

**UNIFORM CONTRACTS AND COST
ACCOUNTING DEFINITIONS AND
METHODS: RECOMMENDATIONS
BY INTERDEPARTMENTAL
CONFERENCE; JULY, 1917**

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Uniform Contracts and Cost Accounting Definitions and Methods

RECOMMENDATIONS BY
INTERDEPARTMENTAL CONFERENCE
CONSISTING OF
DELEGATES FROM THE DEPARTMENTS OF WAR,
NAVY, AND COMMERCE, THE FEDERAL TRADE
COMMISSION, AND THE COUNCIL OF NATIONAL
DEFENSE

▽

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WASHINGTON, D. C., July 31, 1917.

The following recommendations on contracts and costs have been approved for submission to the departments of the Government by an interdepartmental conference composed of the following members:

DEPARTMENT OF COMMERCE.

Chairman: Mr. J. LEE NICHOLSON, Chief of Division of Cost Accounting, Bureau of Foreign and Domestic Commerce.

Mr. BURWELL S. CUTLER, Acting Chief, Bureau of Foreign and Domestic Commerce.

DEPARTMENT OF WAR.

Maj. Gen. H. G. SHARPE, Quartermaster General.

Col. I. W. LITTELL, Office of the Quartermaster General.

Lieut. Col. H. M. LORD, Office of the Quartermaster General.

Maj. WILLIAM KELLY, Office of Chief Engineer.

Lieut. Col. J. E. HOFFER, Ordnance Department, Gun Division.

Maj. L. W. BLYTHE, U. S. R., Ordnance Department, Cost Accounting Section, Finance Division.

Capt. A. M. HOLCOMBE, U. S. R., Ordnance Department, Small Arms Division.

Capt. A. P. OSBORN, U. S. R., Ordnance Department, Legal Section, Finance Division.

Capt. E. A. HAMILTON, U. S. R., Ordnance Department, Purchase and Contracts Section, Gun Division.

Capt. E. A. SHEPARD, U. S. R., Ordnance Department, Small Arms Division.

Capt. A. E. DOWNEY, U. S. R., Signal Corps.

DEPARTMENT OF THE NAVY.

Naval Constructor J. H. LINNARD, Bureau of Construction and Repair.

Pay Inspector DAVID POTTER, Compensation Board.

Paymaster G. P. AULD, Bureau of Supplies and Accounts.

Civil Engineer C. D. THURBER, Bureau of Yards and Docks.

Lieut. H. T. DYER, Bureau of Steam Engineering.

Lieut. N. W. PICKERING, Bureau of Ordnance.

Mr. C. S. ASHDOWN, Bureau of Supplies and Accounts.

FEDERAL TRADE COMMISSION.

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COUNCIL OF NATIONAL DEFENSE.

Mr. W. S. GEE, Aircraft Production Board.

Mr. R. L. MONTGOMERY, Aircraft Production Board.

Mr. J. H. HARRIS, Legal Committee, Aircraft Production Board.

COUNCIL OF NATIONAL DEFENSE—WAR INDUSTRIES BOARD.

Mr. J. E. STERRETT, Accountancy Committee.

Mr. A. W. TEELE, Accountancy Committee.

Mr. H. A. NILES, Accountancy Committee.

Secretary: Mr. H. P. SEIDEMANN, Institute for Government Research.

UNIFORM CONTRACTS AND COST ACCOUNTING DEFINITIONS AND METHODS.

RECOMMENDATIONS ON CONTRACTS.

These recommendations are intended to suggest to contracting officers some of the broad legal and equitable points involved in war contracts, and to express the preference of the conference for a straight purchase-and-sale contract at a fixed price, since it is simpler in terms, easier to work under, and generally speaking, productive of better and quicker results. The British Government, after several years' experience, has discarded the cost-plus contract plan and adopted the straight purchase-and-sale contract in every instance possible. It is not proposed to go into the large question of policy involved in attempting to prevent demoralization of markets by excessive competition. Suffice it to say, that the Government can furnish material and component parts under either a fixed-price or a cost-plus contract, and thus protect market conditions by purchases in bulk.

Recommendations and brief discussion follow:

I. It is recommended that, in every instance where fair terms can be obtained, contracts should be in the form of straight purchase-and-sale contracts at fixed prices.

In the determination of "fair terms" for fixed price contracts, the contractor, in so far as possible, should be required to state the cost and other factors upon which his price is based; such representations to be the subject of investigation by the contracting officer prior to the final execution of the contract, and if found to be incorrect, the price to be adjusted accordingly.

What constitutes "fair terms" can be arrived at only by consideration of many factors, such as:

- (1) The quality and quantity of the articles purchased.
- (2) Whether or not the plant is adaptable to business other than war business.
- (3) The duration of the job and the length of time the contractor's plant and capital will be tied up. Also the amount of capital tied up in comparison with the particular output contracted for.
- (4) The possibility of fluctuations in material and labor costs with attendant risk to the contractor.
- (5) Loss in commercial business by taking Government work, which must be given precedence; disarrangement in plant organization and labor conditions.

(6) Comparison with prices of other manufacturers, competitive bidding, etc.

(7) The prosperity of the trade and of the particular contractor.

In certain instances where the article is standard, ordered in bulk, deliverable promptly, a profit amounting to 10 per cent of costs is unreasonably high. In other instances where the quality of the job is high, the quantity small, or where the job ties up the contractor's plant and capital for a long period of time, or where the material and labor risk is considerable, or for other similar reasons, such 10 per cent profit may well be unreasonably low.

Again, in agreeing upon "fair terms" the following factors should be considered, any or all of which greatly aid the contractor and should tend to lower the price.

(1) United States to supply material or component parts.

(2) United States to readjust price in the event of fluctuations in price of material or component parts resulting in increased costs.

(3) United States to readjust price in the event of labor disputes resulting in increased labor costs.

(4) United States to make frequent payments to reimburse the contractor for expenditures for material, component parts, or the like.

To skimp fair terms will inevitably tend to cause contractors to lose interest in production and disturb general business conditions. Fair terms can only be determined by consideration of these general principles as well as the special factors indicated above that may apply to the particular production contracted for.

II. It is recommended that a standard form of straight purchase-and-sale contract at a fixed price be adopted for use wherever practicable. It should contain clauses which will deal with the following subjects:

(1) Method of delivery; storage of production; shipment to point designated.

(2) United States to pay for raw material when delivered to contractor.

(3) United States to have the right itself to supply material and component parts.

(4) United States to adjust price on increased material costs above estimated costs.

(5) United States to adjust price on increase in labor costs.

(6) Liquidated damages.

(7) War clause termination.

Although a straight purchase-and-sale contract for a fixed price adjusted as indicated is greatly to be preferred, nevertheless in numerous instances the United States will be obliged to obtain pro-

duction by paying for the entire cost of the same and in addition a fair profit to the contractor. Such cost-plus contract may be necessary under the following conditions:

(1) Where the production is novel and the contractor has had no past experience upon which to base a price; for example, steel helmets, large caliber guns and shells for same, aeroplane motors, and the like.

(2) Where the production involves difficult and complicated manufacturing effort subject to changing plans and specifications, or wide fluctuations in material costs; for example, steel and wooden ships, aeroplanes, optical glasswork, and the like.

(3) Where the contractor, though deserving of confidence, lacks sufficient working capital and plant equipment to carry through the job.

(4) Engineering or building jobs for which the cost-plus contract has for many years been standard.

It must be borne in mind that a cost-plus contract establishes a relation of trust between the United States and the contractor, in which the contractor is legally responsible at all times to work in the interest of the United States and receive no profit beyond that definitely specified in his contract. For all excessive costs, hidden profits in the form of depreciation, overhead, discounts, and the like, the United States may refuse to pay, or if the contractor has thereby profited may sue and recover. Practically, however, the interests of the United States and the contractor are inevitably opposed if the profit is based upon a percentage of cost. The temptation is great to the contractor to inflate his own costs, as well as the costs of subcontractors, and the task of the United States is difficult and burdensome in checking and determining proper costs.

III. It is recommended that in cost-plus contracts a fixed profit of a definite sum of money per article be agreed upon instead of a percentage of cost.

Such fixed profit can be arrived at by taking a percentage, say 10 per cent, of the estimated cost of each article or the entire job. In instances where estimates of cost are impracticable it becomes of paramount importance to choose a contractor in whose integrity the United States may have the fullest confidence. Where a fairly close estimate can be made of the cost of the article or job, upon the completion of the contract, the actual cost can be checked against the agreed estimate and the contractor permitted to share in the saving, or be charged with part of the excess of cost, depending upon the outcome. Such an arrangement stimulates the contractor to save costs and time, because the two go together. This cost-plus adjustable fixed-profit contract unquestionably affords the Gov-

ernment the greatest protection in cost-plus contracts. Great care should be used in fixing the estimated price, which, if too high, may result in giving the contractor a profit entirely undeserved.

IV. It is recommended that in cost-plus contracts the fixed profit agreed on be subject to adjustment, so that the contractor may share in the saving of, or be charged with part of the excess of, actual cost over estimated cost.

In some instances the contractor may agree to pay for all excess over a certain named figure of cost, and the advantage to the United States in such an arrangement is too obvious for comment.

In the determination of costs, direct labor and direct material are easily ascertainable; it is the indirect charges to the job, overhead and depreciation, that present difficulties. To contract to pay a proper charge for overhead and depreciation leaves the door wide open for endless discussion, and it is suggested that wherever possible the amount of these items be tentatively fixed in advance, based on definite representations of the contractor as to the amount of fixed capital assets to be depreciated and the estimated overhead. Such amounts should always be subject to revision in case such representations prove to be incorrect. This puts it up to the contractor to make an honest representation and provides ample opportunity to check the same. It is of the utmost importance that standardized forms of contract as well as standardized methods of determining costs be applied to this class of contracts. Such standardization will produce clarity in the relation between the contractor and the United States and will fix precedents of construction for certain clauses and terms. Standardization will also afford great protection to the United States, not alone presently in determining points of difference but also in Court of Claims suits that may arise.

V. It is recommended that a standard form of cost-plus contract be adopted for use wherever practicable. As conditions necessitate changes, the form of such standard contract can be changed to suit.

SUMMARY OF RECOMMENDATIONS.*

I. It is recommended that in every instance where fair terms can be obtained, contracts should be in the form of straight purchase-and-sale contracts at fixed prices.

II. It is recommended that a standard form of straight purchase-and-sale contract at a fixed price be adopted for use wherever practicable containing special war clauses.

III. It is recommended that in cost-plus contracts a fixed profit of a definite sum of money per article be agreed upon instead of a percentage of cost.

* Standard forms of cost-plus and fixed-price contracts will be found in the appendix.

IV. It is recommended that in cost-plus contracts the fixed profit agreed on be subject to adjustment, so that the contractors may share in the saving of, or be charged with part of the excess of, actual cost over estimated cost.

V. It is recommended that a standard form of cost-plus contract be adopted for use wherever practicable.

RECOMMENDATIONS ON COST-ACCOUNTING METHODS.

The chief purpose of these recommendations is to assist the purchasing departments of the Government, and manufacturers and contractors who are contracting on a "cost-plus profit" plan, or on a "fixed-price" plan, in which the price is to be determined after an investigation of costs.

The recommendations are intended to be of a suggestive nature, and should be used wherever the contract or rules issued in connection therewith do not give full information on costs.

It is hoped that the information contained herein may materially assist all engaged in verifying costs for the Government, and also point out to the contractors what elements to use as costs and how to summarize and present the costs to the Government inspectors.

GENERAL DEFINITION OF COSTS.

It is recommended that the following general definition of costs be included as part of the contracts, subject to such interpretation as may be outlined by the contracting or accounting officers:

Cost, as used herein, is defined as follows:

(1) Cost of material and supplies definitely ascertainable as entering into or expended in the production of the articles contracted for hereunder.

(2) Cost of all direct labor definitely ascertainable as employed in the production of the articles contracted for hereunder.

(3) A fair proportion of overhead expenses. By the term "overhead expenses" is meant the indirect labor and other manufacturing expenses, and the general and administrative expenses applicable to and necessary in connection with the production of the articles contracted for hereunder. It does not include (among other items) the following: Interest, rent, advertising, collection expenses, credit losses and customers' discounts, and such taxes as income and excess profits taxes imposed by the United States Government. [Interest, rent, and selling expenses will not be allowed as part of overhead cost, but may be the subject of special compensation when so stipulated in the contract.]

Note.—Notwithstanding the foregoing, charges may be made "direct" or as "overhead" in accordance with the usual methods of cost keeping adopted by the contractor, provided that charges are not made "direct" in Government work, when similar charges for other work done by the contractor are made as "overhead."