear to reflect generally past practices rather than any extensive change in policy. The original Section XV, Part 2 has remained in effect practically unchanged for more than ten years. The text of the new principles is included in the official releases department of this issue.

Because of their use in connection with fixed price type contracts, even within the limits specified therein, the new principles will have a much broader impact on the business community than the old principles which were designed for use only in connection with cost reimbursement type contracts. The new principles will be used by both auditors and contracting officers of the military departments as guides in the preparation of advisory accounting reports and in the negotiation and administration of fixed price type contracts wherever considerations of contractors' cost data are involved. Among the situations where these principles will undoubtedly be so used are redeterminations of prices, pricing of incentive contracts, termination settlements, and <sup>these</sup> initial



pricing actions, <sup>for which</sup> where the amounts to be paid to the contractors are to be negotiated to a substantial degree on the basis of statements of cost.

The new principles will also be used, in the same manner as the old ones, in respect to cost reimbursement type contracts; that is, they will be incorporated in such agreements as the basis for determining allowable costs. As to cost-reimbursement type subcontracts, paragraph 15-204(b) limits the amounts that may be paid to prime contractors, on account of disbursement by them to subcontractors, to those amounts which are allowable under the applicable part of Section XV. It will therefore be prudent for prime contractors to incorporate the cost principles in any cost-reimbursement type subcontracts entered into by them.

The importance of the new principles should not be overlooked by any certified public accountant who has clients engaged in contract work for any of the military departments. It is suggested by the writer that any such CPAs carefully study these principles in order that they may be able to inform their clients of the probable impact on their contract negotiations and reimbursements.

The effective date of the new principles, that is, the time when it is mandatory that they be used in connection with new cost type contracts, is July 1, 1960. However, as in the case of other procurement regulations, the use of the principles is authorized commencing at once. Undoubtedly consideration will be given in the near future to whether or not existing cost-reimbursement type contracts can be amended in order to prevent a situation where two different sets of cost principles will be in effect under different contracts with the same company for the

same period of time. The necessity for determining costs under two different sets of rules could lead to considerable difficulties, particularly in the overhead area.

It may be of interest to note that the new principles do not require that contractors or prospective contractors submit their cost presentations in conformity therewith. However, contractors who prepare cost presentations in accordance with the new principles will be likely to benefit from a reduction of audit time and interference, as well as experience fewer requests for account analyses and data breakdowns as contemplated by paragraph 15-603(d). The principles do, as above indicated, require that contractors' cost presentations be evaluated by military department auditors and contracting officers under the rules set out in the document, but in respect to fixed price contracts they are clearly indicated to be guidelines. There is well worded coverage of this latter point in Part 6 of the principles.

The relative pros and cons of requiring the use of cost principles even as a guide in connection with fixed price types of contracts can be, and has been, debated at length within both the Department of Defense and Industry. While good arguments can be made on both sides of this question, the weight of evidence indicates that a real need existed for these new principles. Incidentally, they are likely to prove of considerable help to contractors in submitting their price proposals in that they will know in advance, in respect to the rather comprehensive list of cost items treated in paragraph 15-205, the attitude of the Department of Defense.

Some people have found it hard to understand why there should be a need for a set of contract cost principles published by the Department

of Defense, except possibly for cost type contracts and for settlements of terminations under fixed price type contracts. They have pointed out many times that after all accounting principles are rather well established by publications of the American Institute of Certified Public Accountants, accounting text books, the Internal Revenue Code, regulations of the SEC, etc. Also, in the fixed price area it is a price which is to be negotiated and, while cost considerations may, and frequently do, play an important part, the real objective is a mutually satisfactory total price rather than the determination of the acceptability of individual items or types of costs. What this line of argument overlooks is the vital fact that billions of dollars of defense expenditures are under types of contracts where, in the last analysis, the price is dependent chiefly upon someone's evaluation of a set of cost figures submitted by the contractor.

What then are the basis reasons for promulgation of a standard set of rules, even as a guide in the consideration of costs leading to the negotiation of fixed prices? No doubt different individuals would give somewhat different answers to this question. But the chief reasons, in the writer's mind, are: first, to fill the guidance vacuum indicated in the preceding paragraph; second, to secure greater uniformity in the consideration of cost throughout the various and rather numerous components and echelons of the Department of Defense; and third, the equalization of cost treatment among the different types of contracts so that no one type of contract will be more or less attractive to either the contractor or the Government solely because of a different approach to the acceptability of costs.

In thinking over this problem, it is important that the reader realize that we are not talking about fixed price contracts where the prices are established as the result of formal advertising. The use of cost principles under these contracts is largely limited to terminations with occasional instances of use in negotiating revised prices because of changes in work or specifications order by the Government.

As to the provisions of the new principles, the wording can and does, to a large extent, speak for itself. The first thing which will be noticed by anyone comparing the new principles with the old is the greater length of the document. As will be seen from a perusal of the text, this is due principally to the comparatively extensive treatment of each of the selected cost items in place of mere listings of examples of allowable and unallowable cost items which were used in the 1949 version.

Of particular significance to any prospective contractor is the fact that advance understandings are suggested in paragraph 15-107 in respect to any cost items which may be difficult or controversial in the case of negotiated fixed price type contracts, as well as under cost reimbursement type contracts.

The discussion in subparagraphs 15-201.2, 15-201.3 and 15-201.4 is suggested for careful study since it is in these subparagraphs that the general criteria for determining allowability are set forth. The definition of reasonableness, in subparagraph 15-201.3, should receive particular attention because this is likely to be the key to most controversial situations. The new principles bring out specifically certain aspects which have been heretofore considered but which have not been a part of

the written regulations; such as, lack of arm's length bargaining, lack of competitive restraints, and substantial increases in such items as salaries concurrent with the commencement of operations under Government contracts.

The comparatively extensive treatment of direct costs and indirect costs, in paragraphs 15-202 and 15-203 respectively, reflects an effort to deal with these fundamental aspects of contract costing in a more definitive manner than heretofore.

A brief picture of the treatment of the selected cost items covered in paragraph 15-205 of the new principles is presented in the form of an item by item chart which is printed on pages \_\_\_\_ and \_\_\_\_.

A discussion of the changes in detail as between the new principles and the older version might become rather lengthy. This is because of the greatly expanded coverage of the selected cost items. However, there is included below a brief discussion of the more significant changes:

Advertising (paragraph 15-205.1):

The former principles limited allowable advertising in trade and technical journals to ads placed for the purpose of offering financial support to the journals. This specific requirement as to financial support being the purpose of the ads is no longer included; however, this does not appear to represent a change in policy. The revised wording should eliminate the controversies which have sometimes arisen in the past when contractors were confronted with the necessity for proving that particular advertisements were placed only for the purpose of

offering financial support of the publication in question. It will be noted that ads which offer products or services for sale are unallowable. Specific provision is also made for allowance of the costs of participation in exhibits, again with the proviso that these expenses will not be allowed if products are offered for sale.

Compensation for Personal Services (paragraph 15-205.6):

This subject has been treated extensively but from the standpoint of actual practice there are few changes of significance. It may be of interest to note the limitation in (a)(1) which restricts amounts allowable to those which are permissible under the Internal Revenue Code, the provision for allowance of compensation to partners and sole proprietors where services are rendered by them in (a)(3), and the unallowability of the cost of stock options in (e). Allowance of management employee incentive compensation; i.e., "profit sharing plans", is now definitely provided for in subparagraph (a).

Depreciation (paragraph 15-205.9):

Subparagraph (f) permits allowance, under the circumstances described therein, of a use charge for fully depreciated assets without a specific contract provision.

Interest and Other Financial Costs (paragraph 15-205.17):

The disallowance of interest follows the traditional pattern but it is now extended to terminations by reason of the applicability of the new principles to those situations.

Losses on Other Contracts (paragraph 15-205.19):

The wording on this item has been amplified and strengthened in

order to make it unmistakably clear that a loss under any other contract, regardless of its type or purpose, is unallowable.

Material Costs (paragraph 15-205.22):

(b) The last sentence of this subparagraph contains specific coverage of cases where contractors are unable to take cash discounts because of circumstances under which it would not be reasonable to expect such discounts to be taken and provides that these lost discounts need not be credited to costs. This has been a controversial point on occasion in the past.

(c) The wording of this subparagraph does not contain the proviso, which was in the old principles, to the effect that inventory adjustments could not include "write-downs" of value. This inclusion was not caused by a change in viewpoint, but simply to recognize the fact that the inventory adjustments being discussed relate only to the differences between physical inventories and book inventories and therefore "write-ups" and "write-downs" of value are not involved.

(e) There is now specific provision for acceptance of charges for inter and intracompany transactions on a price basis under the circumstances outlined in the new principles. In the old principles, the pricing of such transfers was among the items suggested for specific contractual consideration in Part 5.

Precontract Costs (paragraph 15-205.30):

Specific provision has now been made for allowance of precontract costs to the extent they would have been allowable if incurred after the date of the contract. It will be observed that this item is also on the



list in paragraph 15-107 of items regarding which advance understandings are suggested. Previously, precontract costs required a specific contract provision to be allowable.

Professional Service Costs (paragraph 15-205.31):

The new principles provide that retainer fees may be allowed if supported by evidence of bona fide services available or rendered. Formerly, it had been generally held that retainer fees were allowable only where services were actually rendered.

Rental Costs (paragraph 15-205.34):

By subparagraph (b) rentals on an intercompany or interdivisional basis are limited to the normal costs of ownership.

The limitation on sale and leaseback agreements in subparagraph (c) should be noted. This now requires a contract provision for any allowance to be made in excess of normal ownership costs.

Research and Development Costs (paragraph 15-205.35):

This important subject has been treated at considerable length. First of all, definitions have been provided for basic research, applied research and development. For costing purposes, however, only two categories are established; namely, contractors' independent research and contractors' independent development. Both categories are allowable within the limitations and subject to the criteria stated.

One effect of the new principles will be to allow contractors independent research without the specific contract provision which was required under the old principles. In addition, there is provision in subparagraph (f) for costing the contractor's research and development

expenditures, from the standpoint of application of indirect and administrative expenses to such costs, in conformity with the accounting practices established by the contractor. A limitation has been included in subparagraph (g) which makes research and development costs incurred in periods prior to the award of the contract unallowable unless such expenditures are a proper part of precontract costs. The text of subparagraph (h) includes administrative guidelines and procedural suggestions with particular emphasis on advance agreements.

Taken together, all of these provisions should be of great assistance in eliminating some of the controversies of the past.

Selling Costs (paragraph 15-205.37):

Subparagraph (c) permits the allowance of salesman's or agents' fees and commissions to bona fide employees or selling agencies maintained by the contractor for the purpose of securing business. In the old principles, paragraph 15-205(d) provided that commissions and bonuses in connection with obtaining or negotiating for government contracts were unallowable. However, it is important to note the last sentence of subparagraph (b) where the factors upon which allocability of selling costs will be dependent are set out. The emphasis is on the showing of reasonable benefit to the Government.

Termination Costs (paragraph 15-205.42):

The items covered in this paragraph plus the coverage of other subjects in the new cost principles will supersede the principles which have previously been applicable to terminations in ASPR Section VIII. The change in the treatment of interest as mentioned above is important.

Training and Educational Costs (paragraph 15-205.44):

This subparagraph has been given rather extensive treatment.

Except for grants and donations (which are considered contributions) the remainder of the items mentioned are allowable. However, certain limitations have been included, aimed at achieving reasonableness and these may, in some cases, have a cost sharing aspect.

See Note  
August 4, 1958

MEMORANDUM FOR THE SECRETARY OF DEFENSE

SUBJECT: Suggested Language for the Cost Principle Covering Executive Bonuses Based Upon Profit

At the meeting in your office, on the contract cost principles, on August 1, 1958, you asked that we send you the proposed language for inclusion in the principles to make profit sharing payments an allowable part of compensation to the extent total compensation is reasonable.

Since the profit sharing method is simply one portion of the overall treatment of the subject of "compensation" in the principles, there are already general statements under this subject which are applicable. A description of two of these follows:

1. After citing examples of the various methods of compensation, the statement is made that: "Except as otherwise specifically provided in this paragraph, such costs are allowable to the extent that the total compensation of individual employees is reasonable for the services rendered."

2. This is followed by an expansion on the general "reasonableness" provision as follows: "Compensation is reasonable to the extent that the total amount paid or accrued, is commensurate with compensation paid under the contractor's established policy and conforms generally to compensation paid by other contractors of the same size, in the same industry, or in the same geographic area, for similar services. Compensation will be particularly scrutinized to determine whether the compensation is reasonable in amount and is for actual personal services, rather than a distribution of profits, when paid (i) to owners of closely held corporations, (ii) to partners and sole proprietors, (iii) to members of the immediate families of persons within (i) and (ii) above, or (iv) to persons who are committed to acquire a substantial financial interest in the contractor's enterprise. In addition, compensation expenses must be particularly scrutinized in light of the presence or absence of competition in the conduct of competitive business.

In discussing this subject in that portion of the cost principles where allowability of specific types of compensation is dealt with in detail, the following language would be used (the portion in brackets is the only new material):

Cash Bonuses and Incentive Compensation. [Incentive compensation for management employees (whether or not dependent upon or measured by profits), cash bonuses, suggestion awards, and safety awards, based on production, cost reduction or efficient management or performance, are allowable to the extent that the overall compensation is determined to be reasonable and such costs are paid or accrued pursuant to an agreement entered into in good faith between the contractor and the employees before the services were rendered, or pursuant to an established plan followed by the contractor so consistently as to imply, in effect, an agreement to make such payment. (But see ASPR 15-204. 1(b).)]

The reference to ASPR 15-204 1(b) is to that section of the cost principles which we discussed with you, which states that where contractors are predominantly engaged in government work and where the reasonableness of a cost may be difficult to determine, the contractor should arrive at an agreement with the government as to such costs in advance of incurring them.

It is recommended that you approve the above language for inclusion in the cost principles.

8/14/58

Notes below are from Mr. Quarles. Jim & I consider that summary in 8 Aug. memo to ASD(S&L) & info below are essentially similar. 10/15/58

W. J. McNEIL  
Assistant Secretary of Defense  
(Comptroller)

PERKINS McGUIRE  
Assistant Secretary of Defense  
(Supply and Logistics)

- ① Disseminate to industry with explanation that changes to include profit sharing will only be made after <sup>determining</sup> overall allowable salary.
- ② Avoid any sharp increase in salaries charged to contracts by captive contractors.

Can you comm. advise dis. 10/15/58

AD-6



### Covering Brief

PROBLEM: To furnish data on recruitment costs of engineering and scientific personnel as requested by the Sub-Committee on Manpower Utilization of the House Committee on Post Office and Civil Service.

BACKGROUND: In a letter dated January 20, 1960, Chairman James C. Davis of the Sub-Committee requested a report on personnel recruiting costs in FY 1959 of a sample of Defense contractors, in order to ~~stage~~ gauge the effectiveness of Defense policies in "adjudging the recruitment expenditures by Defense contractors." The requested study paralleled a report for FY 1956 which was furnished to the Committee. However, the FY 1959 study was limited to engineers and scientists with degrees or experience equivalent to a degree, while the earlier study did not contain this limitation and therefore also included supporting technical personnel.

DISCUSSION: The attached lists submitted by the Army, Navy and Air Force in response to the Committee request contain data for 102 companies which have been assigned numerical codes to avoid revealing their identities. Of the total, 76 had a preponderance of sales (more than 50%) to the Government while the other 26 had a preponderance of sales to non-governmental organizations.

In FY 1959 recruiting costs for engineers and scientists averaged \$1,022 per new hire for companies doing business mostly with the Government, compared to \$751 for companies selling mostly to non-governmental customers. In the case of the former group, such recruiting costs represented \$1.97 per \$1,000 of sales, while in the case of the latter, they represented \$.58 per \$1,000 of sales. Almost one-third of the recruiting costs of the

ent business" group went for help-wanted ads, as against slightly more than one-fourth for the "commercial business" firms.

Both groups increased the size of their engineering and scientific staffs between the beginning and end of the fiscal year: the "Government business" group by 10% and the other group by 9%. Personnel turnover was higher for the former group (14.8%) than for the latter (12.3%).

Although figures for FY 1959 are not comparable with those for FY 1956 because of the inclusion in the latter of supporting technical personnel, the Committee probably will compare average recruitment costs for these periods. In tabular form the comparative figures are as follows:

<u>Fiscal Year</u>	<u>No. of Companies</u>		<u>Recruitment Costs Per New Hire</u>	
	<u>0 - 50%*</u>	<u>51 - 100 %*</u>	<u>0 - 50%*</u>	<u>51 - 100%*</u>
<u>All Companies in Sample</u>				
FY 1959	26	76	\$751	\$1,022
FY 1956	56	97	551	482
% Increase			36%	112%
<u>Identical Companies Reported in Each Year</u>				
FY 1959	9	39	\$776	\$1,100
FY 1956	9	39	295	413
% Increase			163%	166%

\* ~~Percentages~~ Refer to ratio of Government sales to total.

In terms of all companies in the sample, those with a preponderance of Government business showed an increase of 112% in average recruitment cost between FY 1956 and FY 1959, whereas other companies showed an increase of 36%. However, for identical companies reported in both years, the increase is about the same (165%).

RECOMMENDATION: That you sign letter transmitting lists (without any summary data) to the Committee.

*Conducting*  
ABD Exp. Mr. Kilgore - Mr. Zark.  
ABD Exp. I

LC



28 April 1958

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (S&L)

SUBJECT: 10 September 1957 Draft Contract Cost Principles - Training and Educational Costs

In accordance with the request of your office, we have reviewed the proposed treatment of allowability of training and educational costs, contained in subject version of "Contract Cost Principles." As you know, the proposed treatment was originally developed and concurred in by the Military Departments, ASD (Comp.), ASD (S&L), and this office in late 1956.

It is our opinion that the proposed treatment of training and educational costs is realistic in terms of the current manpower situation, which is characterized by shortages of technical and scientific personnel. At the same time, it is believed that the limitations and standards of allowability are reasonable and proper.

While the proposed treatment is responsive to the current manpower situation, it deals only with training for the purpose of up-grading the technical and scientific skills of personnel employed on defense contracts, and is in that respect directed at affording better performance on defense contracts in this period of military demands for products of ever-increasing quality and complexity. It is not, - nor should it be, - directed at solving the overall national skill-shortage problem in the sense of financing the strengthening of the educational system itself, or of financing college education for promising high school graduates not employed on defense contracts. It has been our feeling that Federal financing for such general educational purposes should be handled by the U. S. Office of Education, rather than by use of military materiel procurement monies. The Executive Branch has, in fact, now proposed in S. 3163 an overall approach of this kind which is financed through the U. S. Office of Education. Needless to say, this office and the Department of Defense are officially on record in support of S. 3163.

In the light of the foregoing, this office concurs in the proposed handling of the above subject.

Mr. Wilson

Stephen S. Jackson  
Deputy Assistant Secretary

contributory, where the total costs of the benefits are paid by the contractor. Usually employees are eligible for most group insurance benefits after 1 to 3 months of service.

(4) Some group insurance plans provide for hospital and surgical benefits for the dependents of employees. The entire cost of dependents' benefits is sometimes borne by the employees.

(b) *Responsibility of the Administrative Contracting Officer.* The administrative contracting officer will determine whether the group insurance benefits are reasonable in amounts and necessary in connection with the performance of AF contracts. This determination will be made only after considering the wages and other fringe benefits to which the employees of a contractor are entitled. Consideration must be given to the general level of total wages and benefits for employees in similar jobs in the immediate geographical vicinity. If the contractor is engaged principally in commercial operations, there is little likelihood that the group insurance benefits will be unreasonable because of competitive reasons. However, where a contractor is primarily working on Government contracts, the restraints imposed by competition may be lacking and a careful review by the administrative contracting officer may be indicated.

#### 10-501.51 Use and Occupancy Insurance.

(a) Use and Occupancy or Business Interruption Insurance is a form of insurance which indemnifies the contractor for certain losses incurred during a period of interruption or suspension of business operations resulting from physical damage to property essential to the conduct of business. The contractor is indemnified for loss on account of fixed charges and other expenses which accrue during such period and for loss of net profit which the contractor is prevented from earning. The amount of indemnity purchased under this form of insurance is based on the probable loss the contractor would sustain during the period of interruption or suspension of business operations. The premium charge is based on the aggregate indemnity under the policy.

(b) (1) When costs in connection with Use and Occupancy Insurance are presented for allowance, the aggregate indemnity available will be analyzed. Only that percentage of total insurance cost which is identifiable with indemnity benefits determined to be acceptable within the intent of subparagraph (2) below will be allowed.

(2) Costs of insuring those items of fixed charges and other expenses, which are allowable items of costs in AF contracts, will be considered allowable. Such fixed charges and other expenses include, but are not limited to, salaries of employees under contract and other key employees, rents, most insurance premiums, and charges for non-cancellable contracts for light, heat, or power.

(3) Costs of insuring the net profit a contractor is prevented from earning during a period of business interruption or suspension are unallowable. Similarly, the costs of insuring certain items of fixed charges are unallowable, namely, Federal income taxes, donations, and certain advertising expenses.

10-502. Self-Insurance. No implementation.

10-503 Government Property. No implementation.

§ 10-504

AIR FORCE PROCUREMENT INSTRUCTION

3/17/59 Re 15-215.16 (a) (2) (b) (c) (d) (e) (f) (g) (h) (i) (j) (k) (l) (m) (n) (o) (p) (q) (r) (s) (t) (u) (v) (w) (x) (y) (z)

State: To keep you fully aware of AF developments on the cost principle, in no way should AF practice, and for point which the AF may well back on, our business people back of Government (Contractors) that getting the info is no great problem - it has been done for years.

OC1  
7560/Aerojet-Gen'l  
12 Feb 1960

From: Officer in Charge, U. S. Navy Area Audit Office, Los Angeles  
To: Comptroller of the Navy (NCT)

Subj: Aerojet-General Corporation, Azusa, California - Review of contractor's request for amendment of existing cost reimbursement type contracts to incorporate new contract cost principles

Ref: (a) NavCompt ltr NCT11, L10-4, Ser: 02958 of 28 Dec 1959  
(b) Aerojet-General ltr 920:1424, ESR:1k of 17 Dec 1959 to Asst.Secy.Def. (S&L)

1. In accordance with request in reference (a) a review has been made of the contractor's contentions that only a negligible difference in reimbursable costs would result from the use of the new cost principles (ASPR Revision No. 50) rather than those cost principles currently incorporated in cost reimbursement type contracts. This review was conducted in conjunction with the Air Force auditor cognizant of the contractor's Sacramento divisions.

2. In reference (b) the contractor presented considerable detail concerning the contracts and subcontracts under which it is performing work for the Government. Based on the year ended 30 November 1959 the contractor's business may be summarized as follows:

	<u>Cost-Type</u>	<u>Cost of Sales</u>	
		<u>Fixed-Price</u> (000 omitted)	<u>Total</u>
Prime contracts			
Navy	\$ 29,666	\$ 7,564	\$ 37,230
Air Force	163,246	469	163,715
Army	4,951	2,504	7,455
Other Government	7,196	793	7,989
Subcontracts under Government primes	<u>116,533</u>	<u>12,233</u>	<u>128,766</u>
Total Government	<u>\$321,992</u>	<u>\$ 23,563</u>	<u>\$345,155</u>
Commercial	<u>          </u>	<u>203</u>	<u>203</u>
Total	<u>\$321,992</u>	<u>\$ 23,766</u>	<u>\$345,358</u>

3. No sound conclusions could be reached as to the effect of the new cost principles on the reimbursement of costs to Aerojet because (a) it was not practicable to determine the effect of the new principles on the reimbursable costs of Aerojet's subcontractors, and (b) the extent and cost of the independent research and development program which Aerojet might pursue in 1960 and subsequent years is not presently known.

4. With respect to subcontractors' costs, it was determined that Aerojet now has ninety-two subcontracts issued to approximately forty subcontractors in the aggregate amount of \$38,831,700. Since the new principles appear to be somewhat more liberal than the old principles, particularly in the areas of research and development and selling costs, it would appear reasonable to assume that the subcontractors' reimbursable cost would increase. The extent of any such potential increase could not be determined unless a survey was made of all Aerojet's subcontractors.

5. With respect to Aerojet's own costs, a review of the provisions of ASPR Revision No. 50 reveals that the only area of potential significant difference in reimbursable costs involves the contractor's independent research and development costs. In order to test the contractor's contention that the effect of the use of the new cost principles would be negligible, a comparison was made of the effect of the old and new cost principles on overhead reimbursable under cost-type contracts for the fiscal year ended 30 November 1958. The contractor's 1958 fiscal year was used because it is the most recent year for which all the information needed to make the comparison was available. The results of this comparison are summarized as follows:

Total Aerojet overhead that would be reimbursable under CPFF contracts and subcontracts for the 1958 fiscal year if costs were determined in accordance with the new cost principles	\$64,656,000
--	--------------

Total Aerojet overhead determined to be reimbursable under CPFF contracts and subcontracts for the 1958 fiscal year in accordance with the old cost principles	<u>64,624,000</u>
--	-------------------

Increase in reimbursable overhead resulting from the application of the new principles - all CPFF work performed by Aerojet	\$ 32,000
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Less - applicable to prime contracts with Government agencies other than Department of Defense and subcontracts	<u>9,000</u>
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Increase applicable to prime contracts with the Department of Defense	<u>\$ 23,000</u>
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# *Aerojet-General*<sup>®</sup> CORPORATION

AZUSA, CALIFORNIA • TELEPHONES: LOS ANGELES, CUMBERLAND 3-6111 • AZUSA, EDGEWOOD 4-6211

A SUBSIDIARY OF THE GENERAL TIRE & RUBBER COMPANY



IN REPLY REFER TO:

920:2290

MAR -7 1960

**The Honorable Philip LeBoutillier, Jr.**  
**Acting Assistant Secretary of Defense**  
**(Supply and Logistics)**  
**The Pentagon**  
**Washington 25, D. C.**

**Subject: Amending Contracts to Incorporate New Contract Cost Principles Issued November 2, 1959**

**Reference:**

- (a) Letter from Aerojet-General Corporation to the Assistant Secretary of Defense (Supply and Logistics), dated December 17, 1959, Serial 920:1424 ESR:lk**
- (b) Letter from Assistant Secretary of Defense to Aerojet-General Corporation, dated December 29, 1959, Serial: CR**

**My dear Mr. LeBoutillier:**

**In connection with Aerojet-General Corporation's offer, reference (a), to serve as a pilot company in establishing a procedure for amending contracts to incorporate the new Contract Cost Principles and in response to the request contained in reference (b), we have contacted prime contractors to ascertain their reaction to amending their subcontracts with this company to incorporate the new Contract Cost Principles.**

**To date, this matter has been discussed with the Lockheed Missile Systems Division and the Douglas Aircraft Company, Inc. At the Lockheed company, the matter was discussed with Mr. Roy Anderson, Manager of Finance, and Mr. Harry Kohl, Materiel Director. It was their opinion that there would be no objection by the Lockheed company to amending its subcontracts to incorporate the new Contract Cost Principles provided no adverse cost**



**The Honorable Philip LeBoutillier, Jr.**

impact arose. Aerojet-General Corporation was advised to submit formal written requests for such amendments which could be expected to receive a favorable action by the Lockheed company.

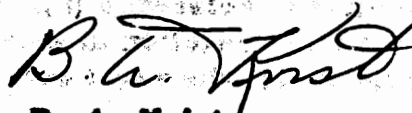
The Douglas company representative with whom the matter was discussed is Mr. J. R. Shelton, Manager - Major Subcontracts. This gentleman stated that the Douglas company has no objection to incorporating the new Contract Cost Principles in its subcontracts. Such amendments as issued would be subject to the customary review and approval by resident government personnel under the terms of the prime contracts held by the Douglas company.

The significance of the viewpoints of these two major prime contractors is highlighted by the dollar magnitude of subcontracts which Aerojet-General Corporation is performing for them. As of January 31, 1960, the total dollar value of subcontracts being performed for the Lockheed company by Aerojet-General Corporation was \$122,114,784; while, subcontracts in performance for the Douglas company by Aerojet-General Corporation at that date totaled \$14,898,881. While these figures include some fixed-price subcontracts, the vast preponderance of the amounts stated are on a CPFF basis. Although comparable figures for the period ending February 29, 1960 are not yet available, any deviation from those reported above would be most likely to increase the amounts involved.

Aerojet-General Corporation appreciates the opportunity to report this information for your consideration and we are hopeful of rendering further assistance in your efforts to establish a procedure for amending existing contracts to include the new Contract Cost Principles.

**Very truly yours,**

**AEROJET-GENERAL CORPORATION**



**B. A. Kvist**

**Director of Contract Administration**

It is believed that the 1959 fiscal year would yield comparable results except that a greater proportion of the increase would be applicable to prime contracts with other Government agencies and to subcontracts under Government primes.

6. The foregoing tabulation appears to support the contractor's contentions, since the increase in reimbursable overhead cost under Department of Defense prime contracts is negligible, i.e. approximately .05 percent. In all probability the increased cost to both this office and the contractor incident to administering contracts under two sets of cost principles simultaneously would be greater than the estimated increase in overhead cost in 1958. However, it should be noted that the increase is due entirely to the difference in the reimbursability of independent research and development costs under the new principles as compared to the old principles. In 1958 the contractor incurred \$291,000 of direct costs in its independent research and development program. In a supplement to reference (b) the contractor has proposed an independent research and development program of over \$7,000,000. This proposal was submitted by the contractor for the purpose of executing an advance agreement in accordance with the new ABPR cost principles, paragraph 15-205.35(h). Until it is known how much of this program will be approved or what cost sharing arrangements will be worked out, no conclusion can be reached as to probable effect of the new cost principles on Aerojet's reimbursable costs for the 1960 fiscal year.

7. The Director, Western District, Auditor General USAF, concurs.

L. A. COUTU





DEPARTMENT OF THE NAVY  
OFFICE OF THE COMPTROLLER  
WASHINGTON 25, D. C.

IN REPLY REFER TO

NOI 11

7560/Aerojet-Gen

18 FEB 1960

MEMORANDUM FOR K. K. KILGORE, Office of Assistant Secretary of Defense  
(Comptroller)

Subj: Aerojet-General Corporation - Report setting forth results of  
review of contractor's request for amendment of existing cost-  
reimbursement type contracts to incorporate new contract  
Cost Principles

Encl: (1) Two copies of NAAO, IA ltr, OCl, 7560/Aerojet-Gen'l of  
12 Feb 1960  
(2) Two copies of NAAO, Wash. ltr, SO, AG-7, Aerojet Gen. Corp., At-  
lantic Div. of 23 Jan 1960

1. The enclosures are forwarded in response to the addressee's request  
for a report on the subject contractor's proposal to amend its existing  
cost reimbursement type contracts to incorporate the new contract Cost  
Principles (ASPR, Sect. XV, Part 2, as revised by ASPR Revision No. 50).

J B KACKLEY  
Assistant Comptroller

DEPARTMENT OF THE NAVY

OFFICE OF THE CHIEF OF NAVAL AIR

WASHINGTON, D.C.

ACTD

LHO-4

Seri 07958

23 Dec 1959

~~CONFIDENTIAL (When Approved for Release)~~

From: Controller of the Navy  
To: Officer in Charge, NAAO Los Angeles

Subj: Aerojet-General Corporation - Request for Review of Contractor's Request for Amendment of Existing Cost Reimbursement Type Contracts to Incorporate New Contract Cost Principles

Encl: (1) Cy Aerojet-General Corp. Ltr to ActSecDef (CNA) of 17 Dec 1959 w/cy encls thereto

1. Enclosure (1) is forwarded with the request that a review thereof be undertaken, in conjunction with the Air Force auditors cognizant of the Sacramento plant, for the purpose of expressing an opinion concerning the contractor's representations to the effect that there would be only a negligible difference in the costs reimbursable under the new cost principles (as published in ASPR Revision No. 50) as compared with those currently incorporated in the contracts.

2. In respect to the Sacramento plant, the Auditor General, USAP, who has also received copies of enclosure (1), is requesting his Western District office to undertake a similar review. The results of that review are to be reported to the addressee in a manner similar to an assist audit for incorporation in the report to be forwarded by NAAO Los Angeles to this office. In the interest of effective coordination of the Navy and Air Force efforts, it is suggested that the addressee arrange for any conferences or other contacts deemed necessary between those responsible for the audit at Sacramento and those that will handle the assignment as it affects the Arusa operations.

3. Particular attention should be given to the contractor's "Analysis of New Contract Cost Principles" submitted as enclosure (2) of enclosure (1) hereof, from the standpoint of verifying the substantial accuracy of the contractor's observations concerning individual cost items as they apply to costs being incurred by Aerojet-General.

4. It is assumed that there would be some administrative savings to the contractor as well as to the Navy and Air Force if all Aerojet-General cost-reimbursement type contracts were based upon one set of cost principles. Comments on this point in as much detail as needed to evaluate its significance are specifically desired. In addition, if it is found practicable to furnish such a statement, an expression as to the dollar significance of any such savings would be helpful.

Ritgore Q  
Luan J2  
7/1/54

WCT11  
110-4  
Ser:

5. In the interest of simplifying consideration of the contractors request at the departmental level, the over-all report, prior to its submission to this office by the addressee, should be reviewed with the Air Force District Director and agreement reached on all points if possible. However, if any differences of opinion remain, these should be mentioned and the basis for the differing viewpoints explained.

6. By copy of this letter, together with a copy of enclosure (1), the Officer in Charge, WAO Washington, is requested to furnish a separate report relative to the cost reimbursement type contract being performed by Aerojet-General Corporation at the Frederick, Maryland, plant. In view of the relatively small size of the Frederick operations and the distances involved the report need not be coordinated with WAO Los Angeles; however, a copy of such report should be furnished to that office.

7. It is requested that reply to this request be expedited to the maximum extent practicable.

J L HACKETT  
Assistant Comptroller

Copy to:  
OIC, WAO Washington (v/enc1)  
OIC (Comptroller) Attn: Mr. Lucas  
AWAD-C  
OIC (MOJA)

CR

Dear Mr. Reichard:

I have your letter of 17 December 1959 in which you have provided us with considerable background information in connection with your request to have all of your contracts cite the new cost principles as of 1 December 1959. This information will be very helpful in our effort to resolve the basic problems which are involved in amending existing contracts.

At the present time, we are actively studying this problem. I would like to accept your offer of Aerojet-General's services as a pilot company in our consideration of this matter. Accordingly, I have requested the Navy, as the cognizant audit agency of your home office plant, to be in touch with you as soon as possible for the purpose of evaluating the impact of the new cost principles on your existing contracts. The Air Force, which has audit cognizance of your Sacramento plant, will assist the Navy in its evaluation.

As mentioned during your recent visit to the Pentagon, the problem of securing an amendment from your prime contractor, in those instances where Aerojet-General is acting as a subcontractor, may present some substantial difficulties. You can be of further assistance to us if you would contact a few of your prime contractors to ascertain their reaction to amending their subcontracts to you, even if they themselves were not at the time cut over to the new cost principles.

While we are initiating the action indicated above as soon as possible, I am sure that you appreciate that we are not yet in a position to give you positive assurance that your existing contracts will be amended as of 1 December to incorporate the new cost principles. We will, however, seek to resolve this matter at the earliest possible time. Again, may I express my appreciation for your helpful assistance in this matter.

Sincerely yours,

(Signed) Philip LeBoutillier, Jr.

PHILIP LeBOUTILLIER, JR.  
Acting Assistant Secretary of Defense

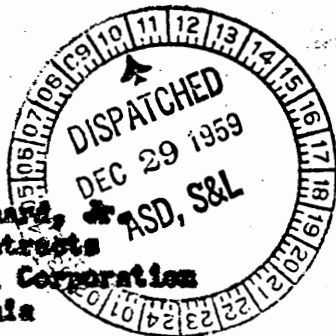
Prepared by: J. H. Hillyer/rbs/28 Dec 59

3D774 X72026

Coordinated with:

Mr. Bannerman

Mr. E. S. Reichard, Jr.  
Director of Contracts  
Aerojet-General Corporation  
Azusa, California



COVERING BRIEF

CR

TO: The Assistant Secretary of Defense (Supply and Logistics)

FROM: Director for Procurement Policy

Problem: To respond to a letter dated 17 December 1959 from the Aerojet-General Corporation which offered the services of Aerojet-General as a pilot company to work out the problems of cutting over companies across the board to the new contract cost principles.

Discussion: The Aerojet-General letter requested that all of its contracts, including those in which the company is a subcontractor to other prime contractors, be cut over to the new contract cost principles as of 1 December 1959 (the beginning of a new fiscal year). The Company offered its services as a pilot company and provided a detailed listing of contracts which total approximately 805 million dollars. The Company also furnished an analysis of the effect of the new cost principles on their existing contracts, indicating that "Based on the preceding analysis, Aerojet-General Corporation concurs in the opinion of the Department of Defense, as expressed in the questions and answers published in connection with publication of the new contract cost principles, to the effect that operating under the new set of rules is not expected to result in increased costs to the Department of Defense."

*Edw. Mallon*

We have had a group from the Military Departments studying the difficult problems involved in the amendment of existing contracts to incorporate the new cost principles. This group will meet again on 5 January. Some of our people have met informally with representatives of the General Accounting Office and further discussions are contemplated. We think that a quick look at the Aerojet-General situation will provide us with valuable information in our overall consideration of this problem. We contemplate issuing an amplifying memorandum to the Military Departments on this subject as soon as possible.

In the meantime, we have requested the audit elements of the Navy and Air Force to make an immediate appraisal of Aerojet-General's contention that the application of the new cost principles to existing contracts will have no material effect.

Recommendation: That you sign the attached letter.

Coordination: ASD Comptroller (Mr. Kilgore).





HEADQUARTERS  
AIR MATERIEL COMMAND  
UNITED STATES AIR FORCE  
WRIGHT-PATTERSON AIR FORCE BASE, OHIO

ADDRESS REPLY TO  
THE ATTENTION OF  
MEL PA/L. E. Todd

26 November 1958

SUBJECT: Industry Comments on Comprehensive Cost Principles  
dated 7 November 1958

TO: Headquarters USAF  
Office, Deputy Chief of Staff, Material  
Directorate of Procurement and Production  
Attn: APMPF-PR-2  
The Pentagon  
Washington 25, D. C.

1. The Industry comments about using comprehensive cost principles apparently assume that all Department of Defense procurements are made in the environment of effective price competition. However, the forces of the market place and competitive restraints are not present in a substantial part of DOD procurement actions. To ignore this fundamental fact is to ignore the basic cause of the most significant pricing problems.

2. Industry's comments are in five principal areas which we will discuss individually. Based on this premise following are comments regarding the five principal areas covered in the Industry letter:

A. Recognition of all normal and legitimate costs

Industry's position on this subject indicates an apparent desire for guaranteed costs and to some extent guaranteed profit. Much has been made of the inconsistencies in the regulation where certain costs are dealt with according to function and others are dealt with according to object. Advertising is an example cited by Industry as illustrating an inconsistency which they say is objectionable. There are, however, other costs related to objectives which because of public policy and as a matter of equity should not be recognized in government pricing. An example is prosecution of claims against the government, entertainment expense or contributions to organizations seeking to influence legislation. All of these costs, from Industry's standpoint, may be proper and ordinary business expenses. However, from the Government's point of view, it would not be proper to recognize these costs. The government should not be in a position of supporting payments made in prosecution of claims against itself. Industry makes a point that contractors must recover all costs incurred, somehow and somewhere.

Re: AWC, MITA ltr dtd 26 Nov 58

While Industry will attempt to recover all costs, the fact that they may not be able to do so lends incentive for management control of costs. This control would be missing completely under a procedure whose primary premise is underwriting all costs. The uncertainty of cost recovery is currently present in commercial business and is one of the normal risks which Industry should expect to assume.

Industry is probably concerned regarding the use of cost data in negotiation. The intent of the regulation is to provide guide lines for evaluation of cost bases rather than rigid rules of allowance and disallowance where estimated costs are a factor in arriving at a price objective. The negotiation procedure inherent in fixed price contracting gives the contractor the opportunity to discuss allocability and a chance to justify the level of expenditures contemplated.

#### B. Reasonableness and Allocability as Adequate Tests and Controls

The Industry position is again based on the concept that effective competitive forces are always present in DOD procurement. Since this premise is not a valid one we believe that reasonableness and allocability are tests that must be exercised on a selective basis with respect to estimated costs rather than accepting the "all cost" concept of Industry.

#### C. Applicability

Industry strongly opines that the proposed provisions will result in formula pricing. Formula pricing need not necessarily result from the use of these principles. This is especially true in areas of prospective pricing where cost estimates are not the sole determinant for pricing. In those cases where cost estimates are a factor, primary concern is with the level of estimated costs and secondary concern with the types of costs included in estimates. Analysis of prospective prices will often result in differences of opinion as to estimates. The Air Force has no fear of being wrong in this forecasting area but desires to provide the best incentive to efficiency by negotiating prices which will encourage contractors to control costs. The Air Force also believes government negotiators must have information regarding cost estimates. The Industry spokesman states, "We oppose in principle, however, any use of cost data as a formula basis for negotiating prospective firm fixed prices". We ask this - Does not the contractor use historical cost data and cost estimates for preparation of his proposal? Is the government expected to ignore this information? Are negotiations to be conducted in a vacuum?



D. Effective Date

We agree with the Industry position on this point. No further comment seems necessary since this does not appear to be a matter of principle.

E. Individual Items of Cost

We are not submitting any detailed comment regarding the individual items of cost since the AMC position has been established in previous correspondence. An exception to this is in the area of research and development costs. We recommend that the separation of basic research and applied research referenced in the cost principles be discarded. General research should be handled as an entity because the separation of basic and applied research is artificial and impractical. We also recommend that the principle of sharing general research expense with those contractors whose business is substantially all government be established. This position recognizes the mutual benefit derived by both the government and industry from general research. It also places a measure of incentive for wholly government contractors to exercise prudent control of their research programs.

This sharing arrangement is not considered necessary with contractors whose business is primarily commercial since the sharing is automatic by the normal method of allocation of general research cost to commercial and government business.

We understand that this concept has been reflected in the latest draft covering research and development dated 18 November 1958.

FOR THE COMMANDER:

PHILIP J. BLATTEN  
Colonel, USAF  
Chief, Pricing and Financial Division  
Directorate of Procurement and  
Production

*Ch. Mallory*

1tr dtd 6 Jan 59 from AFMPP-FR, Hq USAF, Washington, D.C. to  
Commander, AMC, Attn: MJP, W-P AFB, Ohio. Subject: Contract Cost  
Principles.

1st Ind.

MCPPA/Mr. L.E. Todd/ep

Hq, Air Material Command, Wright-Patterson AFB, Ohio. 16 January 1959.

TO: Director of Procurement and Production, Headquarters, USAF, Attn:  
AFMPP-FR, Washington 25, D.C.

1. This Headquarters has reviewed the proposed changes to Cost Principles as contained in basic letter dated 6 January 1959. Generally, we concur in the proposed changes and the reasons expressed for such changes. However, we would like to support the Air Force representative's non-concurrence regarding the treatment of contributions and donations. It is our view that current policy providing for non-recognition of contributions and donations for cost-type contracts should be continued. Generally in a strictly cost reimbursement situation we believe this type of expense should not be under-written by the Government. In limited situations, however, a contracting officer may consider it appropriate to recognize the cost of certain contributions. For example, where an individual contractor is the dominant employer in the community and it is reasonable to assume that many community services are largely dependent upon his financial support. In that event, we believe that sufficient latitude should be given to the contracting officer to recognize such costs by means of a specific contract clause authorizing allowance against the contract. The treatment of this category of expense in fixed price type contracts may properly be more flexible. An environment is provided for the exercise of business judgment since these principles do not contemplate that a contracting officer need reach agreement with a contractor on individual items of cost in fixed price situations.

2. The proposed Part 7 relating to applicability to fixed price type contracts is considered desirable and a marked improvement over the previous position. We believe that sufficient emphasis is contained in Part 7 relating to the evaluation of costs, where costs are a major consideration in pricing. The flexibility to be provided conforms to our present policy as expressed in ASPR Section III, Part 8. It has been our view that although cost estimates and the analysis of costs are an important part of pricing, nevertheless, the contracting officer should not be placed in a "straight jacket" regarding cost evaluation and allowance and disallowance of cost that would preclude him from otherwise negotiating a fair and reasonable price.

3. This revision appears to coincide with and complement our basic objectives which is the negotiation of a price and a contractual arrangement which will provide maximum incentive for cost control.

FOR THE COMMANDER:

2 copies w/d

*B. D. Loebbourrow*  
B. D. LOEBBOURROW  
Deputy Chief  
Pricing and Financial Division  
Directorate of Procurement and  
Production