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# Instruction

<b>TITLE</b> Contract Cost Principles and Procedures	<b>SUBJECT CLASSIFICATION</b> 305.9
	<b>TOPIC</b> General

1. **Purpose.** To prescribe principles and procedures to be followed for (a) the pricing of contracts, subcontracts, and modifications to contracts and subcontracts whenever cost analysis is performed and (b) the determination, negotiation, or allowance of costs when required by a contract clause.
2. **Cancellation.** This Instruction supersedes Procurement Directive PRA 306.2, Contract Cost Principles and Procedures, dated April 1, 1988.
3. **Inquiries.** Inquiries, changes, or requests for an individual deviation to this Instruction shall be addressed to the Director, Analysis and Review Staff.

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# CONTRACT COST PRINCIPLES AND PROCEDURES

## SECTION 1. GENERAL

### 1. Scope.

This Instruction contains cost principles and procedures for (a) the pricing of contracts, sub-contracts, and modifications to contracts and sub-contracts whenever cost analysis is performed and (b) the determination, negotiation, or allowance of costs when required by a contract clause.

### 2. Definitions.

“Accrued benefit cost method” means an actuarial cost method under which units of benefit are assigned to each cost accounting period and are valued as they accrue; i.e., based on the services performed by each employee in the period involved. The measure of normal cost under this method for each cost accounting period is the present value of the units of benefit deemed to be credited to employees for service in that period. The measure of the actuarial accrued liability at a plan’s inception date is the present value of the units of benefit credited to employees for service prior to that date. (This method is also known as the unit credit cost method without salary projection.)

“Accumulating costs” means collecting cost data in an organized manner, such as through a system of accounts.

“Actual cash value” means the cost of replacing damaged property with other property of like kind and quality in the physical condition of the property immediately before the damage.

“Actual costs” means amounts determined on the basis of costs incurred, as distinguished from forecasted costs. Actual costs include standard costs properly adjusted for applicable variances.

“Actuarial accrued liability” means pension cost attributable, under the actuarial cost method in use, to years prior to the current period considered by a particular actuarial valuation. As of such date, the actuarial accrued liability represents the excess of the present value of future benefits and administrative expenses over the present value of future normal costs for all plan participants and beneficiaries. The excess of the actuarial accrued

liability over the actuarial value of the assets of a pension plan is the unfunded actuarial liability. The excess of the actuarial value of the assets of a pension plan over the actuarial accrued liability is an actuarial surplus and is treated as a negative unfunded actuarial liability.

“Actuarial assumption” means an estimate of future conditions affecting pension costs; e.g., mortality rate, employee turnover, compensation levels, earnings on pension plan assets, and changes in values of pension plan assets.

“Actuarial cost method” means a technique that uses actuarial assumptions to measure the present value of future pension benefits and pension plan administrative expenses, and that assigns the cost of such benefits and expenses to cost accounting periods. The actuarial cost method includes the asset valuation method used to determine the actuarial value of the assets of a pension plan.

“Actuarial gain and loss” means the effect on pension cost resulting from differences between actuarial assumptions and actual experience.

“Actuarial valuation” means the determination, as of a specified date, of the normal cost, actuarial accrued liability, actuarial value of the assets of a pension plan, and other relevant values for the pension plan.

“Allocate” means to assign an item of cost, or a group of items of cost, to one or more cost objectives. This term includes both direct assignment of cost and the reassignment of a share from an indirect cost pool.

“Business unit” means any segment of an organization, or an entire business organization which is not divided into segments.

“Compensated personal absence” means any absence from work for reasons such as illness, vacation, holidays, jury duty, military training, or personal activities for which an employer pays compensation directly to an employee in accordance with a plan or custom of the employer.

“Cost input” means the cost, except general and administrative (G&A) expenses, which for contract costing purposes is allocable to the production of goods and services during a cost accounting period.

“Cost objective” means a function, organizational subdivision, contract; or other work unit for which cost data are desired and for which provision is made to accumulate and measure the cost of processes, products, jobs, capitalized projects, etc.

“Cost of capital committed to facilities” means an imputed cost determined by applying a cost of money rate to facilities capital.

“Deferred compensation” means an award made by an employer to compensate an employee in a future cost accounting period or periods for services rendered in one or more cost accounting periods before the date of the receipt of compensation by the employee. This definition shall not include the amount of year end accruals for salaries, wages, or bonuses that are to be paid within a reasonable period of time after the end of a cost accounting period.

“Defined-benefit pension plan” means a pension plan in which the benefits to be paid, or the basis for determining such benefits, are established in advance and the contributions are intended to provide the stated benefits.

“Defined-contribution pension plan” means a pension plan in which the contributions to be made are established in advance and the benefits are determined thereby.

“Directly associated cost” means any cost which is generated solely as a result of the incidence of another cost, and which would not have been incurred had the other cost not been incurred.

“Estimating costs” means the process of forecasting a future result in terms of cost, based upon information available at the time.

“Expressly unallowable cost” means a particular item or type of cost which, under the express provisions of an applicable law, regulation, or contract, is specifically named and stated to be unallowable.

“Facilities capital” means the net book value of tangible capital assets and of those intangible capital assets that are subject to amortization.

“Final cost objective” means a cost objective that has allocated to it both direct and indirect costs and, in the contractor’s accumulation system, is one of the final accumulation points.

“Fiscal year” means the accounting period for which annual financial statements are regularly prepared, generally a period of 12 months, 52 weeks, or 53 weeks.

“Funded pension costs” means the portion of pension cost for a current or prior cost accounting period that has been paid to a funding agency.

“General and administrative (G&A) expense” means any management, financial, and other expense which is incurred by or allocated to a business unit and which is for the general management and administration of the business unit as a whole. G&A expense does not include those management expenses whose beneficial or causal relationship to cost objectives can be more directly measured by a base other than a cost input base representing the total activity of a business unit during a cost accounting period.

“Home office” means an office responsible for directing or managing two or more, but not necessarily all, segments of an organization. It typically establishes policy for, and provides guidance to, the segments in their operations. It usually performs management, supervisory, or administrative functions, and may also perform service functions in support of the operations of the various segments. An organization which has intermediate levels, such as groups, may have several home offices which report to a common home office. An intermediate organization may be both a segment and a home office.

“Immediate-gain actuarial cost method” means any of the several actuarial cost methods under which actuarial gains and losses are included as part of the unfunded actuarial liability of the pension plan, rather than as part of the normal cost of the plan.

“Indirect cost pools” as used in this part means groupings of incurred costs identified with two or more cost objectives but not identified specifically with any final cost objective.

“Insurance administration expenses” means the contractor’s costs of administering an insurance program; e.g., the costs of operating an insurance or risk-management department, processing claims, actuarial fees, and service fees paid to insurance companies, trustees, or technical consultants.

“Intangible capital asset” means an asset that has no physical substance, has more than minimal value, and is expected to be held by an enterprise for continued use or possession beyond the current accounting period for the benefits it yields.

“Job” means a homogeneous cluster of work tasks, the completion of which services an enduring purpose for the organization. Taken as a

whole, the collection of tasks, duties, and responsibilities constitutes the assignment for one or more individuals whose work is of the same nature and is performed at the same skill/responsibility level—as opposed to a position, which is a collection of tasks assigned to a specific individual. Within a job, there may be pay categories which are dependent on the degree of supervision required by the employee while performing assigned tasks which are performed by all persons with the same job.

“Job class of employees” means employees performing in positions within the same job.

“Labor cost at standard” means a preestablished measure of the labor element of cost, computed by multiplying labor-rate standard by labor-time standard.

“Labor market” means a place where individuals exchange their labor for compensation. Labor markets are identified and defined by a combination of the following factors—

- (1) Geography,
- (2) Education and/or technical background required,
- (3) Experience required by the job,
- (4) Licensing or certification requirements,
- (5) Occupational membership, and
- (6) Industry.

“Labor-rate standard” means a preestablished measure, expressed in monetary terms, of the price of labor.

“Labor-time standard” means a preestablished measure, expressed in temporal terms, of the quantity of labor.

“Material cost at standard” means a preestablished measure of the material elements of cost, computed by multiplying material-price standard by material-quantity standard.

“Material-price standard” means a preestablished measure, expressed in monetary terms, of the price of material.

“Material-quantity standard” means a preestablished measure, expressed in physical terms, of the quantity of material.

“Moving average cost” means an inventory costing method under which an average unit cost is computed after each acquisition by adding the cost of the newly acquired units to the cost of the units of inventory on hand and dividing this figure by the new total number of units.

“Nonqualified pension plan” means any pension plan other than a qualified pension plan as defined in this Instruction.

“Normal cost” means the annual cost attributable, under the actuarial cost method in use, to current and future years as of a particular valuation date excluding any payment in respect of an unfunded actuarial liability.

“Original complement of low cost equipment” means a group of items acquired for the initial outfitting of a tangible capital asset or an operational unit, or a new addition to either. The items in the group individually cost less than the minimum amount established by the contractor for capitalization for the classes of assets acquired but in the aggregate they represent a material investment. The group, as a complement, is expected to be held for continued service beyond the current period. Initial outfitting of the unit is completed when the unit is ready and available for normal operations.

“Pay-as-you-go cost method” means a method of recognizing pension cost only when benefits are paid to retired employees or their beneficiaries.

“Pension plan” means a deferred compensation plan established and maintained by one or more employers to provide systematically for the payment of benefits to plan participants after their retirements; *provided*, that the benefits are paid for life or are payable for life at the option of the employees. Additional benefits such as permanent and total disability and death payments, and survivorship payments to beneficiaries of deceased employees may be an integral part of a pension plan.

“Pension plan participant” means any employee or former employee of an employer or any member or former member of an employee organization, who is or may become eligible to receive a benefit from a pension plan which covers employees of such employer or members of such organization who have satisfied the plan’s participation requirements, or whose beneficiaries are receiving or may be eligible to receive any such benefit. A participant whose employment status with the employer has not been terminated is an active participant of the employer’s pension plan.

“Pricing” means the process of establishing a reasonable amount or amounts to be paid for supplies or services.

“Profit center” as used in this part means the smallest organizationally independent segment of

a company charged by management with profit and loss responsibilities.

“Projected average loss” means the estimated long-term average loss per period for periods of comparable exposure to risk of loss.

“Projected benefit cost method” means either—

(1) Any of the several actuarial cost methods which distribute the estimated total cost of all the employees’ prospective benefits over a period of years, usually their working careers;

(2) A modification of the accrued benefit cost method that considers projected compensation levels.

“Proposal” means any offer or other submission used as a basis for pricing a contract, contract modification, or termination settlement or for securing payments thereunder.

‘Qualified pension plan’ means a pension comprising a definite written program communicated to and for the exclusive benefit of employees that meets the criteria deemed essential by the Internal Revenue Service as set forth in the Internal Revenue code for preferential tax treatment regarding contributions, investments, and distributions. Any other plan is a nonqualified pension plan.

“Residual value” means the proceeds, less removal and disposal costs, if any, realized upon disposition of a tangible capital asset. It usually is measured by the net proceeds from the sale or other disposition of the asset, or its fair value if the asset is traded in on another asset. The estimated residual value is a current forecast of the residual value.

“Segment” means one of two or more divisions, product departments, plants, or other subdivisions of an organization reporting directly to a home office, usually identified with responsibility for profit and/or producing a product or service. The term includes Government-owned contractor-operated (GOCO) facilities, and joint ventures and subsidiaries (domestic and foreign) in which the organization has a majority ownership. The term also includes those joint ventures and subsidiaries (domestic and foreign) in which the organization has less than a majority of ownership, but over which it exercises control.

“Self-insurance” means the assumption or retention of the risk of loss by the contractor, whether voluntarily or involuntarily. Self-insurance includes the deductible portion of purchased insurance.

“Self-insurance charge” means a cost which represents the projected average loss under a self-insurance plan.

“Service life” means the period of usefulness of a tangible capital asset (or group of assets) to its current owner. The period may be expressed in units of time or output. The estimated service life of a tangible capital asset (or group of assets) is a current forecast of its service life and is the period over which depreciation cost is to be assigned.

“Spread-gain actuarial cost method” means any of the several projected benefit actuarial cost methods under which actuarial gains and losses are included as part of the current and future normal costs of the pension plan.

“Standard cost” means any cost computed with the use of preestablished measures.

“Tangible capital asset” means an asset that has physical substance, more than minimal value, and is expected to be held by an enterprise for continued use or possession beyond the current accounting period for the services it yields.

“Termination of employment gain or loss” means an actuarial gain or loss resulting from the difference between the assumed and actual rates at which pension plan participants separate from employment for reasons other than retirement, disability, or death.

“Unallowable cost” means any cost which, under the provisions of any pertinent law, regulation, or contract, cannot be included in prices cost-reimbursements, or settlements under a GPO contract to which it is allocable.

“Variance” means the difference between a preestablished measure and an actual measure.

“Weighted average cost” means an inventory costing method under which an average unit cost is computed periodically by dividing the sum of the cost of beginning inventory plus the cost of acquisitions by the total number of units included in these two categories.

## SECTION 2. APPLICABILITY

### 1. Scope.

This section describes the applicability of the cost principles and procedures in succeeding subsections to various types of contracts and subcontracts. It also describes the need for advance agreements.

### 2. Objectives.

The overall objective is to provide that, to the extent practicable, all organizations of similar

types doing similar work will follow the same cost principles and procedures. To achieve this uniformity, individual deviations concerning cost principles require advance approval of the Deputy Public Printer or designee.

### 3. Fixed-price contracts.

The applicable paragraphs of this Instruction shall be used in the pricing of fixed-price contracts, subcontracts, and modifications to contracts and subcontracts whenever (a) cost analysis is performed, or (b) a fixed-price contract clause requires the determination or negotiation of costs. However, application of cost principles to fixed-price contracts and subcontracts shall not be construed as a requirement to negotiate agreements on individual elements of cost in arriving at agreement on the total price. The final price accepted by the parties reflects agreement only on the total price. Further, notwithstanding the mandatory use of cost principles, the objective will continue to be to negotiate prices that are fair and reasonable, cost and other factors considered.

### 4. Contracts with commercial and other organizations.

This category includes all contracts and contract modifications for supplies or services, negotiated with organizations other than construction and architect-engineer and nonprofit organizations on the basis of cost.

(a) The cost principles and procedures in sections 3 and 4 shall be used in pricing negotiated supply or service contracts and contract modifications with organizations cost analysis is performed.

(b) In addition, the contracting officer shall incorporate the cost principles and procedures in sections 3 and 4 by reference in contracts with commercial organizations as the basis for—

(1) Determining reimbursable costs under—

(i) cost-reimbursement contracts and cost-reimbursement subcontracts under these contracts performed by commercial organizations and;

(ii) the cost-reimbursement portion of time-and-materials contracts except when material is priced on a basis other than at cost;

(2) Negotiating indirect cost rates;

(3) Proposing, negotiating, or determining costs under terminated contracts;

(4) Price revision of fixed-price incentive contracts;

(5) Price redetermination of price redetermination contracts;

(6) Pricing changes and other contract modifications.

### 5. Construction and architect-engineer contracts.

(a) This category includes all contracts and contract modifications negotiated on the basis of cost for construction management, or construction alteration or repair of buildings, or other kinds of real property. It also includes architect-engineer contracts relating to construction contracts.

(b) Except as otherwise provided in (d) of this subsection, the cost principles and procedures in sections 3 and 4 shall be used in the pricing of contracts and contract modifications in this category if cost analysis is performed.

(c) In addition, the contracting officer shall incorporate the cost principles and procedures in sections 3 and 4 (as modified by (d) in this subsection) by reference in contracts in this category as the basis for—

(1) Determining reimbursable costs under cost-reimbursement contracts, including cost-reimbursement subcontracts thereunder;

(2) Negotiating indirect cost rates;

(3) Proposing, negotiating, or determining costs under terminated contracts;

(4) Price revision of fixed-price incentive contracts; and

(5) Pricing changes and other contract modifications.

(d) Except as otherwise provided in this paragraph (d), the allowability of costs for construction and architect-engineer contracts shall be determined in accordance with section 3.

(1) Because of widely varying factors such as the nature, size, duration, and location of the construction project, advance agreements as set forth in 2.6 for such items as home office overhead, partners' compensation, employment of consultants, and equipment usage costs, are particularly important in construction and architect-engineer contracts. When appropriate they serve to express the parties' understanding and avoid possible subsequent disputes or disallowances.

(2) "Construction equipment," as used in this subsection, means equipment in sound workable condition, either owned or controlled by the contractor or the subcontractor at any tier, or ob-

tained from a commercial rental source, and furnished for use under Government contracts.

(i) Allowable ownership and operating costs shall be determined as follows:

(A) Actual cost data shall be used when such data can be determined for both ownership and operating costs for each piece of equipment, or groups of similar serial or series equipment, from the contractor's accounting records. When such costs cannot be so determined, the contracting officer may specify the use of a schedule of predetermined rates or any part thereof to determine ownership and operating costs of construction equipment (see paragraphs (B) and (C) below). However, costs otherwise unallowable under this section shall not become allowable through the use of any schedule (see subsection 6(c) of this section). For example, schedules need to be adjusted for Government contract costing purposes if they are based on replacement cost, include unallowable interest costs, or use improper cost of money rates or computations. Contracting officers should review the computations and factors included within the specified schedule and ensure that unallowable or unacceptably computed factors are not allowed in cost submissions.

(B) Predetermined schedules of construction equipment use rates (e.g., the Construction Equipment Ownership and Operating Expense Schedule, published by the U.S. Army Corps of Engineers, industry sponsored construction equipment cost guides, or commercially published schedules of construction equipment use cost) provide average ownership and operating rates for construction equipment. The allowance for operating costs may include costs for such items as fuel, filters, oil, and grease; servicing, repairs, and maintenance; and tire wear and repair. Costs of labor, mobilization, demobilization, overhead, and profit are generally not reflected in schedules, and separate consideration may be necessary.

(C) When a schedule of predetermined use rates for construction equipment is used to determine direct costs, all costs of equipment that are included in the cost allowances provided by the schedule shall be identified and eliminated from the contrac-

tor's other direct and indirect costs charged to the contract. If the contractor's accounting system provides for site or home office overhead allocations, all costs which are included in the equipment allowances may need to be included in any cost input base before computing the contractor's overhead rate. In periods of suspension of work pursuant to a contract clause, the allowance for equipment ownership shall not exceed an amount for standby cost as determined by the schedule or contract provision.

(ii) Reasonable costs of renting construction equipment are allowable (but see paragraph (C) below).

(A) Costs, such as maintenance and minor or running repairs incident to operating such rented equipment, that are not included in the rental rate are allowable.

(B) Costs incident to major repair and overhaul of rental equipment are unallowable.

(C) The allowability of charges for construction equipment rented from any division, subsidiary, or organization under common control, will be determined in accordance with 33(b)(3) in section 4.

(3) Costs incurred at the job site incident to performing the work, such as the cost of superintendence, timekeeping and clerical work, engineering, utility costs, supplies, material handling, restoration and cleanup, etc., are allowable as direct or indirect costs, provided the accounting practice used is in accordance with the contractor's established and consistently followed cost accounting practices for all work.

(4) Rental and any other costs, less any applicable credits incurred in acquiring the temporary use of land, structures, and facilities are allowable. Costs, less any applicable credits, incurred in constructing or fabricating structures and facilities of a temporary nature are allowable.

## **6. Advance agreements.**

(a) The extent of allowability of the costs covered in this subsection applies broadly to many accounting systems in varying contract situations. Thus, the reasonableness and allocability and allowability of certain costs may be difficult to determine. To avoid possible subsequent disallowance or dispute based on unreasonableness, unallocability, or unallowability, contracting offi-



cers and contractors should seek advance agreement on the treatment of special or unusual costs. However, an advance agreement is not an absolute requirement and the absence of an advance agreement on any cost will not, in itself, affect the reasonableness, allocability, or allowability of that cost.

(b) Advance agreements may be negotiated either before or during a contract but should be negotiated before incurrence of the costs involved. The agreements must be in writing, executed by both contracting parties, and incorporated into applicable current and future contracts. An advance agreement shall contain a statement of its applicability and duration.

(c) The contracting officer is not authorized by this subsection 5 to agree to a treatment of costs inconsistent with this Instruction. For example, an advance agreement may not provide that, notwithstanding subsection 4.17, interest is allowable.

(d) Advance agreements may be negotiated with a particular contractor for a single contract, a group of contracts, or all the contracts of a contracting office.

(e) The cognizant contracting officer shall negotiate advance agreements except that an advance agreement affecting only one contract, or class of contracts from a single contracting office, shall be negotiated by a contracting officer in the contracting office, or an administrative contracting officer (ACO) when delegated by the contracting officer. When the negotiation authority is delegated, the ACO shall coordinate the proposed agreement with the contracting officer before executing the advance agreement.

(f) Before negotiating an advance agreement, the Government negotiator shall—

(1) Determine if other contracting offices have a significant unliquidated dollar balance in contracts with the same contractor;

(2) Inform any such office of the matters under consideration for negotiation; and

(3) As appropriate, invite the office and the responsible audit unit to participate in prenegotiation discussions and/or in the subsequent negotiations.

(g) Upon completion of the negotiation, the sponsor shall prepare and distribute to other interested offices, including the audit unit, copies of the executed agreement and a price negotiation memorandum, as applicable.

(h) Examples of costs for which advance agreements may be particularly important are—

(1) Compensation for personal services, including but not limited to allowances for off-site pay, incentive pay, location allowances, hardship pay, cost of living differential, and termination of defined benefit pension plans;

(2) Use charges for fully depreciated assets;

(3) Deferred maintenance costs;

(4) Precontract costs;

(5) Royalties and other costs for use of patents;

(6) Selling and distribution costs;

(7) Travel and relocation costs, as related to maximum per diem rates;

(8) Costs of idle facilities and idle capacity;

(9) Severance pay to employees on support service contracts;

(10) Plant reconversion;

(11) Professional services (e.g., legal, accounting, and engineering);

(12) General and administrative costs (e.g., corporate, division, or branch allocations) attributable to the general management, supervision, and conduct of the contractor's business as a whole. These costs are particularly significant in construction, job-site, architect-engineer, facilities, and Government-owned contractor-operated (GOCO) plant contracts (see section 3.9(f));

(13) Costs of construction plant and equipment;

(14) Costs of public relations; and

(15) Training and education costs.

### **SECTION 3. PRINCIPLES AND STANDARDS**

#### **1. General—Composition of total cost.**

(a) The total cost of a contract is the sum of the direct and indirect costs allocable to the contract, incurred or to be incurred, less any allocable credits, plus any allocable cost of money pursuant to 4.7. In ascertaining what constitutes a cost, any generally accepted method of determining or estimating costs that is equitable and is consistently applied may be used, including standard costs properly adjusted for applicable variances.

(b) While the total cost of a contract includes all costs properly allocable to the contract, the allowable costs to the Government are limited to those allocable costs which are allowable pursuant to this Instruction.

## **2. Determining allowability.**

(a) The factors to be considered in determining whether a cost is allowable include the following:

(1) Reasonableness.

(2) Allocability.

(3) Standards promulgated by the CAS Board, if applicable; otherwise, generally accepted accounting principles and practices appropriate to the particular circumstances.

(4) Terms of the contract.

(5) Any limitations set forth in this section 3.

(b) Certain cost principles in this section 3 incorporate the measurement, assignment, and allocability rules of selected CAS and limit the allowability of costs to the amounts determined using the criteria in those selected standards. Only those CAS or portions of standards specifically made applicable by the cost principles in this section are mandatory unless the contract is CAS-covered. Business units that are not otherwise subject to these standards under a CAS clause are subject to the selected standards only for the purpose of determining allowability of costs on Government contracts. Including the selected standards in the cost principles does not subject the business unit to any other CAS rules and regulations. The applicability of the CAS rules and regulations is determined by the CAS clause, if any, in the contract and the requirements of the standards themselves.

(c) When contractor accounting practices are inconsistent with this Instruction, costs resulting from such inconsistent practices shall not be allowed in excess of the amount that would have resulted from using practices consistent with this Instruction.

(d) A contractor is responsible for accounting for costs appropriately and for maintaining records, including supporting documentation, adequate to demonstrate that costs claimed have been incurred, are allocable to the contract, and comply with applicable cost principles in this Instruction. The contracting officer may disallow all or part of a claimed cost which is inadequately supported.

## **3. Determining reasonableness.**

(a) A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. Reasonableness of specific costs must be examined with particular care in connection with firms or their separate divisions that may not be subject to effective competitive restraints. No presumption of reasonableness shall

be attached to the incurrence of costs by a contractor. If an initial review of the facts results in a challenge of a specific cost by the contracting officer or the contracting officer's representative, the burden of proof shall be upon the contractor to establish that such cost is reasonable.

(b) What is reasonable depends upon a variety of considerations and circumstances including—

(1) Whether it is the type of cost generally recognized as ordinary and necessary for the conduct of the contractor's business or the contract performance;

(2) Generally accepted sound business practices, arm's-length bargaining, Federal and State laws and regulations and Contract Terms and specifications;

(3) The contractor's responsibilities to the Government, the owners of the business, employees, other customers, and the public at large; and

(4) Any significant deviations from the contractor's established practices.

## **4. Determining allocability.**

A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship. Subject to the foregoing, a cost is allocable to a Government contract if it—

(a) Is incurred specifically for the contract;

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

(c) Is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown.

## **5. Credits.**

The applicable portion of any income, rebate, allowance, or other credit relating to any allowable cost and received by or accruing to the contractor shall be credited to the Government either as a cost reduction or by cash refund. See subsection 5(j)(4) for rules governing refund or credit to the Government associated with pension adjustments and asset reversions.

## **6. Accounting for unallowable costs.**

(a) Costs that are expressly unallowable or mutually agreed to be unallowable, including mutually agreed to be unallowable directly associated costs, shall be identified and excluded from any billing, claim, or proposal applicable to a Government contract. A directly associated cost is any cost which is generated solely as a result of incur-

ring another cost, and which would not have been incurred had the other cost not been incurred. When an unallowable cost is incurred, its directly associated costs are also unallowable.

(b) Costs which specifically become designated as unallowable or as unallowable directly associated costs of unallowable costs as a result of a written decision furnished by a contracting officer shall be identified if included in or used in computing any billing, claim, or proposal applicable to a Government contract. This identification requirement applies also to any costs incurred for the same purpose under like circumstances as the costs specifically identified as unallowable under either this paragraph or paragraph (a) above.

(c) The practices for accounting for, and presentation of, unallowable costs will be those as described in 48 CFR 9904.405, Accounting for Unallowable Costs.

(d) If a directly associated cost is included in a cost pool which is allocated over a base that includes the unallowable cost with which it is associated, the directly associated cost shall remain in the cost pool. Since the unallowable costs will attract their allocable share of costs from the cost pool, no further action is required to assure disallowance of the directly associated costs. In all other cases, the directly associated costs, if material in amount, must be purged from the cost pool as unallowable costs.

(e)(1) In determining the materiality of a directly associated cost, consideration should be given to the significance of—

- (i) the actual dollar amount,
- (ii) the cumulative effect of all directly associated costs in a cost pool, or
- (iii) the ultimate effect on the cost of Government contracts.

(2) Salary expenses of employees who participate in activities that generate unallowable costs shall be treated as directly associated costs to the extent of the time spent on the proscribed activity, provided the costs are material in accordance with paragraph (e)(1) above (except when such salary expenses are, themselves, unallowable). The time spent in proscribed activities should be compared to total time spent on company activities to determine if the costs are material. Time spent by employees outside the normal working hours should not be considered except when it is evident that an employee engages so frequently in company activities during periods outside normal working hours

as to indicate that such activities are a part of the employee's regular duties.

(3) When a selected item of cost under subsections 4.1 through 4.45 provides that directly associated costs be unallowable, it is intended that such directly associated costs be unallowable only if determined to be material in amount in accordance with the criteria provided in paragraphs (e)(1) and (e)(2) above, except in those situations where allowance of any of the directly associated costs involved would be considered to be contrary to public policy.

#### **7. Construction and architect-engineer contracts.**

Specific principles and procedures for evaluating and determining costs in connection with contracts and subcontracts for construction, and architect-engineer contracts related to construction projects are in 2.5. The applicability of these principles and procedures is set forth in 1.1 and 2.1.

#### **8. Direct costs.**

(a) A direct cost is any cost that can be identified specifically with a particular final cost objective. No final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose in like circumstances have been included in any indirect cost pool to be allocated to that or any other final cost objective. Costs identified specifically with the contract are direct costs of the contract and are to be charged directly to the contract. All costs specifically identified with other final cost objectives of the contractor are direct costs of those cost objectives and are not to be charged to the contract directly or indirectly.

(b) For reasons of practicality, any direct cost of minor dollar amount may be treated as an indirect cost if the accounting treatment—

- (1) Is consistently applied to all final cost objectives; and
- (2) Produces substantially the same results as treating the cost as a direct cost.

#### **9. Indirect costs.**

(a) An indirect cost is any cost not directly identified with a single, final cost objective, but identified with two or more final cost objectives or an intermediate cost objective. It is not subject to treatment as a direct cost. After direct costs have been determined and charged directly to the contract or other work, indirect costs are those remaining to be allocated to the several cost objectives. An indi-

rect cost shall not be allocated to a final cost objective if other costs incurred for the same purpose in like circumstances have been included as a direct cost of that or any other final cost objective.

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

(c) Once an appropriate base for distributing indirect costs has been accepted, it shall not be fragmented by removing individual elements. All items properly includable in an indirect cost base should bear a pro rata share of indirect costs irrespective of their acceptance as Government contract costs. For example, when a cost input base is used for the distribution of G&A costs, all items that would properly be part of the cost input base, whether allowable or unallowable, shall be included in the base and bear their pro rata share of G&A costs.

(d) The contractor's method of allocating indirect costs shall be in accordance with standards promulgated by the CAS Board, if applicable to the contract; otherwise, the method shall be in accordance with generally accepted accounting principles which are consistently applied. The method may require examination when:

(1) Substantial differences occur between the cost patterns of work under the contract and the contractor's other work;

(2) Significant changes occur in the nature of the business, the extent of subcontracting, fixed-asset improvement programs, inventories, the volume of sales and production, manufacturing

processes, the contractor's products, or other relevant circumstances; or

(3) Indirect cost groupings developed for a contractor's primary location are applied to offsite locations. Separate cost groupings for costs allocable to offsite locations may be necessary to permit equitable distribution of costs on the basis of the benefits accruing to the several cost objectives.

(e) A base period for allocating indirect costs is the cost accounting period during which such costs are incurred and accumulated for distribution to work performed in that period. The criteria and guidance in CAS 406 for selecting the cost accounting periods to be used in allocating indirect costs are incorporated herein for application to contracts subject to full CAS coverage. For contracts subject to modified CAS coverage and for non-CAS-covered contracts, the base period for allocating indirect costs will normally be the contractor's fiscal year. But a shorter period may be appropriate—

(1) For contracts in which performance involves only a minor portion of the fiscal year; or

(2) When it is general practice in the industry to use a shorter period.

When a contract is performed over an extended period, as many base periods shall be used as are required to represent the period of contract performance.

(f) Special care should be exercised in applying the principles of paragraphs (b), (c), and (d) above when Government-owned contractor-operated (GOCO) plants are involved. The distribution of corporate, division, or branch office G&A expenses to such plants operating with little or no dependence on corporate administrative activities may require more precise cost groupings, detailed accounts screening, and carefully developed distribution bases.

## **10. Application of principles and procedures.**

(a) Costs shall be allowed to the extent they are reasonable, allocable, and determined to be allowable under this section. These criteria apply to all of the selected items that follow, even if particular guidance is provided for certain items for emphasis or clarity.

(b) Costs incurred as reimbursements or payments to a subcontractor under a cost-reimbursement, fixed-price incentive, or price redeterminable type subcontract of any tier above the first firm-fixed-price subcontract or fixed-price subcontract

with economic price adjustment provisions are allowable to the extent that allowance is consistent with the appropriate subsection of this Instruction applicable to the subcontract involved. Costs incurred as payments under firm-fixed-price subcontracts or fixed-price subcontracts with economic price adjustment provisions or modifications thereto, when cost analysis was performed, shall be allowable only to the extent that the price was negotiated in accordance with 2.3.

(c) Section 4 does not cover every element of cost. Failure to include any item of cost does not imply that it is either allowable or unallowable. The determination of allowability shall be based on the principles and standards in this section and the treatment of similar or related selected items. When more than one subsection in this section is relevant to a contractor cost, the cost shall be apportioned among the applicable subsections, and the determination of allowability of each portion shall be based on the guidance contained in the applicable subsection. When a cost, to which more than one subsection in this section is relevant, cannot be apportioned, the determination of allowability shall be based on the guidance contained in the subsection that most specifically deals with, or best captures the essential nature of, the cost at issue.

#### SECTION 4.—SELECTED COSTS

##### 1. Public relations and advertising costs.

(a) "Public relations" means all functions and activities dedicated to:

(1) Maintaining, protecting, and enhancing the image of a concern or its products; or

(2) Maintaining or promoting reciprocal understanding and favorable relations with the public at large, or any segment of the public. The term public relations includes activities associated with areas such as advertising, customer relations, etc.

(b) "Advertising" means the use of media to promote the sale of products or services and to accomplish the activities referred to in paragraph (d) of this subsection, regardless of the medium employed, when the advertiser has control over the form and content of what will appear, the media in which it will appear, and when it will appear. Advertising media include but are not limited to conventions, exhibits, free goods, samples, magazines, newspapers, trade papers, direct mail, deal-

er cards, window displays, outdoor advertising, radio, and television.

(c) Public relations and advertising costs include the costs of media time and space, purchased services performed by outside organizations, as well as the applicable portion of salaries, travel, and fringe benefits of employees engaged in the functions and activities identified in paragraphs (a) and (b) of this subsection.

(d) The only allowable advertising costs are those that are—

(1) Specifically required by contract, or that arise from requirements of Government contracts and that are exclusively for—

(i) Recruiting personnel required for performing contractual obligations, when considered in conjunction with all other recruitment costs (but see 4.31);

(ii) Acquiring scarce items for contract performance; or

(iii) Disposing of scrap or surplus materials acquired for contract performance.

(2) Cost of activities to promote sales of products normally sold to the U.S. Government, including trade shows, which contain a significant effort to promote exports from the United States. Such costs are allowable, notwithstanding subparagraphs (f)(1), (f)(3), (f)(4)(ii), and (f)(5) of this subsection. However, such costs do not include the costs of memorabilia (e.g., models, gifts, and souvenirs), alcoholic beverages, entertainment, and physical facilities which are primarily used for entertainment rather than product promotion.

(e) Allowable public relations costs include the following:

(1) Costs specifically required by contract.

(2) Costs of—

(i) Responding to inquiries on company policies and activities;

(ii) Communicating with the public, press, stockholders, creditors, and customers; and

(iii) Conducting general liaison with news media and Government public relations officers, to the extent that such activities are limited to communication and liaison necessary to keep the public informed on matters of public concern such as notice of contract awards, plant closings or openings, employee layoffs or rehires, financial information, etc.

(3) Costs of participation in community service activities (e.g., blood bank drives, charity drives, savings bond drives, disaster assistance, etc.).

(4) Costs of plant tours and open houses (but see paragraph (f)(5)).

(f) Unallowable public relations and advertising costs include the following:

(1) All public relations and advertising costs, other than those specified in paragraphs (d) and (e) of this subsection, whose primary purpose is to promote the sale of products or services by stimulating interest in a product or product line (except for those costs made allowable under 4.35(c)), or by disseminating messages calling favorable attention to the contractor for purposes of enhancing the company image to sell the company's products or services.

(2) All costs of trade shows and other special events which do not contain a significant effort to promote the export sales of products normally sold to the U.S. Government.

(3) Costs of sponsoring meetings, conventions, symposia, seminars, and other special events when the principal purpose of the event is other than dissemination of technical information or stimulation of production.

(4) Costs of ceremonies such as—

- (i) Corporate celebrations and
- (ii) New product announcements.

(5) Costs of promotional material, motion pictures, videotapes, brochures, handouts, magazines, and other media that are designed to call favorable attention to the contractor and its activities.

(6) Costs of souvenirs, models, imprinted clothing, buttons, and other mementos provided to customers or the public.

(7) Costs of memberships in civic and community organizations.

## 2. Bad debts.

Bad debts, including actual or estimated losses arising from uncollectible accounts receivable due from customers and other claims, and any directly associated costs such as collection costs, and legal costs are unallowable.

## 3. Bonding costs.

(a) Bonding costs arise when the Government requires assurance against financial loss to itself or others by reason of the act or default of the contractor. They arise also in instances where the contractor requires similar assurance. Included are

such bonds as bid, performance, payment, advance payment, infringement, and fidelity bonds.

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

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

## 4. Compensation for personal services.

(a) *General.* 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 (except as otherwise provided for in other paragraphs of this subsection. It includes, but is not limited to, salaries; wages; directors' and executive committee members' fees; bonuses (including stock bonuses); incentive awards; employee stock options and stock appreciation rights; employee stock ownership plans; employee insurance; fringe benefits; contributions to pension, other post-retirement benefits, annuity, and employee incentive compensation plans; and allowances for off-site pay, incentive pay, location allowances, hardship pay, severance pay, and cost of living differential. Compensation for personal services is allowable subject to the following general criteria and additional requirements contained in other parts of this cost principle:

(1) Compensation for personal services must be for work performed by the employee in the current year and must not represent a retroactive adjustment of prior years' salaries or wages (but see paragraphs (g), (h), (j), (k), and (l) below).

(2) The compensation in total must be reasonable for the work performed; however, specific restrictions on individual compensation elements must be observed where they are prescribed.

(3) The compensation must be based upon and conform to the terms and conditions of the contractor's established compensation plan or practice followed so consistently as to imply, in effect, an agreement to make the payment.

(4) No presumption of allowability will exist where the contractor introduces major revisions of existing compensation plans or new plans and the contractor—

(i) Has not notified the cognizant ACO of the changes either before their implementa-

tion or within a reasonable period after their implementation, and

(ii) Has not provided the Government, either before implementation or within a reasonable period after it, an opportunity to review the allowability of the changes.

(5) Costs that are unallowable under other paragraphs of this Instruction shall not be allowable under this subsection 4.4 solely on the basis that they constitute compensation for personal services.

(b) *Reasonableness.* The compensation for personal services paid or accrued to each employee must be reasonable for the work performed. Compensation will be considered reasonable if each of the allowable elements making up the employee's compensation package is reasonable. This paragraph addresses the reasonableness of compensation, except when the compensation is set by provisions of a labor-management agreement under terms of the Federal Labor Relations Act or similar state statutes. The tests for reasonableness of labor-management agreements are set forth in paragraph (c) of this subsection. In addition to the provisions of 3.3., in testing the reasonableness of individual elements for particular employees or job classes of employees, consideration should be given to factors determined to be relevant by the contracting officer.

(1) Among other factors which may be relevant include general conformity with the compensation practices of other firms of the same size, the compensation practices of other firms in the same industry, the compensation practices of firms in the same geographic area, the compensation practices of firms engaged in predominantly non-Government work, and the cost of comparable services obtainable from outside sources. The appropriate factors for evaluating the reasonableness of compensation depend on the degree to which those factors are representative of the labor market for the job being evaluated. The relative significance of factors will vary according to circumstances. In administering this principle, it is recognized that not every compensation case need be subjected in detail to the tests described in this cost principle. The tests need be applied only when a general review reveals amounts or types of compensation that appear unreasonable or unjustified. Based on an initial review of the facts, contracting officers or their representatives may challenge the

reasonableness of any individual element or the sum of the individual elements of compensation paid or accrued to particular employees or job classes of employees. In such cases, there is no presumption of reasonableness and, upon challenge, the contractor must demonstrate the reasonableness of the compensation item in question. In doing so, the contractor may introduce, and the contracting officer will consider, not only any circumstances surrounding the compensation item challenged, but also the magnitude of other compensation elements which may be lower than would be considered reasonable in themselves. However, the contractor's right to introduce offsetting compensation elements into consideration is subject to the following limitations:

(i) Offsets will be considered only between the allowable elements of an employee's (or a job class of employees') compensation package or between the compensation packages of employees in jobs within the same job grade or level.

(ii) Offsets will be considered only between the allowable portion of the following compensation elements of employees or job classes of employees:

- (A) Wages and salaries.
- (B) Incentive bonuses.
- (C) Deferred compensation.
- (D) Pension and savings plan benefits.
- (E) Health insurance benefits.
- (F) Life insurance benefits.
- (G) Compensated personal absence benefits.

However, any of the above elements or portions thereof, whose amount is not measurable, shall not be introduced or considered as an offset item.

(iii) In considering offsets, the magnitude of the compensation elements in question must be taken into account. In determining the magnitude of compensation elements, the timing of receipt by the employee must be considered.

(2) Compensation costs under certain conditions give rise to the need for special consideration. Among such conditions are the following:

(i) Compensation to—

(A) owners of closely held corporations, partners, sole proprietors, or members of their immediate families, or



(B) persons who are contractually committed to acquire a substantial financial interest in the contractor's enterprise.

Determination should be made that salaries are reasonable for the personal services rendered rather than being a distribution of profits. Compensation in lieu of salary for services rendered by partners and sole proprietors will be allowed to the extent that it is reasonable and does not constitute a distribution of profits. For closely held corporations, compensation costs covered by this subsection shall not be recognized in amounts exceeding those costs that are deductible as compensation under the Internal Revenue Code and regulations under it.

(ii) Any change in a contractor's compensation policy that results 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. Contracting officers or their representatives should normally challenge increased costs where major revisions of existing compensation plans or new plans are introduced by the contractor, and the contractor—

(A) Has not notified the cognizant contracting officer of the changes either before their implementation or within a reasonable period after their implementation; and

(B) Has not provided the Government, either before implementation or within a reasonable period after it, an opportunity to review the reasonableness of the changes.

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

(iv) The contractor incurs costs for compensation in excess of the amounts which are deductible under the Internal Revenue Code and regulations issued under it.

(c) *Labor-management agreements.* If costs of compensation established under "arms's length" negotiated labor-management agreements are otherwise allowable, the costs are reasonable if they are not unwarranted by the character and circumstances of the work or discriminatory against the Government. The application of the provisions of a labor-management agreement designed to

apply to a given set of circumstances and conditions of employment (e.g., work involving extremely hazardous activities or work not requiring recurrent use of overtime) is unwarranted when applied to a Government contract involving significantly different circumstances and conditions of employment (e.g., work involving less hazardous activities or work continually requiring use of overtime). It is discriminatory against the Government if it results in employee compensation (in whatever form or name) in excess of that being paid for similar non-Government work under comparable circumstances. Disallowance of costs will not be made under this paragraph (c) unless—

(1) The contractor has been permitted an opportunity to justify the costs; and

(2) Due consideration has been given to whether unusual conditions pertain to Government contract work, imposing burdens, hardships, or hazards on the contractor's employees, for which compensation that might otherwise appear unreasonable is required to attract and hold necessary personnel.

(d) *Forms of payment.* (1) Compensation for personal services includes compensation paid or to be paid in the future to employees in the form of cash, corporate securities, such as stocks, bonds, and other financial instruments (see paragraph (d)(2) of this subsection regarding valuation), or other assets, products, or services.

(2) When compensation is paid with securities of the contractor or of an affiliate, the following additional restrictions apply:

(i) Valuation placed on the securities shall be the fair market value on the measurement date (i.e., the first date the number of shares awarded is known) determined upon the most objective basis available.

(ii) Accruals for the cost of securities before issuing the securities to the employees shall be subject to adjustment according to the possibilities that the employees will not receive the securities and that their interest in the accruals will be forfeited.

(e) *Domestic and foreign differential pay.* (1) When personal services are performed in a foreign country, compensation may also include a differential that may properly consider all expenses associated with foreign employment such as housing, cost of living adjustments, transportation, bonuses, additional Federal, State, local or foreign income



taxes resulting from foreign assignment, and other related expenses.

(2) Differential allowances for additional Federal, State, or local income taxes resulting from domestic assignments are unallowable.

(f) *Bonuses and incentive compensation.* (1) Incentive compensation for management employees, cash bonuses, suggestion awards, safety awards, and incentive compensation based on production, cost reduction, or efficient performance are allowable provided the awards are paid or accrued under an agreement entered into in good faith between the contractor and the employees before the services are rendered or pursuant to an established plan or policy followed by the contractor so consistently as to imply, in effect, an agreement to make such payment and the basis for the award is supported.

(2) When the bonus and incentive compensation payments are deferred, the costs are subject to the requirements of paragraphs (f)(1) and (k) of this subsection.

(g) *Severance pay.* (1) Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages by contractors to workers whose employment is being involuntarily terminated. Payments for early retirement incentive plans are covered in paragraph (j)(6).

(2) Severance pay to be allowable must meet the general allowability criteria in paragraph (g)(2)(i) of this subsection, and, depending upon whether the severance is normal or abnormal, criteria in paragraph (g)(2)(ii) for normal severance pay or paragraph (g)(2)(iii) for abnormal severance pay also apply.

(i) Severance pay is allowable only to the extent that, in each case, it is required by—

- (A) law,
- (B) employer-employee agreement,
- (C) established policy that constitutes, in effect, an implied agreement on the contractor's part, or
- (D) circumstances of the particular employment.

Payments made in the event of employment with a replacement contractor where continuity of employment with credit for prior length of service is preserved under substantially equal conditions of employment, or continued employment by the contractor at another facility, subsidiary, affiliate, or

parent company of the contractor are not severance pay and are unallowable.

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

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

(h) *Backpay.* (1) *Backpay resulting from violations of Federal labor laws or the Civil Rights Act of 1964.* Backpay may result from a negotiated settlement, order, or court decree that resolves a violation of Federal labor laws or the Civil Rights Act of 1964. Such backpay falls into two categories: One requiring the contractor to pay employees additional compensation for work performed for which they were underpaid, and the other resulting from other violations, such as when the employee was improperly discharged, discriminated against, or other circumstances for which the backpay was not additional compensation for work performed. Backpay resulting from underpaid work is compensation for the work performed and is allowable. All other backpay resulting from violation of Federal labor laws or the Civil Rights Act of 1964 is unallowable.

(2) *Other backpay.* Backpay may also result from payments to employees (union and non-union) for the difference in their past and current wage rates for working without a contract or labor agreement during labor management negotiations. Such backpay is allowable. Backpay to nonunion employees based upon results of union agreement negotiations is allowable only if—

(i) A formal agreement or understanding exists between management and the employees concerning these payments, or

(ii) An established policy or practice exists and is followed by the contractor so consistently as to

imply, in effect, an agreement to make such payment.

(i) Compensation based on changes in the prices of corporate securities or corporate security ownership, such as stock options, stock appreciation rights, phantom stock plans, and junior stock conversions.

(1) Any compensation which is calculated, or valued, based on changes in the price of corporate securities is unallowable.

(2) Any compensation represented by dividend payments or which is calculated based on dividend payments is unallowable.

(3) If a contractor pays an employee in lieu of the employee receiving or exercising a right, option, or benefit which would have been unallowable under this paragraph (i), such payments are also unallowable.

(j) *Pension costs.* (1) A pension plan as defined in 1.2, is a deferred-compensation plan. Additional benefits such as permanent and total disability and death payments and survivorship payments to beneficiaries of deceased employees may be treated as pension costs, provided the benefits are an integral part of the pension plan and meet all the criteria pertaining to pension costs.

(2) Pension plans are normally segregated into two types of plans: defined-benefit or defined-contribution pension plans. The cost of all defined-benefit pension plans shall be measured, allocated, and accounted for in compliance with the provisions of 48 CFR 9904.412, Cost Accounting Standard for Composition and Measurements of Pension Costs, and 48 CFR 9904.413 Adjustment and Allocation of Pension Cost. The costs of all defined-contribution pension plans shall be measured, allocated, and accounted for in accordance with the provisions of 48 CFR 9904.412 and 48 CFR 9904.413. Pension costs are allowable subject to the referenced standards and the cost limitations and exclusions set forth in this paragraph and in paragraphs (j)(2)(i) and (j)(3) through (8) of this subsection.

(i) Except for nonqualified pension plans using the pay-as-you-go cost method, to be allowable in the current year, pension costs must be funded by the time set for filing the Federal income tax return or any extension thereof. Pension costs assigned to the current year, but not funded by the tax return time, shall not be allowable in any subsequent year. For nonqualified pension plans using the pay-as-you-go cost method, to be

allowable in the current year, pension costs must be allocable in accordance with 48 CFR 9904.412-50(d)(3).

(ii) Pension payments must be reasonable in amount and must be paid pursuant to an agreement entered into in good faith between the contractor and employees before the work or services are performed; and the terms and conditions of the established plan. The cost of changes in pension plans that are discriminatory to the Government or are not intended to be applied consistently for all employees under similar circumstances in the future are not allowable.

(iii) Except as provided for early retirement benefits in paragraph (j)(7) of this subsection, one-time-only pension supplements not available to all participants of the basic plan are not allowable as pension costs unless the supplemental benefits represent a separate pension plan and the benefits are payable for life at the option of the employee.

(iv) Increases in payments to previously retired plan participants covering cost-of-living adjustments are allowable if paid in accordance with a policy or practice consistently followed.

(3) *Defined-benefit pension plans.* This paragraph covers pension plans in which the benefits to be paid or the basis for determining such benefits are established in advance and the contributions are intended to provide the stated benefits. The cost limitations and exclusions pertaining to defined-benefit plans are as follows:

(i) Except for nonqualified pension plans, pension costs (see 48 CFR 9904.412-40(a)(1)) assigned to the current accounting period, but not funded during it, shall not be allowable in subsequent years (except that a payment made to a fund by the time set for filing the Federal income tax return or any extension thereof is considered to have been made during such taxable year). However, any portion of a pension cost computed for a cost accounting period, that exceed the amount required to be funded pursuant to a waiver granted under the provisions of the Employee's Retirement Income Security Act of 1974 (ERISA) will be allowable in those future accounting periods in which the funding occurs of such excess amounts (see 48 CFR 9904.412-50)(d)(3)).

(ii) Any amount funded in excess of the pension cost assigned to a cost accounting period is not allowable and shall be accounted for as set

forth at 48 CFR 9904.412–50(a)(4), and shall be allowable in the future period to which it is assigned, to the extent it is allocable, reasonable, and not otherwise unallowable.

(iii) Increased pension costs caused by delay in funding beyond 30 days after each quarter of the year to which they are assignable are unallowable. If a composite rate is used for allocating pension costs between the segments of a company and if, because of differences in the timing of the funding by the segments, an inequity exists, allowable pension costs for each segment will be limited to that particular segment's calculation of pension costs as provided for in 48 CFR 9904.413–50(c). Determinations of unallowable costs shall be made in accordance with the actuarial method cost used in calculating pension costs.

(iv) Allowability of the cost of indemnifying the Pension Benefit Guaranty Corporation (PBGC) under ERISA Section 4062 or 4064 arising from terminating an employee deferred-compensation plan will be considered on a case-by-case basis; provided, that if insurance was required by the PBGC under ERISA Section 4023, it was so obtained and the indemnification payment is not recoverable under the insurance. Consideration under the foregoing circumstances will be primarily for the purpose of appraising the extent to which the indemnification payment is allocable to Government work. If a beneficial or other equitable relationship exists, the Government will participate, despite the requirements of 4.16 (a)(3) and (b), in the indemnification payment to the extent of its fair share.

(v) Increased pension costs resulting from the withdrawal of assets from a pension fund and transfer to another employee benefit plan fund, or transfer of assets to another account within the same fund, are unallowable except to the extent unauthorized by an advance agreement. If the withdrawal of assets from a pension fund is a plan termination under ERISA, the provisions of paragraph (j)(4) of this subsection apply. The advance agreement shall—

(A) State the amount of the Government's equitable share in the gross amount withdrawn or transferred; and

(B) Provide that the Government receive a credit equal to the amount of the Government's equitable share of the gross withdrawal or transfer.

(4) *Pension adjustments and asset reversion.* (i) For segment closings, pension plan terminations, or curtailment of benefits, the adjustment amount shall be the amount measured, assigned, and allocated in accordance with 48 CFR 9904.413–50(c)(12) for contracts and subcontracts that are subject to Cost Accounting Standards (CAS) Board rules and regulations (48 CFR Chapter 99). For contracts and subcontracts that are not subject to CAS, the adjustment amount shall be the amount measured, assigned, and allocated in accordance with 48 CFR 9904.413–50(c)(12), except the numerator of the fraction at 48 CFR 9904.413–50(c)(12)(vi) shall be the sum of the pension plan costs allocated to all non-CAS-covered contracts and subcontracts that are subject to section 3 or for which cost or pricing data were submitted.

(ii) For all other situations where assets revert to the contractor, or such assets are constructively received by it for any reason, the contractor, shall at the Government's option, make a refund or give a credit to the Government for its equitable share of the gross amount withdrawn. The Government's equitable share shall reflect the Government's participation in pension costs through those contracts for which cost or pricing data were submitted or that are subject to section 3. Excise taxes on pension plan asset revisions or withdrawals under this subparagraph (j)(4)(ii) are unallowable in accordance with subsection 4.36(b)(6).

(5) *Defined-contribution pension plans.* This paragraph covers those pension plans in which the contributions are established in advance and the level of benefits is determined by the contributions made. It also covers profit sharing, savings plans, and other such plans, provided the plans fall within the definition of a pension plan in paragraph (j)(1) of this subsection.

(i) Allowable pension cost limited to the net contribution required to be made for a post accounting period after taking into account dividends and other credits, where applicable. However, any portion of pension cost computed for a cost accounting period that exceeds the amount required to be funded pursuant to a waiver granted under the provisions of ERISA will be allowable in those future accounting periods in which the funding of such excess amounts occurs (see 48 CFR 9904.412–50(c)(3)).

(ii) The provisions of paragraph (j)(3)(ii) and (iv) of this subsection apply to defined-contribution plans.

(6) *Pension plans using pay-as-you-go cost method.* The cost of pension plans using the pay-as-you-go cost method shall be measured, allocated, and accounted for in accordance with 48 CFR 9904.412 and 48 CFR 9904.413. Pension costs for a pension plan using the pay-as-you-go cost method shall be allowable to the extent they are allocable, reasonable, and not otherwise unallowable.

(7) *Early retirement incentive plans.* An early retirement incentive plan is a plan under which employees receive a bonus or incentive, over and above the requirement of the basic pension plan, to retire early. These plans normally are not applicable to all participants of the basic plan and do not represent life income settlements, and as such would not qualify as pension costs. However, for contract costing purposes, early retirement incentive payments are allowable subject to the pension cost criteria contained in subdivisions (j)(3)(i) through (iv) provided—

(i) The costs are accounted for and allocated in accordance with the contractor's system of accounting for pension costs;

(ii) The payments are made in accordance with the terms and conditions of the contractor's plan;

(iii) The plan is applied only to active employees. The cost of extending the plan to employees who retired or were terminated before the adoption of the plan is unallowable; and

(iv) The total of the incentive payments to any employee may not exceed the amount of the employee's annual salary for the previous fiscal year before the employee's retirement.

(8) *Employee stock ownership plans (ESOP).* (i) An ESOP is an individual stock bonus plan designed specifically to invest in the stock of the employer corporation. The contractor's contributions to an Employee Stock Ownership Trust (ESOT) may be in the form of cash, stock, or property. Costs of ESOP's are allowable subject to the following conditions:

(A) Contributions by the contractor in any one year may not exceed 15 percent (25 percent when a money purchase plan is included) of salaries and wages of employees participating in the plan in any particular year.

(B) The contribution rate (ratio of contribution to salaries and wages of participating employees) may not exceed the last approved contribution rate except when approved by the contracting officer based upon justification provided by

the contractor. When no contribution was made in the previous year for an existing ESOP, or when a new ESOP is first established, and the contractor proposes to make a contribution in the current year, the contribution rate shall be subject to the contracting officer's approval.

(C) When a plan or agreement exists wherein the liability for the contribution can be compelled for a specific year, the expense associated with that liability is assignable only to that period. Any portion of the contribution not funded by the time set for filing of the Federal income tax return for that year or any extension thereof shall not be allowable in subsequent years.

(D) When a plan or agreement exists wherein the liability for the contribution cannot be compelled, the amount contributed for any year is assignable to that year provided the amount is funded by the time set for filing of the Federal income tax return for that year.

(E) When the contribution is in the form of stock, the value of the stock contribution shall be limited to the fair market value of the stock on the date that title is effectively transferred to the trust. Cash contributions shall be allowable only when the contractor furnishes evidence satisfactory to the contracting officer demonstrating that stock purchases by the ESOT are or will be at a fair market price; e.g., makes arrangements with the trust permitting the contracting officer to examine purchases of stock by the trust to determine that prices paid are at fair market value. When excessive prices are paid, the amount of the excess will be credited to the same indirect cost pools that were charged for the ESOP contributions in the year in which the stock purchase occurs. However, when the trust purchases the stock with borrowed funds which will be repaid over a period of years by cash contributions from the contractor to the trust, the excess price over fair market value shall be credited to the indirect cost pools pro rata over the period of years during which the contractor contributes the cash used by the trust to repay the loan. When the fair market value of unissued stock or stock of a closely held corporation is not readily determinable, the valuation will be made on a case-by-case basis taking into consideration the guidelines for valuation used by the IRS.

(ii) Amounts contributed to an ESOP arising from either—

(A) an additional investment tax credit (see 1975 Tax Reduction Act—TRASOP's); or

(B) a payroll-based tax credit (see Economic Recovery Tax Act of 1981) are unallowable.

(iii) The requirements of paragraph (j)(3)(ii) of this subsection are applicable to Employee Stock Ownership Plans.

(k) *Deferred compensation of other than pensions.* (1) Deferred compensation is an award given by an employer to compensate an employee in a future cost accounting period or periods for services rendered in one or more cost accounting periods before the date of receipt of compensation by the employee. Deferred compensation does not include the amount of year-end accruals for salaries, wages, or bonuses that are paid within a reasonable period of time after the end of a cost accounting period. Subject to 4.4(a), deferred awards are allowable when they are based on current or future services. Awards made in periods subsequent to the period when the work being remunerated was performed are not allowable.

(2) The costs of deferred awards shall be measured, allocated, and accounted for in compliance with the provisions of 48 CFR 9904.415, Accounting for the Cost of Deferred Compensation.

(3) Deferred compensation payments to employees under awards made before the effective date of 48 CFR 9904.415 are allowable to the extent they would have been allowable under prior acquisition regulations.

(l) *Compensation incidental to business acquisitions.* The following costs are unallowable:

(1) Payments to employees under agreements in which they receive special compensation, in excess of the contractor's normal severance pay practice, if their employment terminates following a change in the management control over, or ownership of, the contractor or a substantial portion of its assets.

(2) Payment to employees under plans introduced in connection with a change (whether actual or prospective) in the management control over, or ownership of, the contractor or a substantial portion of its assets in which those employees receive special compensation, which is contingent upon the employee remaining with the contractor for a specified period of time.

(m) *Fringe benefits.* (1) Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Fringe benefits include,

but are not limited to, the cost of vacations, sick leave, holidays, military leave, employee insurance, and supplemental unemployment benefit plans. Except as provided otherwise in section 3, the costs of fringe benefits are allowable to the extent that they are reasonable and are required by law, employer-employee agreement, or an established policy of the contractor.

(2) That portion of the cost of company-furnished automobiles that relates to personal use by employees (including transportation to and from work) is unallowable regardless of whether the cost is reported as taxable income to the employees (see 4.41(f)).

(n) *Employee rebate and purchase discount plans.* Rebates and purchase discounts, in whatever form, granted to employees on products or services produced by the contractor or affiliates are unallowable.

(o) *Postretirement benefits other than pensions (PRB).* (1) PRB covers all benefits, other than cash benefits and life insurance benefits paid by pension plans, provided to employees, their beneficiaries, and covered dependents during the period following the employees' retirement. Benefits encompassed include, but are not limited to, post-retirement health care; life insurance provided outside a pension plan; and other welfare benefits such as tuition assistance, day care, legal services, and housing subsidies provided after retirement.

(2) To be allowable, PRB costs must be reasonable and incurred pursuant to law, employer-employee agreement, or an established policy of the contractor. In addition, to be allowable, PRB costs must also be calculated in accordance with paragraphs (o)(2)(i), (ii), or (iii) of this subsection.

(i) *Cash basis.* Cost recognized, as benefits when they are actually provided, must be paid to an insurer, provider, or other recipient for current year benefits or premiums.

(ii) *Terminal funding.* If a contractor elects a terminal-funded plan, it does not accrue PRB costs during the working lives of employees. Instead, it accrues and pays the entire PRB liability to an insurer or trustee in lump sum upon the termination of employees (or upon conversion to such a terminal-funded plan) to establish and maintain a fund or reserve for the sole purpose of providing PRB to retirees. The lump sum is allowable if amortized over a period of 15 years.

(iii) *Accrual basis.* Accrual costing other than terminal funding must be measured and assigned according to generally accepted accounting principles and be paid to an insurer or trustee to establish and maintain a fund or reserve for the sole purpose of providing PRB to retirees. The accrual must also be calculated in accordance with generally accepted actuarial principles and practices as promulgated by the Actuarial Standards Board.

(3) To be allowable, costs must be funded by the time set for filing the Federal income tax return or any extension thereof. PRB costs assigned to the current year, but not funded or otherwise liquidated by the tax return time, shall not be allowable in any other subsequent year.

(4) Increased PRB costs caused by delay in funding beyond 30 days after each quarter of the year to which they are assignable are unallowable.

(5) Cost of postretirement benefits in paragraph (o)(2)(iii) of this subsection attributable to past service ("transition obligation") as defined in Financial Accounting Standards Board Statement 106, paragraph 110, are allowable subject to the following limitations: The allowable amount of such costs assignable to a contractor fiscal year cannot exceed the amount of such costs which would be assigned to that contractor fiscal year under the delayed recognition methodology described in paragraphs 112 and 113 of Statement 106.

(6) The Government shall receive an equitable share of any amount of previously funded PRB costs which revert or inure to the contractor. Such equitable share shall reflect the Government's previous participation in PRB costs through those contracts for which certified cost or pricing data were required or which were subject to section 3.

(p) *Limitation on allowability of compensation for certain contractor personnel.* (1) Costs incurred after January 1998, for compensation of a senior executive in excess of the benchmark compensation amount determined applicable for the contractor fiscal year by the Administrator, Office of Federal Procurement Policy (OFPP), under Section 39 of the OFPP Act (41 U.S.C. 435) are unallowable. This limitation is the sole limitation on allowable senior executive compensation costs incurred after January 1, 1998, under new or previously existing contracts. This limitation applies whether or not the affected contracts were previously subject to a statutory limitation on such costs.

(2) As used in this paragraph:

(i) "Compensation" means the total amount of wages, salary, bonuses, deferred compensation (see paragraph (k) of this subsection), and employer contributions to defined contribution pension plans (see paragraphs (j)(5) and (j)(8) of this subsection), for the fiscal year, whether paid, earned, or otherwise accruing, as recorded in the contractor's cost accounting records for the fiscal year.

(ii) "Senior executive" means—

(A) The Chief Executive Officer (CEO) or any individual acting in a similar capacity at the contractor's headquarters;

(B) The four most highly compensated employees in management positions at the contractor's headquarters, other than the CEO; and

(C) If the contractor has intermediate home offices or segments that report directly to the contractor's headquarters, the five most highly compensated employees in management positions at each such intermediate home office or segment.

(iii) "Fiscal year" means the fiscal year established by the contractor for accounting purposes.

(iv) "Contractor's headquarters" means the highest organizational level from which executive compensation costs are allocated to Government contracts.

## 5. Contingencies.

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

(b) Costs for contingencies are generally unallowable for historical costing purposes because such costing deals with costs incurred and recorded on the contractor's books. However, in some cases, as for example, terminations, a contingency factor may be recognized when it is applicable to a past period to give recognition to minor unsettled factors in the interest of expediting settlement.

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

(1) Those that may arise from presently known and existing conditions, the effects of which are foreseeable within reasonable limits of accuracy; e.g., anticipated costs of rejects and defective work. Contingencies of this category are to be included in the estimates of future costs so

as to provide the best estimate of performance cost.

(2) Those that may arise from presently known or unknown conditions, the effect of which cannot be measured so precisely as to provide equitable results to the contractor and to the Government; e.g., results of pending litigation. Contingencies of this category are to be excluded from cost estimates under the several items of cost, but should be disclosed separately (including the basis upon which the contingency is computed) to facilitate the negotiation of appropriate contractual coverage. (See, for example, 4.4(g), 4.16, and 4.21.)

## 6. Contributions or donations.

Contributions or donations, including cash, property and services, regardless of recipient, are unallowable, except as provided in 4.1(e)(3).

## 7. Cost of money.

(a) *Facilities capital cost of money.*—(1) *General.*

(i) Facilities capital cost of money (cost of capital committed to facilities) is an imputed cost determined by applying a cost-of-money rate to facilities capital employed in contract performance. A cost-of-money rate is uniformly imputed to all contractors (see subparagraph (ii) below). Capital employed is determined without regard to whether its source is equity or borrowed capital. The resulting cost of money is not a form of interest on borrowings (see 4.17).

(ii) 48 CFR 9904.414, Cost of Money as an Element of the Cost of Facilities Capital, establishes criteria for measuring and allocating, as an element of contract cost, the cost of capital committed to facilities. Cost-of-money factors are developed on Form CAS8-CFM, broken down by overhead pool at the business unit, using—

(A) business-unit facilities capital data,

(B) overhead allocation base data, and

(C) the cost-of-money rate, which is based on interest rates specified by the Secretary of the Treasury under P.L. 92-41.

(2) *Allowability.* Whether or not the contract is otherwise subject to CAS, facilities capital cost of money is allowable if—

(i) The contractor's capital investment is measured, allocated to contracts, and costed in accordance with 48 CFR 9904.414;

(ii) The contractor maintains adequate records to demonstrate compliance with this standard;

(iii) The estimated facilities capital cost of money is specifically identified or proposed in cost proposals relating to the contract under which this cost is to be claimed, and

(iv) The requirements of 4.45, which limit the allowability of facilities capital cost of money, are observed.

(3) *Accounting.* The facilities capital cost of money need not be entered on the contractor's books of account. However, the contractor shall—

(i) make a memorandum entry of the cost, and

(ii) maintain, in a manner that permits audit and verification, all relevant schedules, cost data, and other data necessary to support the entry fully.

(4) *Payment.* Facilities capital cost of money that is—

(i) allowable under paragraph (2) of this subsection, and

(ii) calculated, allocated, and documented in accordance with this cost principle shall be an "incurred cost" for progress payment purposes under fixed-price contracts.

(5) The requirements of 4.45 shall be observed in determining the allowable cost of money attributable to including asset valuations resulting from business combinations in the facilities capital employed base.

(b) *Cost of money as an element of the cost of capital assets under construction.*—(1) *General.* (i) Cost of money as an element of the cost of capital assets under construction is an imputed cost determined by applying a cost-of-money rate to the investment in tangible and intangible capital assets while they are being constructed, fabricated, or developed for a contractor's own use. Capital employed is determined without regard to whether its source is equity or borrowed capital. The resulting cost of money is not a form of interest on borrowing (see 4.17).

(ii) 48 CFR 9904.417, Cost of Money as an Element of the Cost of Capital Assets Under Construction, establishes criteria for measuring and allocating, as an element of contract cost, the cost of capital committed to capital assets under construction, fabrication, or development.

(2) *Allowability.* (i) Whether or not the contract is otherwise subject to CAS, and except as specified in paragraph (b)(2)(ii) of this subsection, the cost of money for capital assets under construction, fabrication, or development is allowable if—

(A) The cost of money is calculated, allocated to contracts, and costed in accordance with 48 CFR 9904.417;

(B) The contractor maintains adequate records to demonstrate compliance with this standard;

(C) The cost of money for tangible capital assets is included in the capitalized cost that provides the basis for allowable depreciation costs, or, in the case of intangible capital assets, the cost of money is included in the cost of those assets for which amortization costs are allowable; and

(D) The requirements of 4.45, which limit the allowability of cost of money for capital assets under construction, fabrication, or development, are observed.

(ii) Actual interest cost in lieu of the calculated imputed cost of money for capital assets under construction, fabrication, or development is unallowable.

(3) *Accounting.* The cost of money for capital assets under construction need not be entered on the contractor's books of account. However, the contractor shall—

(i) make a memorandum entry of the cost, and

(ii) maintain, in a manner that permits audit and verification, all relevant schedules, cost data, and other data necessary to support the entry fully.

(4) *Payment.* The cost of money for capital assets under construction that is allowable under paragraph (2) above of this cost principle shall be an "incurred cost" for progress payment purposes under fixed-price contracts.

## 8. Depreciation.

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

(b) Contractors having contracts subject to 48 CFR 9904.409, Depreciation of Tangible Capital Assets, must adhere to the requirement of that standard for all fully CAS-covered contracts and may elect to adopt the standard for all other contracts. All requirements of 48 CFR 9904.409 are

applicable if the election is made, and its requirements supersede any conflicting requirements of this cost principle. Once electing to adopt 48 CFR 9904.409 for all contracts, contractors must continue to follow it until notification of final acceptance of all deliverable items on all open negotiated Government contracts. Paragraphs (c) through (e) below apply to contracts to which 48 CFR 9904.409 is not applied.

(c) Normal depreciation on a contractor's plant, equipment, and other capital facilities is an allowable contract cost, if the contractor is able to demonstrate that it is reasonable and allocable (but see paragraph (i) of this subsection).

(d) Depreciation shall be considered reasonable if the contractor follows policies and procedures that are—

(1) Consistent with those followed in the same cost center for business other than Government;

(2) Reflected in the contractor's books of accounts and financial statements; and

(3) Both used and acceptable for Federal income tax purposes.

(e) When the depreciation reflected on a contractor's books of accounts and financial statements differs from that used and acceptable for Federal income tax purposes, reimbursement shall be based on the asset cost amortized over the estimated useful life of the property using depreciation methods (straight line, sum of the years' digits, etc.) acceptable for income tax purposes. Allowable depreciation shall not exceed the amounts used for book and statement purposes and shall be determined in a manner consistent with the depreciation policies and procedures followed in the same cost center on non-Government business.

(f) Depreciation for reimbursement purposes in the case of tax-exempt organizations shall be determined on the basis described in paragraph (e) of this subsection.

(g) Special considerations are required for assets acquired before the effective date of this cost principle if, on that date, the undepreciated balance of these assets resulting from depreciation policies and procedures used previously for Government contracts and subcontracts is different from the undepreciated balance on the books and financial statements. The undepreciated balance for contract cost purposes shall be depreciated over the remaining life using the methods and lives followed for book purposes. The aggregate depreciation of any asset allowable after the effective date



of this subsection shall not exceed the cost basis of the asset less any depreciation allowed or allowable under prior acquisition regulations.

(h) Depreciation should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives in paragraph (a) of this subsection, vary with volume of production or use of multishift operations.

(i) In the case of emergency facilities covered by certificates of necessity, a contractor may elect to use normal depreciation without requesting a determination of "true depreciation," or may elect to use either normal or "true depreciation" after a determination of "true depreciation" has been made by an Emergency Facilities Depreciation Board (EFDB). The method elected must be followed consistently throughout the life of the emergency facility. When an election is made to use normal depreciation, the criteria in paragraphs (c), (d), (e), and (f) of this subsection shall apply for both the emergency period and the post-emergency period. When an election is made to use "true depreciation", the amount allowable as depreciation—

(1) With respect to the emergency period (five years), shall be computed in accordance with the determination of the EFDB 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 covered by the Board's determination; and

(2) After the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life provided the remaining undepreciated portion of such cost shall not include any amount of unrecovered "true depreciation."

(j) No depreciation, rental, or use charge shall be allowed on property acquired at no cost from the Government by the contractor or by any division, subsidiary, or affiliate of the contractor under common control.

(k) The depreciation on any item which meets the criteria for allowance at a "price" under 4.23(e) may be based on that price, provided the same policies and procedures are used for costing all business of the using division, subsidiary, or organization under common control.

(l) No depreciation or rental shall be allowed on property fully depreciated by the contractor or by any division, subsidiary, or affiliate of the contractor under common control. However, a reasonable charge for using fully depreciated property may be agreed upon and allowed (but see 2.6(h)(2)). in determining the charge, consideration shall be given to cost, total estimated useful life at the time of negotiations, effect of any increased maintenance charges or decreased efficiency due to age, and the amount of depreciation previously charged to Government contracts or subcontracts.

(m) 48 CFR 9904.404, Capitalization of Tangible Assets, applies to assets acquired by a "capital lease" as defined in Statement of Financial Accounting Standard No. 13 (FAS-13), Accounting for Leases, issued by the Financial Accounting Standards board (FASB). Compliance with 48 CFR 9904.404 and FAS-13 requires that such leased assets (capital leases) be treated as purchased assets; i.e., be capitalized and the capitalized value of such assets be distributed over their useful lives as depreciation charges, or over the leased life as amortization charges as appropriate. Assets whose leases are classified as capital leases under FAS-13 are subject to the requirements of this subsection while assets acquired under leases classified as operating leases are subject to the requirements on rental costs in 4.33. The standards of financial accounting and reporting prescribed by FAS-13 are incorporated into this principle and shall govern its application, except as provided in subparagraphs (m)(1) and (2) of this subsection.

(1) Rental costs under a sale and leaseback arrangement shall be allowable up to the amount that would have been allowed had the contractor retained title to the property.

(2) Capital leases, as defined in FAS-13, for all real and personal property, between any related parties are subject to the requirements of this paragraph 4.8(m). If it is determined that the terms of the lease have been significantly affected by the fact that the lessee and lessor are related, depreciation charges shall not be allowed in excess of those which would have occurred if the lease contained terms consistent with those found in a lease between unrelated parties.

(n) Whether or not the contract is otherwise subject to CAS, the requirements of 4.45, which limit the allowability of depreciation, shall be observed.

(o) In the event of a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances, allowable depreciation of the impaired assets shall be limited to the amounts that would have been allowed had the assets not been written down (see 4.13(g)). However, this does not preclude a change in depreciation resulting from other causes such as permissible changes in estimates of service life, consumption of services, or residual value.

#### **9. Economic planning costs.**

(a) This category includes costs of generalized long-range management planning that is concerned with the future overall development of the contractor's business and that may take into account the eventual possibility of economic dislocations or fundamental alterations in those markets in which the contractor currently does business. Economic planning costs do not include organization or reorganization costs covered by 4.24.

(b) Economic planning costs are allowable as indirect costs to be properly allocated.

#### **10. Employee morale, health, welfare, food service, and dormitory costs and credits.**

(a) Aggregate costs incurred on activities designed to improve working conditions, employer-employee relations, employee morale, and employee performance (less income generated by these activities) are allowable, except as limited by paragraph (b), (c) and (d) of this subsection. Some examples of allowable activities are house publications, health clinics, wellness/fitness centers, employee counseling services, and food and dormitory services, which include operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, living accommodations, or similar types of services for the contractor's employees at or near the contractor's facilities.

(b) *Cost of gifts are unallowable.* (Gifts do not include awards for performance made pursuant to 4.4(f) or awards made in recognition of employee achievements pursuant to an established contractor plan or policy).

(c) Costs of recreation are unallowable, except for the costs of employees' participation in company sponsored sports teams or employee organizations designed to improve company loyalty, team work, or physical fitness.

(d) Losses from operating food and dormitory services may be included as costs only if the con-

tractor's objective is to operate such services on a break-even basis. Losses sustained because food services or lodging accommodations are furnished without charge or at prices or rates which obviously would not be conducive to the accomplishment of the above objective are not allowable. A loss may be allowed, however, to the extent that the contractor can demonstrate that unusual circumstances exist (e.g., where the contractor must provide food or dormitory services at remote locations where adequate commercial facilities are not reasonably available, or where charged but unproductive labor costs would be excessive but for the services provided or where cessation or reduction of food or dormitory operations will not otherwise yield net cost savings) such that even with efficient management, operating the services on a break-even basis would require charging inordinately high prices, or prices or rates higher than those charged by commercial establishments offering the same services in the same geographical areas. Costs of food and dormitory services shall include an allocable share of indirect expenses pertaining to these activities.

(e) When the contractor has an arrangement authorizing an employee association to provide or operate a service, such as vending machines in the contractor's plant, and retain the profits, such profits shall be treated in the same manner as if the contractor were providing the service (but see paragraph (f) of this subsection).

(f) Contributions by the contractor to an employee organization, including funds from vending machine receipts or similar sources, may be included as costs incurred under paragraph (a) of this subsection only to the extent that the contractor demonstrates that an equivalent amount of the costs incurred by the employee organization would be allowable if directly incurred by the contractor.

#### **11. Entertainment costs.**

Costs of amusement, diversion, social activities, and any directly associated costs such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities are unallowable. Costs made specifically unallowable under this cost principle are not allowable under any other cost principle. Costs of membership in social, dining, or country clubs or other organizations having the same purposes are also unallowable, regardless of whether the cost is reported as taxable income to the employees.

## **12. Fines and penalties.**

(a) Costs of fines and penalties resulting from violations of, or failure of the contractor to comply with, Federal, State, local, or foreign laws and regulations, are unallowable except when incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer.

(b) Costs incurred in connection with, or related to, the mischarging of costs on Government contracts are unallowable when the costs are caused by, or result from, alteration or destruction of records, or other false or improper charging or recording of costs. Such costs include those incurred to measure or otherwise determine the magnitude of the improper charging, and costs incurred to remedy or correct the mischarging, such as the costs to rescreen and reconstruct records.

## **13. Gains and losses on disposition or impairment of depreciable property or other capital assets.**

(a) Gains and losses from the sale, retirement, or other disposition (but see 4.16) of depreciable property shall be included in the year in which they occur as credits or charges to the cost grouping(s) in which the depreciation or amortization applicable to those assets was included (but see paragraph (d) of this subsection). However, no gain or loss shall be recognized as a result of the transfer of assets in a business combination (see 4.45).

(b) Gains and losses on disposition of tangible capital assets, including those acquired under capital leases (see 4.8(m)), shall be considered as adjustments of depreciation costs previously recognized. The gain or loss for each asset disposed of is the difference between the net amount realized, including insurance proceeds from involuntary conversions, and its undepreciated balance. The gain recognized for contract costing purposes shall be limited to the difference between the acquisition cost (or for assets acquired under a capital lease, the value at which the leased asset is capitalized) of the asset and its undepreciated balance (except see paragraphs (c)(2)(i) or (ii) of this subsection).

(c) Special considerations apply to an involuntary conversion which occurs when a contractor's property is destroyed by events over which the owner has no control, such as fire, windstorm, flood, accident, theft, etc., and an insurance award is recovered. The following govern involuntary conversions:

(1) When there is a cash award and the converted asset is not replaced, gain or loss shall be recognized in the period of disposition. The gain recognized for contract costing purposes shall be limited to the difference between the acquisition cost of the asset and its undepreciated balance.

(2) When the converted asset is replaced, the contractor shall either—

(i) Adjust the depreciable basis of the new asset by the amount of the total realized gain or loss; or

(ii) Recognize the gain or loss in the period of disposition, in which case the Government shall participate to the same extent as outlined in subparagraph (c)(1) of this subsection.

(d) Gains and losses on the disposition of depreciable property shall not be recognized as a separate charge or credit when—

(1) Gains and losses are processed through the depreciation reserve account and reflected in the depreciation allowable under 4.8; or

(2) The property is exchanged as part of the purchase price of a similar item, and the gain or loss is taken into consideration in the depreciation cost basis of the new item.

(e) Gains and losses arising from mass or extraordinary sales, retirements, or other disposition other than through business combinations shall be considered on a case-by-case basis.

(f) Gains and losses of any nature arising from the sale or exchange of capital assets other than depreciable property shall be excluded in computing contract costs.

(g) With respect to long-lived tangible and identifiable intangible assets held for use, no loss shall be allowed for a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances (e.g., environmental damage, idle facilities arising from a declining business base, etc.). If depreciable property or other capital assets have been written down from carrying value to fair value due to impairments, gains or losses upon disposition shall be the amounts that would have been allowed had the assets not been written down.

## **14. Idle facilities and idle capacity costs.**

(a) "Costs of idle facilities or idle capacity," means costs such as maintenance, repair, housing, rent, and other related costs; e.g., property taxes, insurance, and depreciation.

"Facilities" means plant or any portion thereof (including land integral to the operation), equip-

ment, individually or collectively, or any other tangible capital asset, wherever located, and whether owned or leased by the contractor.

“Idle capacity” means the unused capacity of partially used facilities. It is the difference between that which a facility could achieve under 100 percent operating time on a one-shift basis, less operating interruptions resulting from time lost for repairs, setups, unsatisfactory materials, and other normal delays, and the extent to which the facility was actually used to meet demands during the accounting period. A multiple-shift basis may be used in the calculation instead of a one-shift basis if it can be shown that this amount of usage could normally be expected for the type of facility involved.

“Idle facilities” means completely unused facilities that are excess to the contractor’s current needs.

(b) The costs of idle facilities are unallowable unless the facilities—

(1) Are necessary to meet fluctuations in workload; or

(2) Were necessary when acquired and are now idle because of changes in requirements, production economies, reorganization, termination, or other causes which could not have been reasonably foreseen. (Costs of idle facilities are allowable for a reasonable period, ordinarily not to exceed 1 year, depending upon the initiative taken to use, lease, or dispose of the idle facilities (but see 4.38)).

(c) Costs of idle capacity are costs of doing business and are a factor in the normal fluctuations of usage or overhead rates from period to period. Such costs are allowable provided the capacity is necessary or was originally reasonable and is not subject to reduction or elimination by subletting, renting, or sale, in accordance with sound business, economic, or security practices. Widespread idle capacity throughout an entire plant or among a group of assets having substantially the same function may be idle facilities.

(d) Any costs to be paid directly by the Government for idle facilities or idle capacity reserved for defense mobilization production shall be the subject of a separate agreement.

## 15. Bid and proposal costs.

### (a) Definitions.

“Bid and proposal (B&P) costs” means the costs incurred in preparing, submitting, and supporting bids and proposals (whether or not solicited) on po-

tential Government or non-Government contracts. The term does not include the costs of effort sponsored by a grant or cooperative agreement or required in contract performance.

“Company” means all divisions, subsidiaries, and affiliates of the contractor under common control.

“Development” means the systematic use, under whatever name, of scientific and technical knowledge in the design, development, test, or evaluation of a potential new product or service (or of an improvement in an existing product or service) for the purpose of meeting specific performance requirements or objectives. Development includes the functions of design engineering, prototyping, and engineering testing. Development excludes:

(1) Subcontracted technical effort which is for the sole purpose of developing an additional source for an existing product, or

(2) Development effort for manufacturing or production materials, systems, processes, methods, equipment, tools, and techniques not intended for sale.

(b) *Composition and allocation of costs.* The requirements of 48 CFR 9904.420, Accounting for Bid and Proposal Costs, are incorporated in their entirety and shall apply as follows—

(1) *Fully-CAS-covered contracts.* Contracts that are fully-CAS-covered shall be subject to all requirements of 48 CFR 9904.420.

(2) *Modified-CAS-covered and non-CAS-covered contracts.* Contracts that are not CAS-covered or that contain terms or conditions requiring modified CAS coverage shall be subject to all requirements of 48 CFR 9904.420 except 48 CFR 9904.420–50(e)(2) and 48 CFR 9904.420–50(f)(2), which are not then applicable. However, non-CAS-covered or modified CAS-covered contracts awarded at a time the contractor has CAS-covered contracts requiring compliance with 48 CFR 9904.420, shall be subject to all the requirements of 48 CFR 9904.420. When the requirements of 48 CFR 9904.420–50(e)(2) and 48 CFR 420–50(f)(2) are not applicable, the following apply:

(i) B&P costs shall be allocated to final cost objectives on the same basis of allocation used for the G&A expense grouping of the profit center (see 1.2) in which the costs are incurred. However, when B&P costs clearly benefit other profit centers or benefit the entire company, those costs shall be allocated

through the G&A of the other profit centers or through the corporate G&A, as appropriate.

(ii) If allocations of B&P through the G&A base do not provide equitable cost allocation, the contracting officer may approve use of a different base.

(c) *Allowability.* Costs for B&P are allowable as indirect expenses on contracts to the extent that the costs are allowable and reasonable.

#### **16. Insurance and indemnification.**

(a) Insurance by purchase or by self-insuring includes coverage the contractor is required to carry, or to have approved, under the terms of the contract and any other coverage the contractor maintains in connection with the general conduct of its business. Any contractor desiring to establish a program of self-insurance applicable to contracts that are not subject to 48 CFR 9904.416, Accounting for Insurance Costs, shall comply with the self-insurance requirements of that standard. The amount of insurance costs which may be allowed is subject to the cost limitations and exclusions in the following subparagraphs.

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

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

(i) Types and extent of coverage shall follow sound business practice, and the rates and premiums must be reasonable.

(ii) Costs allowed for business interruption or other similar insurance must be limited to exclude coverage of profit.

(iii) The cost of property insurance premiums for insurance coverage in excess of the acquisition cost of the insured assets is allowable only when the contractor has a formal written policy assuring that in the event the insured property is involuntarily converted, the new asset shall be valued at the book value of the replaced asset plus or minus adjustments for differences between insurance proceeds and actual replacement cost. If the contractor does not have such a formal written policy, the cost of premiums for insurance coverage in excess of the acquisition cost of the insured asset is unallowable.

(iv) Costs of insurance for the risk of loss of or damage to Government property are allow-

able only to the extent that the contractor is liable for such loss or damage and such insurance does not cover loss or damage that results from willful misconduct or lack of good faith on the part of any of the contractor's directors or officers or other equivalent representatives.

(v) Contractors operating under a program of self-insurance must obtain approval of the program when required.

(vi) Costs of insurance on the lives of officers, partners, or proprietors are allowable only to the extent that the insurance represents additional compensation (see 4.4).

(3) Actual losses are unallowable unless expressly provided for in the contract, except—

(i) Losses incurred under the nominal deductible provisions of purchased insurance, in keeping with sound business practice, are allowable for contracts not subject to 48 CFR 9904.416 and when the contractor did not establish a self-insurance program. Such contracts are not subject to the self-insurance requirements of 48 CFR 9904.416. For contracts subject to 48 CFR 9904.416, and for those made subject to the self-insurance requirements of that standard as a result of the contractor's having established a self-insurance program (see paragraph (a) of this subsection), actual losses may be used as a basis for charges under a self-insurance program when the actual amount of losses will not differ significantly from the projected average losses for the accounting period (see 48 CFR 9904.416-50(a)(2)(ii)). In those instances where an actual loss has occurred and the present value of the liability is determined under the provisions of 48 CFR 9904.416-50(a)(2)(ii), the allowable cost shall be limited to an amount computed using as a discount rate the interest rate determined by the Secretary of the Treasury pursuant to 50 U.S.C. App. 1215(b)(2) in effect at the time the loss is recognized. However, the full amount of a lump-sum settlement to be paid within a year of the date of settlement is allowable.

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

(4) The cost of insurance to protect the contractor against the costs of correcting its own defects in materials or workmanship is unallowable. However, insurance costs to cover fortuitous or casualty losses resulting from defects in materials or workmanship are allowable as a normal business expense.

(5) Premiums for retroactive or backdated insurance written to cover occurred and known losses are unallowable.

(b) If purchased insurance is available, the charge for any self-insurance coverage plus insurance administration expenses shall not exceed the cost of comparable purchased insurance plus associated insurance administration expenses.

(c) Insurance provided by captive insurers (insurers owned by or under the control of the contractor) is considered self-insurance, and charges for it must comply with the self-insurance provisions of 48 CFR 9904.416. However, if the captive insurer also sells insurance to the general public in substantial quantities and it can be demonstrated that the charge to the contractor is based on competitive market forces, the insurance will be considered purchased insurance.

(d) The allowability of premiums for insurance purchased from fronting insurance companies (insurance companies not related to the contractor but who reinsure with a captive insurer of the contractor) shall not exceed the amount (plus reasonable fronting company charges for services rendered) which the contractor would have been allowed had it insured directly with the captive insurer.

(e) Self-insurance charges for risks of catastrophic losses are not allowable.

(f) The Government is obligated to indemnify the contractor only to the extent authorized by law, as expressly provided for in the contract, except as provided in paragraph (a)(3) of this subsection.

(g) Late premium payment charges related to employee deferred compensation plan insurance incurred pursuant to Section 4007 (29 U.S.C. 1307) or Section 4023 (29 U.S.C. 1323) of the Employee Retirement Income Security Act of 1974 are unallowable.

#### **17. Interest and other financial costs.**

Interest on borrowings (however represented), bond discounts, costs of financing and refinancing capital (net worth plus long-term liabilities), legal and professional fees paid in connection with preparing prospectuses, costs of preparing and issuing

stock rights, and directly associated costs are unallowable except for interest assessed by State or local taxing authorities under the conditions specified in 4.36 (but see 4.25).

#### **18. Labor relations costs.**

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

#### **19. Lobbying and political activity costs.**

(a) Costs associated with the following activities are unallowable:

(1) Attempts to influence the outcomes of any Federal, State, or local election, referendum, initiative, or similar procedure, through in kind or cash contributions, endorsements, publicity, or similar activities;

(2) Establishing, administering, contributing to, or paying the expenses of a political party, campaign, political action committee, or other organization established for the purpose of influencing the outcomes of elections;

(3) Any attempt to influence—

(i) the introduction of Federal, State, or local legislation, or

(ii) the enactment or modification of any pending Federal, State, or local legislation through communication with any member or employee of the Congress or State legislature (including efforts to influence State or local officials to engage in similar lobbying activity), or with any government official or employee in connection with a decision to sign or veto enrolled legislation;

(4) Any attempt to influence—

(i) the introduction of Federal, State, or local legislation, or

(ii) the enactment or modification of any pending Federal, State, or local legislation by preparing, distributing or using publicity or propaganda, or by urging members of the general public or any segment thereof to contribute to or participate in any mass demonstration, march, rally, fund raising drive, lobbying campaign or letter writing or telephone campaign.

(5) Legislative liaison activities, including attendance at legislative sessions or committee hearings, gathering information regarding legislation, and analyzing the effect of legislation,

when such activities are carried on in support of or in knowing preparation for an effort to engage in unallowable activities; or

(6) Cost incurred in attempting to improperly influence, either directly or indirectly, an employee or officer of the executive or legislative branches of the Federal Government to give consideration to or act regarding a regulatory or contract matter.

(b) The following activities are excepted from the coverage of (a) of this subsection:

(1) Providing a technical and factual presentation of information on a topic directly related to the performance of a contract through hearing testimony, statements or letters to the Congress or a State legislature, or subdivision, member, or cognizant staff member thereof, in response to a documented request (including a Congressional Record notice requesting testimony or statements for the record at a regularly scheduled hearing) made by the recipient member, legislative body or subdivision, or a cognizant staff member thereof; provided such information is readily obtainable and can be readily put in deliverable form; and further provided that costs under this section for transportation, lodging or meals are unallowable unless incurred for the purpose of offering testimony at a regularly scheduled congressional hearing pursuant to a written request for such presentation made by the chairman or ranking minority member of the committee or subcommittee conducting such hearing.

(2) Any lobbying made unallowable by (a)(3) of this subsection to influence State or local legislation in order to directly reduce contract cost, or to avoid material impairment of the contractor's authority to perform the contract.

(3) Any activity specifically authorized by statute to be undertaken with funds from the contract.

(c) When a contractor seeks reimbursement for indirect costs, total lobbying costs shall be separately identified in the indirect cost rate proposal, and thereafter treated as other unallowable activity costs.

(d) Contractors shall maintain adequate records to demonstrate that the certification of costs as being allowable or unallowable pursuant to this subsection complies with the requirements of this subsection.

(e) Existing procedures should be utilized to resolve in advance any significant questions or disagreements concerning the interpretation or application of this subsection.

## **20. Losses on other contracts.**

An excess of costs over income under any other contract (including the contractor's contributed portion under cost-sharing contracts) is unallowable.

## **21. Maintenance and repair costs.**

(a) Costs necessary for the upkeep of property (including Government property, unless otherwise provided for) that neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are to be treated as follows (but see 4.8):

(1) Normal maintenance and repair costs are allowable.

(2) Extraordinary maintenance and repair costs are allowable, provided those costs are allocated to the applicable periods for purposes of determining contract costs (but see 2.6).

(b) Expenditures for plant and equipment, including rehabilitation which should be capitalized and subject to depreciation, according to generally accepted accounting principles as applied under the contractor's established policy or, when applicable, according to 48 CFR 9904.404, Capitalization of Tangible Assets, are allowable only on a depreciation basis.

## **22. Manufacturing and production engineering costs.**

(a) The costs of manufacturing and production engineering effort as described in (1) through (4) of this subsection:

(1) Developing and deploying new or improved materials, systems, processes, methods, equipment, tools and techniques that are or are expected to be used in producing products or services;

(2) Developing and deploying pilot production lines;

(3) Improving current production functions, such as plant layout, production scheduling and control, methods and job analysis, equipment capabilities and capacities, inspection techniques, and tooling analysis (including tooling design and application improvements); and

(4) Material and manufacturing producibility analysis for production suitability and to opti-

mize manufacturing processes, methods, and techniques.

(b) Where manufacturing or production development costs are capitalized or required to be capitalized under the contractor's capitalization policies, allowable cost will be determined in accordance with the requirements of 4.8, Depreciation.

### **23. Material costs.**

(a) Material costs include the costs of such items as raw materials, parts, sub-assemblies, components, and manufacturing supplies, whether purchased or manufactured by the contractor, and may include such collateral items as inbound transportation and intransit insurance. In computing material costs, consideration shall be given to reasonable overruns, spoilage, or defective work (unless otherwise provided in any contract provision relating to inspecting and correcting defective work). These costs are allowable, subject to the requirements of paragraphs (b) through (e) of this subsection.

(b) Costs of material shall be adjusted for income and other credits, including available trade discounts, refunds, rebates, allowances, and cash discounts, and credits for scrap, salvage, and material returned to vendors. Such income and other credits shall either be credited directly to the cost of the material or be allocated as a credit to indirect costs. When the contractor can demonstrate that failure to take cash discounts was reasonable, lost discounts need not be credited.

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

(d) When materials are purchased specifically for and are identifiable solely with performance under a contract, the actual purchase cost of those materials should be charged to the contract. If material is issued from stores, any generally recognized method of pricing such material is acceptable if that method is consistently applied and the results are equitable. When estimates of future material costs are required, current market price or anticipated acquisition cost may be used, but the basis of pricing must be disclosed.

(e) Allowance for all materials, supplies, and services that are sold or transferred between any divisions, subdivisions, subsidiaries, or affiliates of the contractor under a common control shall be on the basis of cost incurred in accordance with this

subpart. However, allowance may be at a price when it is the established practice of the transferring organization to price interorganizational transfers at other than cost for commercial work of the contractor or any division, subsidiary, or affiliate of the contractor under a common control, and when the item being transferred qualifies for an exception and the contracting officer has not determined the price to be unreasonable.

(f) When a commercial item under paragraph (e) of this subsection is transferred at a price based on a catalog or market price, the price should be adjusted to reflect the quantities being acquired and may be adjusted to reflect actual cost of any modifications necessary because of contract requirements.

### **24. Organization costs.**

(a) Except as provided in paragraph (b) of this subsection, expenditures in connection with—

(1) Planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions,

(2) Resisting or planning to resist the reorganization of the corporate structure of a business or a change in the controlling interest in the ownership of a business, and

(3) Raising capital (net worth plus long-term liabilities), are unallowable.

Such expenditures include but are not limited to incorporation fees and costs of attorneys, accountants, brokers, promoters and organizers, management consultants and investment counsellors, whether or not employees of the contractor. Unallowable "reorganization" costs include the cost of any change in the contractor's financial structure, excluding administrative costs of short-term borrowings for working capital, resulting in alterations in the rights and interests of security holders, whether or not additional capital is raised.

(b) The cost of activities primarily intended to provide compensation will not be considered organizational costs subject to this subsection, but will be governed by 4.4. These activities include acquiring stock for—

(1) executive bonuses,

(2) employee savings plans, and

(3) employee stock ownership plans.

### **25. Other business expenses.**

The following types of recurring costs are allowable when allocated on an equitable basis:



(a) Registry and transfer charges resulting from changes in ownership of securities issued by the contractor.

(b) Cost of shareholders' meetings.

(c) Normal proxy solicitations.

(d) Preparing and publishing reports to shareholders.

(e) Preparing and submitting required reports and forms to taxing and other regulatory bodies.

(f) Incidental costs of directors' and committee meetings.

(g) Other similar costs.

#### **26. Plant protection costs.**

Costs of items such as (a) wages, uniforms, and equipment of personnel engaged in plant protection, (b) depreciation on plant protection capital assets, and (c) necessary expenses to comply with military requirements, are allowable.

#### **27. Patent costs.**

(a) The following patent costs are allowable to the extent that they are incurred as requirements of a Government contract (but see 4.30):

(1) Costs of preparing invention disclosures, reports, and other documents.

(2) Costs for searching the art to the extent necessary to make the invention disclosures.

(3) Other costs in connection with the filing and prosecution of a United States patent application where title or royalty-free license is to be conveyed to the Government.

(b) General counseling services relating to patent matters, such as advice on patent laws, regulations, clauses, and employee agreements, are allowable (but see 4.30).

(c) Other than those for general counseling services, patent costs not required by the contract are unallowable. (See also 4.34).

#### **28. Plant reconversion costs.**

Plant reconversion costs are those incurred in restoring or rehabilitating the contractor's facilities to approximately the same condition existing immediately before the start of the Government contract, fair wear and tear excepted. Reconversion costs are unallowable except for the cost of removing Government property and the restoration or rehabilitation costs caused by such removal. However, in special circumstances where equity so dictates, additional costs may be allowed to the extent agreed upon before costs are incurred. Care should be exercised to avoid duplication through

allowance as contingencies, additional profit or fee, or in other contracts.

#### **29. Precontract costs.**

Precontract costs are those incurred before the effective date of the contract directly pursuant to the negotiation and in anticipation of the contract award when such incurrence is necessary to comply with the proposed contract delivery schedule. Such costs are allowable to the extent that they would have been allowable if incurred after the date of the contract (see 2.6).

#### **30. Professional and consultant service costs.**

(a) *Definition.* "Professional and consultant services" are those services rendered by persons who are members of a particular profession or possess a special skill and who are not officers or employees of the contractor. Examples include those services acquired by contractors or subcontractors in order to enhance their legal, economic, financial, or technical positions. Professional and consultant services are generally acquired to obtain information, advice, opinions, alternatives, conclusions, recommendations, training, or direct assistance, such as studies, analyses, evaluations, liaison with Government officials, or other forms of representation.

(b) Costs of professional and consultant services are allowable subject to this paragraph and paragraphs (c) through (f) of this subsection when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see 4.27 and 4.42).

(c) Costs of professional and consultant services performed under any of the following circumstances are unallowable:

(1) Services to improperly obtain, distribute, or use information or data protected by law or regulation (such as restriction on disclosure and use of data).

(2) Services that are intended to improperly influence the contents of solicitations, the evaluation of proposals or quotations, or the selection of sources for contract award, whether award is by the Government, or by a prime contractor or subcontractor.

(3) Any other services obtained, performed, or otherwise resulting in violation of any statute or regulation prohibiting improper business practices or conflicts of interest.

(4) Services performed which are not consistent with the purpose and scope of the services contracted for or otherwise agreed to.

(d) In determining the allowability of costs (including retainer fees) in a particular case, no single factor or any special combination of factors is necessarily determinative. However, the contracting officer shall consider the following factors, among others:

(1) The nature and scope of the service rendered in relation to the service required.

(2) The necessity of contracting for the service, considering the contractor's capability in the particular area.

(3) The past pattern of acquiring such services and their costs, particularly in the years prior to the award of Government contracts.

(4) The impact of Government contracts on the contractor's business.

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

(6) Whether the service can be performed more economically by employment rather than by contracting.

(7) The qualifications of the individual or concern rendering the service and the customary fee charged, especially on nongovernment contracts.

(8) Adequacy of the contractual agreement for the service (e.g., description of the service, estimate of time required, rate of compensation, termination provisions).

(e) Retainer fees, to be allowable, must be supported by evidence that—

(1) The services covered by the retainer agreement are necessary and customary;

(2) The level of past services justifies the amount of the retainer fees (if no services were rendered, fees are not automatically unallowable);

(3) The retainer fee is reasonable in comparison with maintaining an in-house capability to perform the covered services, when factors such as cost and level of expertise are considered; and

(4) The actual services performed are documented in accordance with paragraph (f) of this subsection.

(f) Fees for services rendered shall be allowable only when supported by evidence of the nature and

scope of the service furnished. (See also 4.35(f).) However, retainer agreements generally are not based on specific statements of work. Evidence necessary to determine that work performed is proper and does not violate law or regulation shall include—

(1) Details of all agreements (e.g., work requirements, rate of compensation, and nature and amount of other expenses, if any) with the individuals or organizations providing the services and details of actual services performed;

(2) Invoices or billings submitted by consultants, including sufficient detail as to the time expended and nature of the actual services provided; and

(3) Consultants' work products and related documents, such as trip reports indicating persons visited and subjects discussed, minutes of meetings, and collateral memoranda and reports.

### **31. Recruitment costs.**

(a) Subject to paragraphs (b) and (c) below, and provided that the size of the staff recruited and maintained is in keeping with workload requirements, the following costs are allowable:

(1) Costs of help-wanted advertising.

(2) Costs of operating an employment office needed to secure and maintain an adequate labor force.

(3) Costs of operating an aptitude and educational testing program.

(4) Travel costs of employees engaged in recruiting personnel.

(5) Travel costs of applicants for interviews.

(6) Costs for employment agencies, not in excess of standard commercial rates.

(b) Help-wanted advertising costs are unallowable if the advertising—

(1) Is for personnel other than those required to perform obligations under a Government contract;

(2) Does not describe specific positions or classes of positions;

(3) Is excessive relative to the number and importance of the positions or to the industry practices;

(4) Includes material that is not relevant for recruitment purposes, such as extensive illustrations or descriptions of the company's products or capabilities;

(5) Is designed to "pirate" personnel from another Government contractor; or

(6) Includes color (in publications).

(c) Excessive compensation costs offered to prospective employees to "pirate" them from another Government contractor are unallowable. Such excessive costs may include salaries, fringe benefits, or special emoluments which are in excess of standard industry practices or the contractor's customary compensation practices.

### 32. Relocation costs.

(a) Relocation costs are costs incident to the permanent change of duty assignment (for an indefinite period or for a stated period of not less than 12 months) of an existing employee or upon recruitment of a new employee. The following types of costs are allowable as noted, subject to paragraphs (b) and (f) of this subsection:

(1) Cost of travel of the employee and members of the immediate family (see 4.41) and transportation of the household and personal effects to the new location.

(2) Cost of finding a new home, such as advance trips by employees and spouses to locate living quarters, and temporary lodging during the transition periods not exceeding separate cumulative totals of 60 days for employees and 45 days for spouses and dependents, including advance trip time.

(3) Closing costs (i.e., brokerage fees, legal fees, appraisal fees, points, finance charges, etc.) incident to the disposition of actual residence owned by the employee when notified of transfer, except that these costs when added to the costs described in paragraph (a)(4) of this subsection shall not exceed 14 percent of the sales price of the property sold.

(4) Continuing costs of ownership of the vacant former actual residence being sold, such as maintenance of building and grounds (exclusive of fixing up expenses), utilities, taxes, property insurance, mortgage interest, after settlement date or lease date of new permanent residence, except that these costs when added to the costs described in subparagraph (a)(3) of this subsection, shall not exceed 14 percent of the sales price of the property sold.

(5) Other necessary and reasonable expenses normally incident to relocation, such as disconnecting and connecting household appliances; automobile registration; driver's license and use taxes; cutting and fitting rugs, draperies, and curtains; forfeited utility fees and deposits; and

purchase of insurance against damage to or loss of personal property while in transit.

(6) Costs incident to acquiring a home in a new location, except that—

(i) these costs will not be allowable for existing employees or newly recruited employees who, before the relocation, were not homeowners, and

(ii) the total costs shall not exceed 5 percent of the purchase price of the new home.

(7) Mortgage interest differential payments, except that these costs are not allowable for existing or newly recruited employees who, before the relocation, were not homeowners and the total payments are limited to an amount determined as follows:

(i) The difference between the mortgage interest rates of the old and new residences times the current balance of the old mortgage times 3 years.

(ii) When mortgage differential payments are made on a lump sum basis and the employee leaves or is transferred again in less than 3 years, the amount initially recognized shall be proportionately adjusted to reflect payments only for the actual time of the relocation.

(8) Rental differential payments covering situations where relocated employees retain ownership of a vacated home in the old location and rent at the new location. The rented quarters at the new location must be comparable to those vacated, and the allowable differential payments may not exceed the actual rental costs for the new home, less the fair market rent for the vacated home times 3 years.

(9) Cost of canceling an unexpired lease.

(b) The costs described in paragraph (a) of this subsection must also meet the following criteria to be considered allowable:

(1) The move must be for the benefit of the employer.

(2) Reimbursement must be in accordance with an established policy or practice that is consistently followed by the employer and is designed to motivate employees to relocate promptly and economically.

(3) The costs must not otherwise be unallowable under section 3.

(4) Amounts to be reimbursed shall not exceed the employee's actual expenses, except that for miscellaneous costs of the type discussed in

paragraph (a)(5) of this subsection, a flat amount, not to exceed \$1,000, may be allowed in lieu of actual costs.

(c) The following types of costs are not allowable:

(1) Loss on sale of a home.

(2) Costs incident to acquiring a home in a new location as follows:

(i) Real estate brokers fees and commissions.

(ii) Cost of litigation.

(iii) Real and personal property insurance against damage or loss of property.

(iv) Mortgage life insurance.

(v) Owner's title policy insurance when such insurance was not previously carried by the employee on the old residence (however, cost of a mortgage title policy is allowable).

(vi) Property taxes and operating or maintenance costs.

(3) Continuing mortgage principal payments on residence being sold.

(4) Payments for employee income or FICA (social security) taxes incident to reimbursed relocation costs.

(5) Payments for job counseling and placement assistance to employee spouses and dependents who were not employees of the contractor at the old location.

(6) Costs incident to furnishing equity or non-equity loans to employees or making arrangements with lenders for employees to obtain lower-than-market rate mortgage loans.

(d) If relocation costs for an employee have been allowed either as an allocable indirect or direct cost, and the employee resigns within 12 months for reasons within the employee's control, the contractor shall refund or credit the relocation costs to the Government.

(e) Subject to the requirements of paragraphs (a) through (d) of this subsection, the costs of family movements and of personnel movements of a special or mass nature are allowable. The cost, however, should be assigned on the basis of work (contracts) or time period benefited.

(f) Relocation costs (both outgoing and return) of employees who are hired for performance on specific contracts or long-term field projects are allowable if—

(1) The term of employment is not less than 12 months;

(2) The employment agreement specifically limits the duration of employment to the time

spent on the contract or field project for which the employee is hired;

(3) The employment agreement provides for return relocation to the employee's permanent and-principle home immediately prior to the outgoing relocation, or other location of equal or lesser cost; and

(4) The relocation costs are determined under the rules of paragraphs (a) through (d) of this subsection. However, the costs to return employees, who are released from employment upon completion of field assignments pursuant to their employment agreements, are not subject to the refund or credit requirements of paragraph (d).

### **33. Rental costs.**

(a) This subsection is applicable to the cost of renting or leasing real or personal property acquired under "operating leases" as defined in Statement of Financial Accounting Standards No. 13 (FAS-13), Accounting for Leases. Compliance with 4.8(m) requires that assets acquired by means of capital leases, as defined in FAS-13, shall be treated as purchased assets; i.e., be capitalized and the capitalized value of such assets be distributed over their useful lives as depreciation charges, or over the lease term as amortization charges, as appropriate (but see paragraph (b)(4) of this subsection).

(b) The following costs are allowable:

(1) Rental costs under operating leases, to the extent that the rates are reasonable at the time of the lease decision, after consideration of—

(i) rental costs of comparable property, if any;

(ii) market conditions in the area;

(iii) the type, life expectancy, condition, and value of the property leased;

(iv) alternatives available; and

(v) other provisions of the agreement.

(2) Rental costs under a sale and leaseback arrangement only up to the amount the contractor would be allowed if the contractor retained title.

(3) Charges in the nature of rent for property between any divisions, subsidiaries, or organization under common control, to the extent that they do not exceed the normal costs of ownership, such as depreciation, taxes, insurance, facilities capital cost of money, and maintenance (excluding interest or other unallowable costs pursuant to this Instruction), provided that no part of such costs shall duplicate any other al-

lowed cost. Rental cost of personal property leased from any division, subsidiary, or affiliate of the contractor under common control, that has an established practice of leasing the same or similar property to unaffiliated lessees shall be allowed in accordance with paragraph (b)(1) of this subsection.

(c) The allowability of rental costs under unexpired leases in connection with terminations is treated in 4.37(e).

#### **34. Royalties and other costs for use of patents.**

(a) Royalties on a patent or amortization of the cost of purchasing a patent or patent rights necessary for the proper performance of the contract and applicable to contract products or processes are allowable unless—

(1) The Government has a license or the right to a free use of the patent;

(2) The patent has been adjudicated to be invalid, or has been administratively determined to be invalid;

(3) The patent is considered to be unenforceable; or

(4) The patent is expired.

(b) Care should be exercised in determining reasonableness when the royalties may have been arrived at as a result of less-than-arm's-length bargaining; e.g., royalties—

(1) Paid to persons, including corporations, affiliated with the contractor;

(2) Paid to unaffiliated parties, including corporations, under an agreement entered into in contemplation that a Government contract would be awarded; or

(3) Paid under an agreement entered into after the contract award.

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

(d) See 2.6 regarding advance agreements.

#### **35. Selling costs.**

(a) "Selling" is a generic term encompassing all efforts to market the contractor's products or services, some of which are covered specifically in other subsections of section 4. Selling activity includes the following broad categories:

(1) Advertising.

(2) Corporate image enhancement including broadly-targeted sales efforts, other than advertising.

(3) Bid and proposal costs.

(4) Market planning.

(5) Direct selling.

(b) Advertising costs are defined at 4.1(b) and are subject to the allowability provisions of 4.1(d) and (f). Corporate image enhancement activities are included within the definitions of public relations at 4.1(a) and entertainment at 4.11 and are subject to the allowability provisions at 4.1(e) and (f) and 4.11, respectively. Bid and proposal costs are defined at 4.15 and have their allowability controlled by that subsection. Market planning involves market research and analysis and generalized management planning concerned with development of the contractor's business. The allowability of long-range market planning costs is controlled by the provisions of 4.9. Other market planning costs are allowable to the extent that they are reasonable and not in excess of the limitations of paragraph (c)(2) of this subsection. Costs of activities which are correctly classified and disallowed under cost principles referenced in this paragraph (b) are not to be reconsidered for reimbursement under any other provision of this subsection.

(c)(1) Direct selling efforts are those acts or actions to induce particular customers to purchase particular products or services of the contractor. Direct selling is characterized by person-to-person contact and includes such activities as familiarizing a potential customer with the contractor's products or services, conditions of sale, service capabilities, etc. it also includes negotiation, liaison between customer and contractor personnel, technical and consulting activities, individual demonstrations, and any other activities having as their purpose the application or adaptation of the contractor's products or services for a particular customer's use. The cost of direct selling efforts is allowable if reasonable in amount.

(2) The costs of broadly targeted and direct selling efforts and market planning other than long-range, that are incurred in connection with a significant effort to promote export sales of products normally sold to the U.S. Government, including the costs of exhibiting and demonstrating such products, are allowable on contracts with the U.S. Government provided the costs are allocable, reasonable, and otherwise allowable under sections 3 and 4 of this Instruction.

(d) The costs of any selling efforts other than those addressed in paragraphs (b) or (c) of this subsection are unallowable.

(e) Costs of the type identified in paragraphs (b), (c), and (d) of this subsection are often commingled on the contractor's books in the selling expense account because these activities are performed by the sales departments. However, identification and segregation of unallowable costs is required under the provisions of 3.6, and such costs are not allowable merely because they are incurred in connection with allowable selling activities.

(f) Notwithstanding any other provision of this subsection, sellers' or agents' compensation, fees, commissions, percentages, retainer or brokerage fees, whether or not contingent upon the award of contracts, are allowable only when paid to bona fide employees or established commercial or selling agencies maintained by the contractor for the purpose of securing business.

### 36. Taxes.

(a) The following types of costs are allowable:

(1) Federal, State, and local taxes, except as otherwise provided in paragraph (b) of this subsection that are required to be and are paid or accrued in accordance with generally accepted accounting principles. Fines and penalties are not considered taxes.

(2) Taxes otherwise allowable under paragraph (a)(1) of this subsection, but upon which a claim of illegality or erroneous assessment exists; provided the contractor, before paying such taxes—

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

(ii) Takes all action directed by the contracting officer arising out of subparagraph (2)(1) of this subsection or an independent decision of the Government as to the existence of a claim of illegality or erroneous assessment, to (A) determine the legality of the assessment or (B) secure a refund of such taxes.

(3) Pursuant to paragraph (a)(2) of this subsection, the reasonable costs of any action taken by the contractor at the direction or with the concurrence of the contracting officer. Interest or penalties incurred by the contractor for non-payment of any tax at the direction of the contracting officer or by reason of the failure of the contracting officer to ensure timely direction after a prompt request.

(4) The environmental tax found at section 59A of the Internal Revenue Code, also called the "Superfund Tax."

(b) The following types of costs are not allowable:

(1) Federal income and excess profits taxes.

(2) Taxes in connection with financing, refinancing, refunding operations, or reorganizations (see 4.17 and 4.20).

(3) Taxes from which exemptions are available to the contractor directly, or available to the contractor based on an exemption afforded the Government, except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the Government. When partial exemption from a tax is attributable to Government contract activity, taxes charged to such work in excess of that amount resulting from application of the preferential treatment are unallowable. These provisions intend that tax preference attributable to Government contract activity be realized by the Government. The term "exemption" means freedom from taxation in whole or in part and includes a tax abatement or reduction resulting from mode of assessment, method of calculation, or otherwise.

(4) Special assessments on land that represent capital improvements.

(5) Taxes (including excises) on real or personal property, or on the value, use, possession or sale thereof, which is used solely in connection with work other than on Government contracts (see paragraph (c) of this subsection).

(6) Any excise tax in subtitle D, chapter 43 of the Internal Revenue Code of 1986, as amended. That chapter includes excise taxes imposed in connection with qualified pension plans, welfare plans, deferred compensation plans, or other similar types of plans.

(7) Income tax accruals designed to account for the tax effects of differences between taxable income and pretax income as reflected by the books of account and financial statements.

(c) Taxes on property (see paragraph (b)(5) of this subsection) used solely in connection with either non-Government or Government work should be considered directly applicable to the respective category of work unless the amounts involved are insignificant or comparable results would otherwise be obtained; e.g., taxes on contractor-owned

work-in-process which is used solely in connection with non-Government work should be allocated to such work; taxes on contractor-owned work-in-process inventory (and Government-owned work-in-process inventory when taxed) used solely in connection with Government work should be charged to such work. The cost of taxes incurred on property used in both Government and non-Government work shall be apportioned to all such work based upon the use of such property on the respective final cost objectives.

(d) Any taxes, interest, or penalties that were allowed as contract costs and are refunded to the contractor shall be credited or paid to the Government in the manner it directs. If a contractor or subcontractor obtains a foreign tax credit that reduces its U.S. Federal income tax because of the payment of any tax or duty allowed as contract costs, and if those costs were reimbursed by a foreign government, the amount of the reduction shall be paid to the Treasurer of the United States at the time the Federal income tax return is filed. However, any interest actually paid or credited to a contractor incident to a refund of tax, interest, or penalty shall be paid or credited to the Government only to the extent that such interest accrued over the period during which the contractor had been reimbursed by the Government for the taxes, interest, or penalties.

### 37. Termination costs.

Contract terminations generally give rise to the incurrence of costs or the need for special treatment of costs that would not have arisen had the contract not been terminated. The following cost principles peculiar to termination situations are to be used in conjunction with the other cost principles in sections 3 and 4:

(a) *Common items.* The costs of items reasonably usable on the contractor's other work shall not be allowable unless the contractor submits evidence that the items could not be retained at cost without sustaining a loss. The contracting officer should consider the contractor's plans and orders for current and planned production when determining if items can reasonably be used on other work of the contractor. 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.

(b) *Costs continuing after termination.* Despite all reasonable efforts by the contractor, costs which cannot be discontinued immediately after the effective date of termination are generally allowable. However, any costs continuing after the effective date of the termination due to the negligent or willful failure of the contractor to discontinue the costs shall be unallowable.

(c) *Initial costs.* Initial costs, including starting load and preparatory costs, are allowable as follows:

(1) Starting load costs not fully absorbed because of termination are nonrecurring labor, material, and related overhead costs incurred in the early part of production and result from factors such as—

(i) Excessive spoilage due to inexperienced labor;

(ii) Idle time and subnormal production due to testing and changing production methods;

(iii) Training; and

(iv) Lack of familiarity or experience with the product, materials, or manufacturing processes.

(2) Preparatory costs incurred in preparing to perform the terminated contract include such costs as those incurred for initial plant rearrangement and alterations, management and personnel organization, and production planning. They do not include special machinery and equipment and starting load costs.

(3) When initial costs are included in the settlement proposal as a direct charge, such costs shall not also be included in overhead. Initial costs attributable to only one contract shall not be allocated to other contracts.

(4) If initial costs are claimed and have not been segregated on the contractor's books, they shall be segregated for settlement purposes from cost reports and schedules reflecting that high unit cost incurred during the early stages of the contract.

(5) If 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 before 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.

(d) *Loss of useful value.* Loss of useful value of special tooling, and special machinery and equipment is generally allowable, provided—

(1) The special tooling, or special machinery and equipment is not reasonably capable of use in the other work of the contractor;

(2) The Government's interest is protected by transfer of title or by other means deemed appropriate by the contracting officer; and

(3) The loss of useful value for 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, or special machinery and equipment was acquired.

(e) *Rental under unexpired leases.* Rental costs under unexpired leases, less the residual value of such leases, are generally allowable when shown to have been reasonably necessary for the performance of the terminated contract, if—

(1) The amount of 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

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

(f) *Alterations of leased property.* The cost of alterations and reasonable restorations required by the lease may be allowed when the alterations were necessary for performing the contract.

(g) *Settlement expenses.* (1) Settlement expenses, including the following, are generally allowable:

(i) Accounting, legal, clerical, and similar costs reasonably necessary for—

(A) The preparation and presentation, including supporting data, of settlement claims to the contracting officer; and

(B) The termination and settlement of subcontracts.

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

(iii) Indirect costs related to salary and wages incurred as settlement expenses in (i) and (ii); normally, such indirect costs shall be limited to payroll taxes, fringe benefits, occupancy costs, and immediate supervision costs.

(2) If settlement expenses are significant, a cost account or work order shall be established to separately identify and accumulate them.

(h) *Subcontractor claims.* Subcontractor claims, including the allocable portion of the claims common to the contract and to other work of the contractor, are generally allowable. An appropriate share of the contractor's indirect expense may be allocated to the amount of settlements with subcontractors; provided, that the amount allocated is reasonably proportionate to the relative benefits received and is otherwise consistent with 3.4 and 3.9(c). The indirect expense so allocated shall exclude the same and similar costs claimed directly or indirectly as settlement expenses.

### **38. Trade, business, technical and professional activity costs.**

The following types of costs are allowable:

(a) Memberships in trade, business, technical, and professional organizations.

(b) Subscriptions to trade, business, professional, or other technical periodicals.

(c) When the principle purpose of a meeting, convention, conference, symposium, or seminar is the dissemination of trade, business, technical or professional information or the stimulation of production or improved productivity—

(1) Costs of organizing, setting up, and sponsoring the meetings, conventions, symposia, etc., including rental of meeting facilities, transportation, subsistence, and incidental costs;

(2) Costs of attendance by contractor employees, including travel costs (see 4.41); and

(3) Costs of attendance by individuals who are not employees of the contractor, provided—

(i) Such costs are not also reimbursed to the individual by the employing company or organization, and

(ii) The individuals attendance is essential to achieve the purpose of the conference, meeting, symposium, etc.

### **39. Training and educational costs.**

(a) *Allowable costs.* Training and education costs are allowable to the extent indicated below.

(b) *Vocational training.* Costs of preparing and maintaining a non-college level program of instruction, including but not limited to on-the-job, classroom, and apprenticeship training, designed to increase the vocational effectiveness of employees are allowable. These costs include—



(1) Salaries or wages of trainees (excluding overtime compensation),

(2) Salaries of the director of training and staff when the training program is conducted by the contractor,

(3) Tuition and fees when the training is in an institution not operated by the contractor and/or

(4) Training materials and textbooks.

(c) *Part-time college level education.* Allowable costs of part-time college education at an undergraduate or postgraduate level, including that provided at the contractor's own facilities, are limited to—

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

(2) Salaries and related costs of instructors who are employees of the contractor;

(3) Training materials and textbooks and;

(4) Straight-time compensation of each employee for time spent attending classes during working hours not in excess of 156 hours per year where circumstances do not permit the operation of classes or attendance at classes after regular working hours. In unusual cases, the period may be extended (see paragraph (h) of this subsection).

(d) *Full-time education.* Costs of tuition, fees, training materials and textbooks (but not subsistence, salary, or any other emoluments) in connection with full-time education, including that provided at the contractor's own facilities, at a postgraduate but not undergraduate college level, are allowable only when the course or degree pursued is related to the field in which the employee is working or may reasonably be expected to work and are limited to a total period not to exceed two school years or the length of the degree program, whichever is less, for each employee so trained.

(e) *Specialized programs.* Costs of attendance of up to 16 weeks per employee per year at specialized programs specifically designed to enhance the effectiveness of managers or to prepare employees for such positions are allowable. Such costs include enrollment fees and related charges and employees' salaries, subsistence, training materials and textbooks, and travel. Costs allowable under this paragraph do not include costs for courses that are

part of a degree-oriented curriculum, which are only allowable pursuant to paragraphs (c) and (d) of this subsection.

(f) *Other expenses.* Maintenance expense and normal depreciation or fair rental on facilities owned or leased by the contractor for training purposes are allowable in accordance with 4.8, 4.14, 4.21, and 4.33.

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

(h) *Advance agreements.* Training and education costs in excess of those otherwise allowable under paragraphs (c) and (d) of this subsection, including subsistence, salaries or other emoluments, may be allowed to the extent set forth in an advance agreement negotiated under 2.6. To be considered for an advance agreement, the contractor must demonstrate that the costs are consistently incurred under an established managerial, engineering, or scientific training and education program and that the course or degree pursued is related to the field in which the employees are now working or may reasonably be expected to work.

(i) *Training or education costs for other than bona-fide employees.* Costs of tuition fees, textbooks, and similar or related benefits provided for other than bona-fide employees are unallowable.

(j) *Employee dependent education plans.* Costs of college plans for employee dependents are unallowable.

#### **40. Transportation costs.**

Allowable transportation costs include freight, express, cartage, and postage charges relating to goods purchased, in process, or delivered. When these costs can be identified with the items involved, they may be directly costed as transportation costs or added to the cost of such items. When identification with the materials received cannot be made, inbound transportation costs may be charged to the appropriate indirect cost accounts if the contractor follows a consistent and equitable procedure. Outbound freight, if reimbursable under the terms of the contract, shall be treated as a direct cost.

#### **41. Travel costs.**

(a) *Costs for transportation, lodging, meals, and incidental expenses.* (1) Costs incurred by contractor personnel on official company business are allowable, subject to the limitations of this sub-

section. Costs for transportation may be based on mileage rates, actual costs incurred, or on a combination thereof, provided the method used results in a reasonable charge. Costs for lodging, meals, and incidental expenses may be based on per diem, actual expenses, or a combination thereof, provided the method used results in a reasonable charge.

(2) Except as provided in paragraph (a)(3) of this subsection, costs incurred for lodging, meals, and incidental expenses (as defined in the regulations cited in (a)(2) (i) and (ii) of this subsection) shall be considered to be reasonable and allowable only to the extent that they do not exceed on a daily basis the maximum per diem rates in effect at the time of travel as set forth in the—

(i) Federal Travel Regulations, prescribed by the General Services Administration, for travel in the conterminous 48 United States, available on a subscription basis from the Superintendent of Documents, Stock No. 922-022-001-00000-2; or

(ii) Joint Travel Regulation, Volume 2, DoD Civilian Personnel, Appendix A, prescribed by the Department of Defense, for travel in Alaska, Hawaii, The Commonwealth of Puerto Rico, and territories and possessions of the United States, available from the Superintendent of Documents, Stock No. 908-010-00000-1.

(3) In special or unusual situations, actual costs in excess of the above-referenced maximum per diem rates are allowable provided that such amounts do not exceed the higher amounts authorized for Federal civilian employees as permitted in the regulations referenced in (a)(2) (i) or (ii) of this subsection. For such higher amounts to be allowable, all of the following conditions must be met:

(i) One of the conditions warranting approval of the actual expense method, as set forth in the regulations referred in (a)(2) (i) or (ii) of this subsection, must exist.

(ii) A written justification for use of the higher amounts must be approved by an officer of the contractor's organization or designee to ensure that the authority is properly administered and controlled to prevent abuse.

(iii) If it becomes necessary to exercise the authority to use the higher actual expense method repetitively or on a continuing basis in a particular area, the contractor must obtain advance approval from the contracting officer.

(iv) Documentation to support actual costs incurred shall be in accordance with the contrac-

tor's established practices, subject to paragraph (a)(7) of this subsection and provided that a receipt is required for each expenditure in excess of \$75.00 or more. The approved justification required by (a)(3)(ii) of this subsection must be retained.

(4) Paragraphs (a)(2) and (a)(3) of this subsection do not incorporate the regulations cited in (a)(2) (i) and (ii) in their entirety. Only the maximum per diem rates, the definitions of maximum per diem rates, the definitions of lodging, meals and incidental expenses, and the regulatory coverage dealing with special or unusual situations are incorporated herein.

(5) An advance agreement (see 2.6) with respect to compliance with paragraphs (a)(2) and (a)(3) of this subsection may be useful and desirable.

(6) The maximum per diem rates referenced in paragraph (a)(2) of this subsection generally would not constitute a reasonable daily charge—

(i) When no lodging costs are incurred; and/or

(ii) On partial travel days (e.g., day of departure and return).

Appropriate downward adjustments from the maximum per diem rates would normally be required under these circumstances. While these adjustments need not be calculated in accordance with the Federal Travel Regulation or Joint Travel Regulations, they must result in a reasonable charge.

(7) Costs shall be allowable only if the following information is documented—

(i) Date and place (city, town, or other similar designation) of the expenses;

(ii) Purpose of the trip; and

(iii) Name of person on trip and that person's title or relationship to the contractor.

(b) Travel costs incurred in the normal course of overall administration of the business are allowable and shall be treated as indirect costs.

(c) Travel costs directly attributable to specific contract performance are allowable and may be charged to the contract under 3.8.

(d) Airfare costs in excess of the lowest customary standard, coach, or equivalent airfare offered during normal business hours are unallowable except when such accommodations require circuitous routing, require travel during unreasonable hours, excessively prolong travel, result in increased cost that would offset transportation savings, are not reasonably adequate for the physical or medical needs of the traveler, or are not reasonably available to meet mission requirements. How-

ever, in order for airfare costs in excess of the above standard airfare to be allowable, the applicable condition(s) set forth in this paragraph must be documented and justified.

(e)(1) "Cost of travel by contractor-owned, -leased, or -chartered aircraft" includes the cost of lease, charter, operation (including personnel), maintenance, depreciation, insurance, and other related costs.

(2) The costs of travel by contractor-owned, -leased, or -chartered aircraft are limited to the standard airfare described in paragraph (d) of this subsection for the flight destination unless travel by such aircraft is specifically required by contract specification, term, condition, or a higher amount is approved by the contracting officer. A higher amount may be agreed to when one or more of the circumstances for justifying higher than standard airfare listed in paragraph (d) of this subsection are applicable, or when an advance agreement under paragraph (e)(3) of this subsection has been executed. In all cases, travel by contractor-owned, -leased, or -chartered aircraft must be fully documented and justified. For each contractor-owned, -leased, or -chartered aircraft used for any business purpose which is charged or allocated, directly or indirectly, to a Government contract, the contractor must maintain and make available manifest/logs for all flights on such company aircraft. As a minimum, the manifest/log shall indicate—

- (i) Date, time, and points of departure;
- (ii) Destination, date, and time of arrival;
- (iii) Name of each passenger and relationship to the contractor;
- (iv) Authorization for trip; and
- (v) Purpose of trip.

(3) Where an advance agreement is proposed (see 2.6), consideration may be given to the following:

- (i) Whether scheduled commercial airlines or other suitable, less costly, travel facilities are available at reasonable times, with reasonable frequency, and serve the required destinations conveniently.
- (ii) Whether increased flexibility in scheduling results in time savings and more effective use of personnel that would outweigh additional travel costs.

(f) Costs of contractor-owned or leased automobiles, as used in this paragraph, include the costs of lease, operation (including personnel),

maintenance, depreciation, insurance, etc. These costs are allowable, if reasonable, to the extent that the automobiles are used for company business. That portion of the cost of company-furnished automobiles that relates to personal use by employees (including transportation to and from work) is compensation for personal services and is unallowable as stated in 4.4(m)(2).

#### **42. Costs related to legal and other proceedings.**

(a) *Definitions.* "Conviction" means a judgement or conviction of a criminal offense by any court of competent jurisdiction, whether entered upon a verdict or a plea, and includes a conviction entered upon a plea of nolo contendere. "Costs" include, but are not limited to, administrative and clerical expenses; the cost of legal services, whether performed by in-house or private counsel; the costs of the services of accountants, consultants, or others retained by the contractor to assist it; costs of employees, officers, and directors; and any similar costs incurred before, during, and after commencement of a judicial or administrative proceeding which bears a direct relationship to the proceeding.

"Fraud" means (1) acts of fraud or corruption or attempts to defraud the Government or to corrupt its agents, (2) acts which constitute a cause for debarment or suspension and (3) acts which violate the False Claims Act, 31 U.S.C., sections 3729-3731, or the Anti-Kickback Act, 41 U.S.C., sections 51 and 54.

"Penalty," does not include restitution, reimbursement, or compensatory damages.

"Proceeding," includes an investigation.

(b) Costs incurred in connection with any proceeding brought by Federal, State, local, or foreign Government for violation of, or a failure to comply with, law or regulation by the contractor (including its agents or employees), or costs incurred in connection with any proceeding brought by a third party in the name of the United States under the False Claims Act, 31 U.S.C. 3730, are unallowable if a result is—

- (1) In a criminal proceeding, a conviction;
- (2) In a civil or administrative proceeding, either a finding of contractor liability where the proceeding involves an allegation of fraud or similar misconduct or imposition of a monetary penalty where the proceeding does not involve an allegation of fraud or similar misconduct;

(3) A final decision by an appropriate official to—

(i) Debar or suspend the contractor;

(ii) Rescind or void a contract; or

(iii) Terminate a contract for default by reason of a violation or failure to comply with a law or regulation.

(4) Disposition of the matter by consent or compromise if the proceeding could have led to any of the outcomes listed in paragraphs (b)(1) through (3) of this subsection (but see paragraphs (c) and (d) of this subsection); or

(5) Not covered by paragraphs (b)(1) through (4) of this subsection, but where the underlying alleged contractor misconduct was the same as that which led to a different proceeding whose costs are unallowable by reason of paragraphs (b)(1) through (4) of this subsection.

(c)(1) To the extent they are not otherwise unallowable, costs incurred in connection with any proceeding under paragraph (b) of this subsection commenced by the United States that is resolved by consent or compromise pursuant to an agreement entered into between the contractor and the United States, and which are unallowable solely because of paragraph (b) of this subsection, may be allowed to the extent specifically provided in such agreement.

(2) In the event of a settlement of any proceeding brought by a third party under the False Claims Act in which the United States did not intervene, reasonable costs incurred by the contractor in connection with such a proceeding, that are not otherwise unallowable by regulation or by separate agreement with the United States, may be allowed if the contracting officer, in consultation with his or her legal advisor, determines that there was very little likelihood that the third party would have been successful on the merits.

(d) To the extent that they are not otherwise unallowable, costs incurred in connection with any proceeding under paragraph (b) of this subsection commenced by a State, local, or foreign government may be allowable when the contracting officer determines, that the costs were incurred either:

(1) As a direct result of a specific term or condition of a Federal contract; or

(2) As a result of compliance with specific written direction of the cognizant contracting officer.

(e) Costs incurred in connection with proceedings described in paragraph (b) of this subsection, but which are not made unallowable by that paragraph, may be allowable to the extent that:

(1) The costs are reasonable in relation to the activities required to deal with the proceeding and the underlying cause of action;

(2) The costs are not otherwise recovered from the Federal Government or a third party, either directly as a result of the proceeding or otherwise; and

(3) The percentage of costs allowed does not exceed the percentage determined to be appropriate considering the complexity of procurement litigation, generally accepted principles governing the award of legal fees in civil actions involving the United States as a party, and such other factors as may be appropriate. Such percentage shall not exceed 80 percent. Agreements reached under paragraph (c) of this subsection shall be subject to this limitation. If, however, an agreement described in paragraph (c)(1) of this subsection explicitly states the amount of otherwise allowable incurred legal fees and limits the allowable recovery to 80 percent or less of the stated legal fees, no additional limitation need be applied. The amount of reimbursement allowed for legal costs in connection with any proceeding described in paragraph (c)(2) of this subsection shall be determined by the cognizant contracting officer, but shall not exceed 80 percent of otherwise allowable legal costs incurred.

(f) Costs not covered elsewhere in this subsection are unallowable if incurred in connection with:

(1) Defense against Government claims or appeals or the prosecution of claims or appeals against the Federal Government.

(2) Organization, reorganization (including mergers and acquisitions), or resisting mergers and acquisitions (see also 4.24).

(3) Defense of antitrust suits.

(4) Defense of suits brought by employees or ex-employees of the contractor under section 2 of the Major Fraud Act of 1988 where the contractor was found liable or settled.

(5) Costs of legal, accounting, and consultant services and directly associated costs incurred in connection with the defense or prosecution of lawsuits or appeals between contractors arising from either—

(i) An agreement or contract concerning a teaming arrangement, a joint venture, or similar arrangement of shared interest; or

(ii) Dual sourcing, coproduction, or similar programs, are unallowable, except when—

(A) Incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer, or

(B) When agreed to in writing by the contracting officer.

(6) Patent infringement litigation, unless otherwise provided for in the contract.

(7) Representation of, or assistance to, individuals, groups, or legal entities which the contractor is not legally bound to provide, arising from an action where the participant was convicted of violation of a law or regulation or was found liable in a civil or administrative proceeding.

(8) Protests of Federal Government solicitations or contract awards, or the defense against protests of such solicitations or contract awards, unless the costs of defending against a protest are incurred pursuant to a written request from the cognizant contracting officer.

(g) Costs which may be unallowable under this subsection, including directly associated costs, shall be segregated and accounted for by the contractor separately. During the pendency of any proceeding covered by paragraph (b), (f)(4), and (f)(7) of this subsection, the contracting officer shall generally withhold payment of such costs. However, if in the best interests of the Government, the contracting officer may provide for conditional payment upon provision of adequate secu-

rity, or other adequate assurance, and agreement by the contractor to repay all unallowable costs, plus interest, if the costs are subsequently determined to be unallowable.

#### **43. Goodwill.**

Goodwill, an unidentifiable intangible asset, originates under the purchase method of accounting for a business combination when the price paid by the acquiring company exceeds the sum of the identifiable individual assets acquired less liabilities assumed, based upon their fair values. The excess is commonly referred to as goodwill. Goodwill may arise from the acquisition of a company as a whole or a portion thereof. Any costs for amortization, expensing, write-off, or write-down of goodwill (however represented) are unallowable.

#### **44. Costs of alcoholic beverages.**

Costs of alcoholic beverages are unallowable.

#### **45. Asset valuations resulting from business combinations.**

(a) For tangible capital assets, when the purchase method of accounting for a business combination is used, whether or not the contract or subcontract is subject to CAS, the allowable depreciation and cost of money shall be based on the capitalized asset values measured and assigned in accordance with 48 CFR 9904.404–50(d), if allocable, reasonable, and not otherwise unallowable.

(b) For intangible capital assets, when the purchase method of accounting for a business combination is used. Allowable amortization and cost of money shall be limited to the total combination not taken place.