

**BONNEVILLE PURCHASING INSTRUCTIONS
APPENDIX 13-A**

**CONTRACT COST PRINCIPLES FOR
COMMERCIAL ORGANIZATIONS**

BONNEVILLE PURCHASING INSTRUCTIONS
APPENDIX 13A -- CONTRACT COST PRINCIPLES FOR COMMERCIAL ORGANIZATIONS

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SECTION 1 ADVANCE AGREEMENTS.

(a) The extent of allowability of the costs covered in this Section applies broadly to many accounting systems in varying contract situations. Thus, the reasonableness and allocability of certain costs may be difficult to determine, particularly for firms or their divisions that may not be under effective competitive restraints. To avoid possible subsequent disallowance or dispute based on unreasonableness or nonallocability, COs 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 or allocability 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 CO is not authorized to agree to a treatment of costs inconsistent with this Appendix. For example, an advance agreement may not provide that, notwithstanding 8.20, interest is allowable.

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

SECTION 2 CONTRACTS WITH COMMERCIAL ORGANIZATIONS

This category includes all contracts and contract modifications for supplies, services, or experimental, developmental, or research work negotiated on the basis of cost with organizations other than educational institutions, State and local governments and nonprofit organizations.

(a) The cost principles and procedures in this Appendix shall be used in pricing contracts and contract modifications with commercial organizations whenever cost analysis is performed.

(b) In addition, the CO shall incorporate these cost principles and procedures by reference in contracts with commercial organizations as the basis for -

- (1) Determining reimbursable costs under cost-reimbursement contracts and cost-reimbursement subcontracts under these contracts performed by commercial organizations, and 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; and
- (6) Pricing changes and other contract modifications.

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SECTION 3 CONSTRUCTION AND ARCHITECT-ENGINEER CONTRACTS.

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

(a) Because of widely varying factors such as the nature, size, duration, and location of the construction site, advance agreements under Section 1 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 to avoid subsequent disputes or disallowances.

(b) "Construction equipment," as used in this section, means equipment (including marine equipment) in sound workable condition, either owned or controlled by the contractor, or by the subcontractor at any tier, or obtained from a commercial rental source, and furnished for its use under BPA contracts.

(1) 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, BPA may specify the use of a particular schedule of predetermined rates or any part thereof to determine ownership and operating costs of construction equipment (see subdivisions (b)(1)(B) and (1)(C) below). However, costs otherwise unallowable under this Section shall not become allowable through the use of any schedule (see 1(c)). For example, schedules need to be adjusted for contract costing purposes if they are based on replacement cost, include unallowable interest costs, or use improper cost of money rates or computations. COs should review the computations and factors included within the specified schedule and ensure that unallowable or unacceptably computed factors are not included 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 contractor'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.

(2) 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.

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(C) The allowability of charges for construction equipment rented from any division, subsidiary, or organization under common control, will be determined in accordance with 8.36(b)(3).

(c) Costs incurred at the job site incident to performing the work, such as the cost of superintendence, timekeeping and clerical work, engineering, utility cost, 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.

(d) 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.

SECTION 4 COMPOSITION OF TOTAL COST.

The total cost of a contract is the sum of the allowable direct and indirect costs allocable to the contract, incurred or to be incurred, less any allocable credits, plus any allocable cost of money (see 8.10). Any generally accepted method of determining or estimating costs that is equitable and is consistently applied may be used to ascertain total costs.

4.1 Determination of Allowability.

The following factors shall be considered in determining whether a cost is allowable:

- (a) Reasonableness.
- (b) Allocability.
- (c) Generally accepted accounting principles and practices appropriate to the particular circumstances.
- (d) Terms of the contract.
- (e) Any limitations set forth in this Appendix.

4.2 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 CO or the CO'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 contract performance;
 - (2) Generally accepted sound business practices, arm's-length bargaining, and Federal and State laws and regulations.
 - (3) The contractor's responsibilities to BPA, other customers, the owners of the business, employees, and the public at large; and
 - (4) Any significant deviations from the contractor's established practices.

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4.3 Determination of 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 the 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.

4.4 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 BPA either as a cost reduction or by cash refund.

SECTION 5 DIRECT COSTS.

(a) A direct cost is any cost that can be identified specifically with a specific final cost objective. No cost shall be allocated as a direct cost to a final cost objective, if the same cost is allocated as an indirect cost and has been included in any indirect 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.

(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.

SECTION 6 INDIRECT COSTS.

(a) An indirect cost is any cost not directly identified with a specific, single, final cost objective, but instead is 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 indirect 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. This necessitates the selection of a distribution base common to all cost objectives to which the grouping is to be allocated. 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 the distribution of indirect costs has been accepted, it shall not be fragmented by the removal of individual elements. All items properly includable in an indirect

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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 general and administrative (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 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 other products, or other relevant circumstances; or
- (3) Indirect cost groupings developed for a contractor's primary location are applied to off-site locations. Separate cost groupings for costs allocable to off-site locations may be necessary to permit equitable distribution of costs on the basis of the benefits accruing to the several cost objectives.

SECTION 7 APPLICATION OF PRINCIPLES AND PROCEDURES.

(a) Costs shall be allowed to the extent they are reasonable, allocable, and determined to be allowable under this Appendix. 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 or fixed-price incentive type subcontract are allowable to the extent consistent with this Appendix. 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 this Appendix.

(c) Section 8 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 subsection and the treatment of similar or related selected items. When more than one subsection in Section 8 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 Section 8 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.

(d) Deviations from the cost principles in this subsection shall be processed in accordance with the procedures in BPI subpart 1.7.

SECTION 8 SELECTED COSTS.

8.1 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.

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(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, dealer cards, window displays, outdoor advertising, radio and television.

(c) Public relations and advertising costs include the costs of media time and space, and 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 advertising costs that are allowable are those specifically required by contract, or that arise from requirements of BPA contracts and that are exclusively for--

- (1) Recruiting personnel required for performing contractual obligations, when considered in conjunction with all other recruitment costs (but see 8.34);
- (2) Acquiring scarce items for contract performance; or
- (3) Disposing of scrap or surplus materials acquired for contract performance.

(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 subparagraph (f)(5) of this subsection).

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

- (1) All advertising costs other than those specified in paragraph (d) of this subsection.
- (2) Costs of air shows and other special events or trade shows which do not include a significant effort to promote the export of products normally sold to the U.S. Government.
- (3) Costs of sponsoring meetings, 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 corporate celebrations and 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.

8.2 Automatic Data Processing Equipment Leasing Costs.

(a) This subsection applies to all contractor-leased automatic data processing equipment (ADPE) (except as components of an end item to be delivered to BPA acquired under operating leases, as defined in Statement of Financial Accounting Standard No. 13 (FAS-13), Accounting for Leases, issued by the Financial Accounting Standards Board. Compliance with 8.11(M) requires that ADPE acquired by means of capital leases, as defined in FAS-13, shall be treated

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as purchased assets. Allowability of costs related to contractor-owned ADPE is governed by other provisions of this subsection.

(b)

(1) If the contractor leases ADPE but cannot demonstrate, on the basis of facts existing at the time of the decision to lease or continue leasing (and documented in accordance with paragraph (d) below) that leasing will result in less cost to BPA over the anticipated useful life (see paragraph (c) below), then rental costs are allowable only up to the amount that would be allowed had the contractor purchased the ADPE.

(2) The costs of leasing ADPE are allowable to the extent that the contractor can annually demonstrate in accordance with paragraph (d) below (whether or not the term of lease is renewed or otherwise extended) that these costs meet the following criteria:

(i) The costs are reasonable and necessary for the conduct of the contractor's business in light of factors such as the contractor's requirements for ADPE, costs of comparable facilities, the various types of leases available, and the provisions of the rental agreement.

(ii) The costs do not give rise to a material equity in the facilities but represent charges only for the current use of the equipment, including incidental service costs such as maintenance, insurance, and applicable taxes.

(iii) The CO's approval was obtained for the leasing arrangement (see subparagraph (d)(3) below) when the total cost of leasing the ADPE

(A) is to be allocated to one or more Government contracts which require the negotiation or determination of costs, or

(B) in a single plant, division, or cost center exceeds \$500,000 a year and 50 percent or more of the total leasing cost is to be allocated to one or more Government contracts which require the negotiation or determination of costs.

(3) Rental costs under a sale and leaseback arrangement are allowable only up to the amount that would have been allowed had the contractor retained title to the ADPE.

(4) Allowable rental costs of ADPE leased from any division, subsidiary, or organization under a common control are limited to the cost of ownership (excluding interest or other costs unallowable under this Section 8, and including the cost of money [see 8.10]). When there is an established practice of leasing the same or similar equipment to unaffiliated lessees, rental costs shall be allowed under subparagraphs (b)(1) and (2) above, except that the purchase price and costs of ownership shall be determined under 8.26(e).

(c)

(1) An estimate of the anticipated useful life of the ADPE may present the application life (utility in a given function), technological life (utility before becoming obsolete in whole or in part), or physical life (utility before wearing out). Each case must be evaluated individually. In estimating anticipated useful life, the contractor may use the application life if it can be demonstrated that the ADPE has utility only in a given function and the duration of the function can be determined. Technological life may be used if the contractor can demonstrate that existing ADPE must be replaced because of --

(i) Specific program objectives or contract requirements that cannot be accomplished with the existing ADPE;

(ii) Cost reductions that will produce identifiable savings in production or overhead costs;

(iii) Increase in workload volume that cannot be accomplished efficiently by modifying or augmenting existing ADPE; or

(iv) Consistent pattern of capacity operation (2 1/2 - 3 shifts) on existing ADPE.

(2) Technological advances will not justify replacing existing ADPE before the end of its physical life if it will be able to satisfy future requirements or demands.

(3) In estimating the least cost to BPA for useful life, the cumulative costs that would be allowed if the contractor owned the ADPE should be compared with cumulative costs that would be allowed under any of the various types of leasing arrangements available.

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(d)

(1) Except as provided in subparagraph (3) below, the contractor's justification, under paragraph (b) above, of the leasing decisions shall consist of the following supporting data, prepared before purchase:

(i) Analysis of use of existing ADPE.

(ii) Application of the criteria in paragraph (b) above.

(iii) Specific objectives or requirements, generally in the form of a data system study and specification.

(iv) Solicitation of proposals, based on the data system specification, from qualified sources.

(v) Proposals received in response to the solicitation and reasons for selection of the equipment chosen and for the decision to lease.

(2) Except as provided in subparagraph (3) below, the contractor's annual justification, under subparagraph (b)(2) above, of the decision to retain or change existing ADPE capability and the need to continue leasing shall consist of current data as specified in (d)(1)(i) through (iii) above.

(3) If the contractor's prospective ADPE lease cost meets the threshold in 8.2(b)(2)(iii) above, the contractor shall furnish data in support of the initial decision to lease (see subparagraph (b)(1) above). If the total cost of leasing ADPE in a single plant, division, or cost center exceeds \$500,000 per year and 50 percent or more of the total leasing cost is allocated to BPA contracts which require the negotiating or determining costs, the contractor shall furnish data supporting the annual justification for retaining or changing existing ADPE capability and the need to continue leasing shall also be furnished (see subparagraph (b)(2) above).

8.3 Bad Debts.

Bad debts, including actual or estimated losses arising from uncollectable accounts receivable due from customers and other claims, related collection costs, and related legal costs are unallowable.

8.4 Bonding Costs.

(a) Bonding costs arise when BPA 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.

8.5 Civil Defense Costs.

(a) Civil defense costs are those incurred in planning for, and protecting life and property against, the possible effects of enemy attack. Costs of civil defense measures (including costs in excess of normal plant protection costs, first-aid training and supplies, fire-fighting training and equipment, posting of additional exit notices and directions, and other approved civil defense measures) undertaken on the contractor's premises pursuant to suggestions or requirements of civil defense authorities are allowable when allocated to all work of the contractor.

(b) Costs of capital assets acquired for civil defense purposes are allowable through depreciation (see 8.11).

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(c) Contributions to local civil defense funds and projects are unallowable.

8.6 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, 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 severance pay costs in paragraph (g) below and for pension costs in paragraph (j) below). It includes, but is not limited to, salaries; wages; directors' and executive committee members' fees; bonuses (including stock bonuses); incentive awards; employee stock options, stock appreciation rights, 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 Sections 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 8.6(g), (h), (j), (k), (m), and (o) 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 CO of the changes, either before their implementation or within a reasonable period after their implementation, and

(ii) Has not provided BPA, 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 Appendix shall not be allowable under this subsection 8.6 solely on the basis that they constitute compensation for personal services. (See 8.34(c))

(b) Reasonableness.

(1) 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. In determining the reasonableness of individual elements for particular employees or classes of employees, consideration should be given to all potentially relevant facts. Facts 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 other 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. While all of the above factors, as well as any other relevant ones, should be considered, their relative significance will vary according to circumstances. For example, in the case of secretarial salaries, conformity with the compensation paid by other firms in the same geographic area would likely be a more significant criterion than conformity with the compensation paid by other firms in the same industry wherever located. The tests for reasonableness of labor-management agreements are set forth in paragraph (c) of this subsection. In addition to the provisions of section 4.2 of this appendix, in testing the reasonableness of individual elements for particular employees or job classes of employees,

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consideration should be given to factors determined to be relevant by the CO. In administering this principle, it is recognized that not every compensation case need be subjected in detail to the above or other tests. 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, COs 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 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 CO 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. For example, a contractor, if challenged on the amount of base salaries for management, could counter by showing lower-than-normal end-of-year management bonuses. 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 class of employees') compensation package. For example, excessive management salaries cannot be offset against lower-than-normal secretarial salaries.
- (ii) Offsets will be considered only between the allowable portion of the following compensation elements of employees or 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. An executive bonus that is excessive by \$100,000 is not fully offset by a base salary that is low by only \$25,000. In determining the magnitude of compensation elements, the timing of receipt by the employee must be considered. For example, a bonus of \$100,000 in the current period will be considered as of greater value than a deferred compensation arrangement to make the same payment in some future period.

(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 subdivision 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. COs or their representatives should normally challenge increased

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costs where major revisions of existing compensation plans or new plans are introduced by the contractor, and the contractor--

- (A) Has not notified the CO of the changes either before their implementation or within a reasonable period after their implementation; and
 - (B) Has not provided BPA, 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 cost of compensation established under "arm's length" negotiated labor-management agreements is otherwise allowable, the costs are reasonable if, as applied to work in performing Government contracts, it is not determined to be 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) Form 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

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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 subparagraph (f)(1) above and of paragraph (k) below.

(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 subparagraph (j)(7) below.

(2) Severance pay, to be allowable, must meet the general allowability criteria in subdivision (g)(2)(i) below, and, depending upon whether the severance is normal or abnormal, criteria in subdivision (g)(2)(ii) for normal severance pay or subdivision (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) Back pay.

(1) Back pay resulting from violations of Federal labor laws or the Civil Rights Act of 1964. Back pay 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 back pay 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 back pay was not additional compensation for work performed. Back pay resulting from underpaid work is compensation for the work performed and is allowable. All other back pay resulting from violation of Federal labor laws or the Civil Rights Act of 1964 is unallowable.

(2) Other back pay. Back pay 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 back pay is allowable. Back pay 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.

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- (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.
- (A) Any compensation which is calculated, or valued, based on changes in the price of corporate securities is unallowable.
 - (B) Any compensation represented by dividend payments or which is calculated based on dividend payments is unallowable.
 - (C) 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 is a deferred compensation plan that is established and maintained by one or more employers to provide systematically for paying benefits to plan participants after their retirement, provided that the benefits are paid for life or are payable for life at the option of the employee. 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, Composition and Measurement 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. Pension costs are allowable subject to the referenced standards and the cost limitations and exclusions set forth below in subparagraphs (j)(2)(i) and (j)(3) through (8) of this subsection.
- (i) Except for unfunded pension plans 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.
 - (ii) Pension payments must be reasonable in amount and be paid pursuant to (A) an agreement entered into in good faith between the contractor and employees before the work or services are performed, and (B) the terms and conditions of the established plan. The cost of changes in pension plans which 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 subparagraph (j)(7) below, 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 subparagraph 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)
 - (A) Except for unfunded pension plans, normal costs of pension plans not funded in the year incurred, and all other components of pension costs assignable to the current accounting period but not funded during it, shall not be allowable in subsequent years (except that a payment made to fund by the time set for filing the Federal income tax return or any extension thereof is considered to have been made

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during such taxable year). However, any part of a pension cost that is computed for a cost accounting period that is deferred 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 does occur. The allowability of these deferred contributions will be limited to the amounts that would have been allowed had the funding occurred in the year the costs would have been assigned except for the waiver.

(B) Reserved.

(ii) Any amount paid or funded before the time it becomes assignable and allowable shall be applied to future years, in order of time, as if actually paid and deductible in those years. The interest earned on such premature funding, based on the valuation rate of return, may be excluded from future years' computations of pension costs.

(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. Determination of unallowable costs shall be made in accordance with the actuarial method 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 8.19(a)(3) and (b), in the indemnification payment to the extent of its fair share.

(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 8.19(a)(3) and (b), in an 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 are unallowable except to the extent authorized by an advance agreement. The advance agreement shall:

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

(B) Provide that the Government receive a credit equal to the amount of the Government's equitable share of the gross withdrawal. If a transfer is made without such an agreement, paragraph (j)(4) of this subsection will apply to the transfer as a constructive withdrawal and receipt of funds by the contractor.

(4) Termination of defined benefit pension plans. When excess or surplus assets revert to the contractor as a result of termination of a defined pension plan, or such assets are constructively received by it for any reason, the contractor shall 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 certified cost or pricing data were submitted or which are subject to this Appendix.

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(5) Defined contribution pension plans. This subparagraph covers those pension plans in which the contributions to be made 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 subparagraph (j)(1) above.

(i) The pension cost assignable to a cost accounting period is the net contribution required to be made for that period after taking into account dividends and other credits, where applicable. However, any portion of pension cost computed for a cost accounting period that is deferred pursuant to a waiver granted under the provisions of ERISA will be allowable in those future accounting periods when the funding does occur. The allowability of these deferred contributions will be limited to the amounts that would have been allowed had the funding been made in the year the costs would have been assigned except for the waiver.

(ii) Any amount paid or funded to the trust before the time it becomes assignable and allowable shall be applied to future years, in order of time, as if actually paid and deductible in such years.

(iii) The provisions of subdivision (j)(3)(iv) above concerning payments to PBGC apply to defined contribution plans.

(6) Reserved.

(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 ESOPs 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 CO 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 CO'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.

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(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 CO 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 CO 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 subdivision (j)(3)(ii) above are applicable to Employee Stock Ownership Plans.

(k) Deferred compensation.

(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 8.6(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 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) Payments 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.

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(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 elsewhere in this Appendix, 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 8.46(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) Post-retirement 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 be calculated in accordance with paragraphs (o)(2)(i), (ii), or (iii) of this subparagraph.

(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 a 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 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) Costs of post-retirement benefits in subdivision (o)(2)(iii) of this subsection attributable to past service ("transaction obligation") as defined in Financial Accounting Standards Board Statement 106, paragraph 110, are allowable, subject to the following limitation: 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 this Appendix.

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8.7 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. A contingency factor may be recognized when it is applicable to a past period (such as in a contract termination action) 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. Contingencies of this category are to be included in the estimates of future cost.

(2) Those that may arise from presently known or unknown conditions, the effect of which cannot be measured precisely enough to provide equitable results to the contractor and to the Government. 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.

8.8 Contributions or Donations.

Contributions or donations, including cash, property and services, regardless of recipient, are unallowable, except as provided in 8.1(e)(3).

8.9 Reserved.

8.10 Cost of Money.

(a) Policy. Facilities capital cost of money and cost of money as an element of capital assets under construction are not allowable costs under BPA contracts or intergovernmental contracts.

(b) Background. Facilities Capital Cost of Money is a concept which was originally developed by the Cost Accounting Standards Board as CAS 414 and was applied by law to defense contractors. Allowing facilities capital cost of money for this purpose was intended to reward a contractor's investment in plant and equipment used to increase the productivity of the firm, to encourage the use of modern manufacturing technology, to broaden the nation's mobilization base, and to make the performance of defense contracts more efficient. The cost of capital committed to facilities is an imputed cost determined by applying a cost of money rate to facilities capital. Allowing the recovery of these costs was intended to create an incentive for contractors to invest in cost-cutting machinery. The allowance of such costs was felt necessary for defense contractors who had major investments in plant and equipment designed for the production of supplies and equipment in support of the Nation's defense programs. The cost principles were apparently not intended to cover the costs of service contractors, nor to provide recovery of the cost of money expended by contractors to obtain working capital.

(c) BPA's supply contracts do not normally provide a substantial volume of business for any particular contractor over an extended period, and because contractors are not making major investments primarily or exclusively in support of BPA contracts, allowing such costs would be inappropriate. Contractors who do derive a substantial portion of their activities from BPA recover their costs of capital through profits and/or depreciation.

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8.11 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) 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 (h) below).

(c) 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.

(d) 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 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.

(e) Depreciation for reimbursement purposes in the case of tax-exempt organizations shall be determined on the basis described in paragraph (d) immediately above.

(f) 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 8.11 shall not exceed the cost basis of the asset less any depreciation allowed or allowable under prior acquisition regulations.

(g) 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) above, vary with volume of production or use of multi-shift operations.

(h) 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.

(i) The depreciation on any item which meets the criteria for allowance at a "price" under 8.26(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.

(j) 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. In

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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.

(k) 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 8.11, while assets acquired under leases classified as operating leases are subject to the requirements on rental costs in 8.36. 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 (1), (2), and (3) below.

(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 for all real and personal property between related parties are subject to the requirements of this subparagraph 8.11(k). 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.

(3) Assets acquired under leases that the contractor must capitalize under FAS-13 shall not be treated as purchased assets for contract purposes if the leases are covered by 8.36(b)(4).

(l) 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 8.16(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.

8.12 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 8.27.

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

(c) Research and development and engineering costs designed to lead to new products for sale to the general public are not allowable under this provision (see 8.9).

8.13 Employee Morale and Similar Costs.

(a) Aggregate costs incurred for 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) immediately below, and to the extent that the net amount is reasonable. Some examples 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.

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(b) Costs of gifts are unallowable. (Gifts do not include awards for performance made pursuant to 8.6(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 contractor'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., (1) where the contractor must provide food or dormitory services at remote locations where adequate commercial facilities are not reasonably available, or (2) 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) immediately below).

(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) above 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.

8.14 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 (but see 8.1 and 8.13). 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.

8.15 Fines, Penalties, and Mischarging Costs.

(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 CO.

(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.

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8.16 Gains and Losses on Disposition of Depreciable Property.

(a) Gains and losses from the sale, retirement, or other disposition (but see 8.19) 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) below). However, no gain or loss shall be recognized as a result of the transfer of assets in a business combination.

(b) Gains and losses on disposition of tangible capital assets, including those acquired under capital leases, shall be considered as adjustments of depreciation costs previously recognized. The gain recognized for contract costing purposes shall be limited to the difference between the acquisition cost of the asset and its undepreciated balance (except see subdivision (c)(2)(i) or (ii) below).

(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 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) above.

(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 8.11; 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.

8.17 Idle Facilities and Idle Capacity Costs.

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

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"Facilities" means plant or any portion thereof (including land integral to the operation), equipment, 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 8.42)).

- (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. Widespread idle capacity throughout an entire plant or among a group of assets having substantially the same function may be idle facilities.

8.18 Independent R and D Bid and Proposal Costs.

- (a) Reserved

- (b) Composition and allocation of costs.
 - (1) IR&D and B&P costs shall be allocated to final cost objectives on the same basis of allocation used for the general and administrative (G&A) expense grouping of the profit center in which the costs are incurred. However, when IR&D or 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.
 - (2) If allocations of IR&D or B&P through the G&A base do not provide equitable cost allocation, the CO may approve use of a different base.

- (c) Allowability. Except as provided in paragraph (d) below, costs for IR&D and B&P are allowable only in accordance with the following:
 - (1) Companies required to negotiate advance agreements.
 - (i) Any company that received payments for IR&D and B&P costs in a fiscal year, either as a prime contractor or subcontractor, exceeding \$7 million from Government agencies, is required to negotiate with the Government an advance agreement which establishes a ceiling for allowability of IR&D and B&P costs for the following fiscal year. This agreement is binding on all Government agencies, unless prohibited by statute. The requirements of Section 203 of Public Law 91-441 necessitate that DOD be the lead negotiating agency when the contractor has received more than \$7 million in payments for IR&D and B&P from DOD. Computation of IR&D and B&P costs to determine whether the threshold criterion was reached shall include only recoverable IR&D and B&P costs allocated during the company's previous fiscal year to prime contracts and

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subcontracts for which the submission and certification of cost or pricing data were required. The computation shall include full burdening.

(ii) When a company meets the criterion in (i) above, required advance agreements may be negotiated at the corporate level and/or with those profit centers that contract directly with the Government and that in the preceding year allocated recoverable IR&D and B&P costs exceeding \$700,000, including burdening, to contracts and subcontracts for which the submission and certification of cost or pricing data were required. When ceilings are negotiated for separate profit centers of the company, the allowability of IR&D and B&P costs for any center that in its previous fiscal year did not reach the threshold cited above may be determined in accordance with subparagraph (c)(2) below.

(iii) Ceilings are the maximum dollar amounts of total IR&D and B&P costs that will be allowable for allocation over the appropriate base for that part of the company's operation covered by an advance agreement.

(iv) No IR&D and B&P cost shall be allowable if a company fails to initiate negotiation of a required advance agreement prior to the end of the fiscal year for which the agreement is required.

(v) When negotiations are held with a company meeting the \$7 million criterion or with separate profit centers (when negotiations are held at that level under (ii) above), and if no advance agreement is reached, payment for IR&D and B&P costs shall be reduced below that which the company or profit center would have otherwise received. The amount of such reduced payment shall not exceed 75 percent of the amount which, in the opinion of the CO, the company or profit center would be entitled to receive under an advance agreement. Written notification of the CO's determination of a reduced amount shall be provided the contractor. In the event that an advance agreement is not reached before the end of the contractor's fiscal year for which the agreement is to apply, negotiations shall immediately be terminated, and the CO shall furnish a determination of the reduced amount.

(vi) Contractors may appeal decisions of the CO to reduce payment. The appeal shall be filed with the CO within 30 days of receipt of the CO's determination.

(2) Companies not required to negotiate advance agreements. Costs for IR&D and B&P are allowable as indirect expenses on contracts to the extent that those costs are allocable and reasonable.

(d) Deferred IR&D and B&P costs. When appropriate, an agreement may be negotiated between the contractor and the CO to establish the amounts of IR&D and B&P costs incurred in previous accounting periods that will be allowable.

8.19 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. 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

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- 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 allowable 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 by the CO.
- (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 8.6).
- (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) above) 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)(3)(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 USC 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. 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.

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- (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) above.
- (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.

8.20 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 the preparation of prospectuses, costs of preparation and issuance of stock rights, and directly associated costs are unallowable except for interest assessed by State or local taxing authorities under the conditions specified in 8.41 (but see 8.28).

8.21 Labor Relations Costs.

(a) Costs incurred in maintaining satisfactory relations between the contractor and its employees (other than those made unallowable in paragraph (b) of this section), including costs of shop stewards, labor management committees, employee publications, and other related activities, are allowable.

(b) As required by Executive Order 13494, Economy in Government Contracting, costs of any activities undertaken to persuade employees, of any entity, to exercise or not to exercise, or concerning the manner of exercising, the right to organize and bargain collectively through representatives of the employees' own choosing are unallowable. Examples of unallowable costs under this paragraph include, but are not limited to, the costs of--(1) Preparing and distributing materials; (2) Hiring or consulting legal counsel or consultants; (3) Meetings (including paying the salaries of the attendees at meetings held for this purpose); and (4) Planning or conducting activities by managers, supervisors, or union representatives during work hours.

8.22 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,

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

(6) Costs incurred in attempting to improperly influence (see Part 3.5), either directly or indirectly, an employee or officer of the Executive branch 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) above:

(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) above 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 (see 14.17) 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 the subsection.

8.23 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.

8.24 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 8.11):

(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.

(b) Expenditures for plant and equipment, including rehabilitation which should be capitalized and subjected to depreciation, are allowable only on a depreciation basis.

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8.25 Manufacturing and Production Engineering Costs.

Costs of manufacturing and production engineering, including engineering activities in connection with the following, are allowable:

- (a) Current manufacturing processes -- Methods analysis, job analysis, motion and time study, and tool design and improvement.
- (b) Current production problems -- Materials analysis for production suitability and component design for simplifying production.

8.26 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, and may include such collateral items as inbound transportation and in-transit 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 inspection and correction of defective work). These costs are allowable, subject to the provisions of (b) through (e) below.

(b) Costs of material shall be adjusted for income and other credits, including trade discounts, refunds, rebates, allowances, 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 should be charged to the contract. If material is issued from stores, any generally recognized method of pricing is acceptable if that method is consistently applied and the results are equitable. When estimates of future materials 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 sold or transferred between any divisions, 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 price --

- (1) Is, or is based on, an "established catalog or market price of commercial items sold in substantial quantities to the general public", or
- (2) Is the result of "adequate price competition" and is the price at which an award was made to the affiliated organization after obtaining quotations on an equal basis from such organization and one or more outside sources which produce the item or its equivalent in significant quantity.
- (3) Provided that either subparagraphs (1) or (2) above apply only when --
 - (i) The price is not in excess of the transferor's current sales price to the most favored customer (including any division, subsidiary or affiliate of the contractor under a common control) for a like quantity under comparable conditions; and
 - (ii) The CO has not determined the price to be unreasonable.

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(f) The price determined in accordance with paragraph (e)(1) above and Part 12.5.4 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.

8.27 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 counselors, 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 8.6. These activities include acquiring stock for (1) executive bonuses, (2) employee savings plans, and (3) employee stock ownership plans.

8.28 Other Business Expenses.

The following types of 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.

8.29 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.

8.30 Patent Costs.

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

- (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.

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(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 are allowable.

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

8.31 Reserved.

8.32 Precontract Costs.

Precontract costs are those incurred prior to the effective date of the contract directly pursuant to the negotiation and in anticipation of the contract award when 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.

8.33 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 8.30].

(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.
- (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 CO 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

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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 8.38(g).] 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.

8.34 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;

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

(6) Includes color (in publications).

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(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.

8.35 Relocation Costs.

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

(1) Cost of travel of the employee and members of the immediate family (see 8.46) 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 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 subparagraph (a)(4) below 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) above, 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) above must also meet the following criteria to be considered allowable:

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

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(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 this Appendix.

(4) Amounts to be reimbursed shall not exceed the employee's actual expenses, except that for miscellaneous costs of the type discussed in subparagraph (a)(5) above, 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 nonequity 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) above, 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 principal 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) above. 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 requirement of paragraph (d).

8.36 Rental Costs.

(a) This subsection is applicable to the cost of renting or leasing real or personal property, except ADPE, acquired under "operating leases" as defined in Statement of Financial Accounting Standards No. 13 (FAS-13), Accounting for Leases. Compliance with 8.11(m) requires assets acquired by means of capital leases, as defined in FAS-13 shall be treated as purchased assets.

(b) The following costs are allowable:

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- (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 nor duplicate any other allowed 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 subparagraph (b)(1) above.

(4) Reserved.

(c) The allowability of rental costs under unexpired leases in connection with terminations is treated in 8.42(e).

8.37 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 to satisfy contract obligations are allowable unless--

- (1) The Government has a license or the right to a free use of the patent;
- (2) The patent is invalid due to adjudication or administrative determination;
- (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 award of the contract.

(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.

8.38 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 8. 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 8.1(b) and are subject to the allowability provisions of 8.1(d) and (f). Corporate image enhancement activities are included within the definitions of public relations at 8.1(a) and entertainment at 8.14, and are subject to the allowability provisions at 8.1(e) and (f) and 8.14, respectively. Bid and proposal costs are defined at 8.18 and have their

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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 8.12. Other market planning costs are allowable to the extent that they are reasonable. 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) Reserved.

(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 8.6 and 48 CFR 9904.405, 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, and 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.

8.39 Service and Warranty Costs.

Service and warranty costs incurred in fulfilling any contractual obligation are allowable when not inconsistent with the terms of the contract. However, care should be taken to avoid duplication of the allowance as an element of both risk and estimated product cost.

8.40 Special Tooling and Special Test Equipment Costs.

(a) The cost of special tooling and special test equipment is allowable and shall be allocated to the Government contracts for which acquired, except that the cost of items acquired by the contractor prior to the effective date of the contract (or replacement of such items), whether or not altered or adapted for the contract, and items which the contract schedule specifically excludes shall be allowable only as depreciation or amortization.

(b) When items are disqualified as special tooling or special test equipment because with minor expense they can be made suitable for general purpose use and have a value as such commensurate with their value as special tooling or test equipment, the cost of adapting the items for use under the contract and the cost of returning them to their prior configuration are allowable.

8.41 Taxes.

(a) The following types of costs are allowable:

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(1) Federal, State and local taxes, except as otherwise provided in paragraph (b) below 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 subparagraph (a)(1) above, but upon which a claim of illegality or erroneous assessment exists; provided the contractor, before paying such taxes -

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

(ii) Takes all action directed by the CO arising out of subparagraph (2)(i) above 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) The reasonable cost of any action taken by the contractor at the direction or with the concurrence of the CO. Interest or penalties incurred by the contractor for non-payment of any tax at the direction of the CO or by reason of the failure of the CO to insure timely direction after a prompt request.

(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.

(3) Taxes from which exemptions are available to the contractor directly or based on an exemption afforded the Government, except when the CO 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 assure that any 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) below).

(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 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.

(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.

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8.42 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 are to be used in conjunction with the others in this Appendix:

(a) Common items. The cost 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 CO 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.

(b) Costs continuing after termination. 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 negligence 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 are nonrecurring labor, material, and related overhead costs that are incurred in the early part of production and result from factors such as --

- (i) Excessive spoilage due to inexperienced labor;
- (ii) Idle time and lower-than-expected production due to testing and changing production methods;
- (iii) Training; and
- (iv) Lack of familiarity or experience with the product, materials, or processes.

(2) Preparatory costs 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 the 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 prior to termination; however, if the contract includes end items of a diverse nature, some other equitable basis may be used, such as machine or labor hours.

(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 CO; 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 the which the special tooling, or special machinery and equipment was acquired.

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(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 the performance of 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 CO; 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 as 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 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. The indirect expense so allocated shall exclude costs claimed directly or indirectly as settlement expenses.

8.43 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 principal 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 8.46); 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, convention, symposium, etc.

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8.44 Training and Education 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, 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, instructor's 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.
- (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, 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 8.11, 8.17, 8.24, and 8.36.
- (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. (1) Training and education costs in excess of those otherwise allowable under (c) and (d) of this subsection, including subsistence, salaries, or any other emoluments, may be allowed to the extent set forth in an advance agreement negotiated under Section 1. To be considered for an advance agreement, the contractor must demonstrate that the costs are consistently incurred under an established managerial, engineering, or scientific

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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. Before entering into the advance agreement, the CO shall give consideration to such factors as --

- (i) The length of employees' service with the contractor;
 - (ii) Employees' past performance and potential;
 - (iii) Whether employees are in formal development programs; and
 - (iv) The total number of participating employees.
- (2) Any advance agreement must include a provision requiring the contractor to refund to the Government training and education costs for employees who resign within 12 months of completion of such training or education for reasons within an employee's control.

(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, except that the costs incurred for educating employee dependents (primary and secondary level studies) when the employee is working in a foreign country where public education is not available and where suitable private education is inordinately expensive may be included in overseas differential.

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

8.45 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.

8.46 Travel Costs.

- (a)
- (1) Costs for transportation, lodging, meals, and incidental expenses incurred by contractor personnel on official company business are allowable subject to the limitation contained in this subsection. 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 subparagraph (a)(3) of this subsection, costs incurred for lodging, meals, and incidental expenses (as defined in the regulations cited in (a)(2)(i) through (iii) of this subparagraph) 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, U.S. Government Printing Office, Washington, DC 20402, Stock No. 022-001-81003-7;
 - (ii) Joint Travel Regulations, 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 on a subscription basis from the Superintendent of Documents, U. S. Government Printing Office, Washington, DC 20402, Stock No. 908-010-00000-1; or

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- (iii) Standardized Regulations (Government Civilians, Foreign Areas), section 925, "Maximum Travel Per Diem Allowances of Foreign Areas," prescribed by the Department of State, for travel in areas not covered in (a)(2)(i) and(ii) of this paragraph, available on a subscription basis from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, Stock No. 744-088-00000-0.
- (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), (ii), or (iii) 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 referenced in (a)(2)(i), (ii), or (iii) 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 CO.
 - (iv) Documentation to support actual costs incurred shall be in accordance with the contractor's established practices provided that a receipt is required for each expenditure of \$75.00 or more. The approved justification required by (a)(3)(ii) and, if applicable, (a)(3)(iii) of this subsection must be retained.
- (4) Subparagraphs (a)(2) and (a)(3) of this subsection do not incorporate the regulations cited in (a)(2)(i), (ii), and (iii) in their entirety. Only the maximum per diem rates, the definitions of lodging, meals and incidental expenses, and the regulatory coverage dealing with specific or unusual situations are incorporated herein.
- (5) An advance agreement (see Section 1) with respect to compliance with subparagraphs (a)(2) and (a)(3) of this subsection may be useful and desirable.
- (6) The maximum per diem rates referenced in subparagraph (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.

(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. However, in order for airfare costs in excess of the above standard airfare to be

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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, or condition, or a higher amount is approved by the CO. 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 subparagraph (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 point 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 Section 1), 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 8.6(m)(2).

8.47 Defense of Fraud Proceedings.

(a) Definitions.

"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 bear a direct relationship to the proceedings.

"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.

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"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 employers) 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 or imposition of a monetary penalty;
- (3) A final decision by an appropriate official of an executive agency 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 subparagraphs (b)(1) through (3) of this subsection (but see paragraphs (c) and (d) of this subsection); or
- (5) Not covered by subparagraphs (b)(1) through (4) of the 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 subparagraphs (b)(1) through (4) of this subsection.

(c) 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.

(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 CO 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 CO.

(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 the 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%. However, if an agreement reached under paragraph (c) of this subsection has explicitly considered this 80% rule, then the full amount of costs resulting from that agreement shall be allowable.

(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 Government.
- (2) Organization, reorganization, (including mergers and acquisitions) or resisting mergers and acquisitions.
- (3) Defense of antitrust suits.

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(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 (1) an agreement or contract concerning a teaming arrangement, a joint venture, or similar arrangement of shared interest, or (2) dual sourcing, co-production, or similar programs, are unallowable, except when (i) incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the CO, or (ii) when agreed to in writing by the CO.

(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 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 CO.

(g) Costs which may be unallowable under 8.47, including directly associated costs, shall be segregated and accounted for by the contractor separately. During the pendency of any proceeding covered by paragraph (b) and subparagraphs (f)(4) and (f)(7) of this subsection, the CO shall generally withhold payment of such costs. However, if in the best interests of the Government, the CO may provide for conditional payment upon provision of adequate security, 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.

8.48 Deferred Research and Development Costs.

"Research and development" means the type of technical effort which is described in 8.18 but which is sponsored by, or required in performance of, a contract or grant. Research and development costs (including amounts capitalized that were incurred before the award of a particular contract) are unallowable except when allowable as precontract costs. In addition, when costs are incurred in excess of either the price of a contract or amount of a grant for research and development effort, such excess may not be allocated as a cost to any other Government contract.

8.49 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.

8.50 Reserved.

8.51 Costs of Alcoholic Beverages.

Costs of alcoholic beverages are unallowable.