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AUDITS UNDER TERMINATED WAR CONTRACTS

Contract Termination from the Navy Viewpoint

War Contract Terminations

Independent Public Accountants and Termination Settlements

Treatment of Initial Expenses on Termination of Fixed-
Price Supply Contracts

Treatment of Specific Expenses, other than Initial Expenses,
upon Termination of Contracts

PROCEEDINGS OF THE TECHNICAL SESSION ON
WAR CONTRACT TERMINATION PROBLEMS
FIFTY-SIXTH ANNUAL MEETING OF THE
AMERICAN INSTITUTE OF ACCOUNTANTS

October 20, 1943

*Preprinted from "Accounting Problems in War Contract
Termination, Taxes, and Postwar Planning"—1943*

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FOREWORD

The 56th annual meeting of the American Institute of Accountants, held in New York on October 19, 20, and 21, 1943, devoted its open session of the afternoon of October 20th to the subject of "War Contract Termination Problems." The program was planned to deal principally with the problems of accounting and of accountants in the termination procedures. It had, as its foundation, Procurement Regulation No. 15 and the Termination Accounting Manual, both of which had recently been published by the War Department. Taken together, those documents were believed to be sufficiently indicative of departmental policy to warrant professional accounting consideration of them.

On September 20, 1943, the Comptroller General requested of Congress the right to approve all termination settlements before they became final. If his request were to be granted, the procedures and policies set forth in the manuals would be altered materially. If Congress should grant the request the regulations of the War Department will undoubtedly be affected materially. That question was still unsettled at October 20, 1943, the day of the meeting, and is still unsettled as this goes to press.

In spite of the uncertainty created by the request of the Comptroller General, it was decided to go ahead with the program as originally planned because it was believed that adoption of the policy requested by the Comptroller General would serve to increase the importance of accounting in the termination settlements. A program based originally on such a minimum of auditing and examination as might be appropriate in the circumstances would be even more helpful if the accounting and auditing were to be increased. The same considerations prompt the issuance of the proceedings of that session in advance of the full report of the annual meeting. It is believed that whatever action is taken on the request of the Comptroller General the proceedings herein published will be helpful to all accountants, particularly the independent public accountant, and to others interested in the accounting and auditing phases of termination.

This pamphlet is published, also, in partial recognition of the promise made by the Institute to the War Department that it would do what it could to inform its members and other accountants about termination procedures, not only because of the possible participation of accountants in some phases, but because of the certainty that accountants would be called upon to explain and advise business on the accounting problems. Other information will be published from time to time.

The Institute has felt an obligation to make known its views on those phases of termination on which the training and experience of its members particularly qualifies it to speak. It has appeared, by request, before the Senate subcommittee of the Committee on Military Affairs to express its views on certain broad questions inherent in and engendered by the request of the Comptroller General. A resolution of council of the American Institute of Accountants on the subject, which was presented to the Senate subcommittee, is included herein. The undersigned committee has from time to time presented to the departments recommendations on policies and procedures. Current recommendations are reported herein, page 32.

The papers presented by Messrs. Jones, Queenan, and Dennis should be helpful to accountants. The release of the Institute's committee on auditing procedure relating to the participation of independent public accountants in termination matters should be available for publication within the near future. Reproductions of Procurement Regulation No. 15 and the Termination Accounting Manual have been sent to all members of the Institute, and both have been discussed in *The Journal of Accountancy* by George N. Farrand, secretary of the undersigned committee and a member of the research staff of the Institute. Last, but not least, the editorial in *The Journal of Accountancy* in November, dealing with the request of the Comptroller General, is believed to be a significant contribution to the discussion of the subject, and it is included herein.

Respectfully submitted,

COMMITTEE ON TERMINATION OF WAR CONTRACTS

GEORGE D. BAILEY, *Chairman*
SAMUEL J. BROAD
JOHN B. INGLIS
CHARLES W. JONES
DONALD M. RUSSELL

Remarks of the Chairman

GEORGE D. BAILEY

WE START OUT this afternoon on a subject which is not only vital for the future of business, but which at the moment seems to be particularly "hot." It has certain elements of delicacy about it that have required the holding of the program until the last minute before it could be finally frozen.

We have been unfortunate in one respect—in having received word yesterday that Colonel Houston, who has been chief of the Contract Termination Branch of the War Department, would be unable to be present. Colonel Houston, as some of you may have noticed in the papers, has been temporarily transferred to OPA on a very special assignment. Those of us who have watched his work in the War Department in dealing with this termination problem regret that transfer very much but, like all things of that kind, the finished product is never the product of one person, and we have no doubt that his successors will carry on with the same general policies and equal vigor.

Colonel Houston would have been particularly helpful in one way because he has been in the field a good deal discussing problems with business and he talks somewhat from the business standpoint, and is quite reassuring. However, at the time we got the word, it was too late for the Army to send a substitute.

The current controversy in Washington, or the delicacy of the present situation, is that in connection with the request of the Comptroller General that his General Accounting Office be given authority to approve all contract termination settlements before they become final, regardless of whether there was fraud involved or otherwise. There seems to be some controversy, I believe, as to whether that really is an extension of authority but, regardless of that, the

matter is before Congress for a determination of just what should be the function of the Comptroller General and his office in this whole problem of contract termination.

You will hear something about that today, but first let me pay my respects to it in a little different fashion. The problem really does not affect this particular program this afternoon. We are dealing with the accounting phases of termination generally, the place of the public accountant and some of the accounting points. We will deal later on with the recommendations of the Institute with regard to some of the termination problems.

If the general accounting office is successful in its request for authority over termination settlements, such authority will not reduce the accounting work but will tremendously increase it. The accounting problems involved will increase. This program has been laid out today on the basis of the minimum accounting that had seemed possible to the Army. Therefore, any change will be a change for greater accounting and give even greater importance to the things which are to be discussed today.

I have talked as if the Army were reasonably important on this termination problem, and they are, of course, but the Army, after all, is only one service. The Navy is involved, to mention only one other, and when we had word of Colonel Houston's inability to be here, Commander J. Harold Stewart, whom most of you know, agreed to step into the breach and talk informally for a short time.

Commander Stewart is the executive assistant to the head of the Cost Inspection Service in the Navy Department. Cost Inspection Service performs the audit functions of the Navy, except for

price adjustment matters. Contract audits are all in the hands of this Cost Inspection Service. Commander Stewart was formerly a practicing accountant in Boston, head of his own firm of Stewart, Watts & Bollong. He is at present a member of the council, and has been active for many years in Institute work,

particularly the committee on auditing procedure.

We are very fortunate indeed to have Commander Stewart willing to step in without notice and talk from his knowledge of this problem as he sees it from his point of vantage in the Navy Department. Commander Stewart—

War Contract Termination from the Viewpoint of the Navy Department

BY COMMANDER J. H. STEWART

I FIND myself once again rattling around in a rather large pair of boots. George Bailey very well described the situation when he said I was standing in the breach, and how wide that breach is you will know better after I am through.

The usual protection which one affords himself in a talk of this kind is to say that he is speaking from his own personal observation and the remarks do not reflect, necessarily, the views of the Navy, and I think in discussing this subject I will need all the protection I can get.

The problem is probably the most important and thought-provoking that the war agencies are concerned with at the moment. The philosophy which will be applied to it is going to be all-important in determining the role of the public accountant in war contract termination. Certainly, I do not have to indicate more than briefly that the public accountant is going to be one of the supports on which the services will have to rely in order to get contracts terminated seasonably. However, it seems to me that there has been over-emphasis put on the accounting features of termination. It is going to be tremendously important and there will be more accounting work to do than there will be people to do it, even though it be reduced to a bare minimum. However,

as I see it, contract termination is procurement in reverse, and why you should apply a more meticulous measure to a contract termination than you did to the original procurement is not exactly clear. Possibly it might be justified on the ground that a gauge is available, but that I question. After reviewing several large terminations and cancellations, I still believe that unless these matters are cleaned up on a negotiated basis, we won't live long enough to see the end of them. Also, it seems as though contracts will be disposed of, the bulk of them, in one of two ways—either by negotiation or in the court of claims.

The possibilities of settlement under a formula do not appear to be very bright. Imagine yourself in the place of a contractor who has been unable to negotiate and the contracting officer who likewise has been unwilling to trade. They are presumably going to have difficulty agreeing on a formula, or to the application of certain principles to the formula, which means that the contractor will take the only other course which is open to him—suit in the court of claims.

The essence of a successful termination is speed. It seems to me a great deal more important to get reasonable justice speedily than meticulous justice slowly. We can paint the termination

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picture with a brush a foot wide or we can paint with a brush a sixteenth of an inch wide. I leave it to you to determine which you would rather use, and you might have some ideas as to which brush the Comptroller General would use were the responsibility his.

A principal sufferer from delay will be labor. If you don't get money promptly, you don't meet your payrolls. As far as the larger industries of the country are concerned, the larger corporations, they can probably take care of themselves. As for the small manufacturer, with, we will say, fewer than five hundred people, it is going to be terribly important to him to get his money speedily, because he has no national reputation to support him, his credit standing may be precarious, and he may have a much more serious labor problem due to his lack of diversity.

The accounting features of contract termination, even though they be subordinate, will be serious. One of the most bothersome problems will be the settlement and determination of subcontractors' claims. Unless the prime contractor can make a trade with a subcontractor with some reasonable assurance that the trade will stick when he comes around to collect his money from the contracting agency, there won't be very many trades made speedily.

As far as the Army and Navy are concerned, their philosophy in this matter is, I think, pretty much the same. You have about the same sort of people directing the accounting thought in both agencies. There is no substantial difference today in their concept of cost. I think you have already some idea as to the kind of accounting philosophy which will be applied to terminations if they are handled by the war agencies. If they are handled by the Comptroller General, I think you might well do some thinking as to the philosophy that might be applied in that case.

This quarrel, we will call it, or controversy with the Comptroller General,

is not a controversy between the executive agencies and the Comptroller. The really interested party is industry, and it would be a pity if in emotion something was done which strangled industry. You might ask yourselves several questions in connection with it, because it seems to me that at this juncture there can be more done by giving serious thought to this impasse with the Comptroller and the war agencies than in any other particular direction. People have been writing and discussing, publicly and privately, contract terminations for about a year now. At this particular moment, something concrete can be done, and that is examine the situation dispassionately and if you believe that one course or the other is the desirable one, I think you as accountants should be heard, and industry likewise should be heard.

First of all, you might consider whether you think the Comptroller has the personnel to do the job speedily. As I understand it, the Comptroller says if he is given funds he can get personnel, and you might have some opinions as to whether or not he can get it, that is, within the limits of Civil Service salaries.

The considerations which will be uppermost in negotiating a contract termination settlement will be technical considerations. In the terminations which I have had a chance to observe, one of the biggest obstacles to speed has been the difficulty of getting speedy technical terminations. You might ask yourselves whether you believe the Comptroller is equipped, or can be equipped to pass upon the technical features of contract termination, he not having been a party of the original procurement. You might also ask yourselves as to whether, if you were a contractor, you would prefer to make your negotiated settlement with the agency which made the contract in the first place, or whether you would rather deal with a person who was detached from

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the original negotiation, and even the operations under the contract.

You may have read recently of some of the Comptroller's accomplishments in saving government funds through calling Congress's attention and the services' attention to purchase of false teeth, and some other things. I only ask this, that you look at that matter from this standpoint: As a practical matter, in auditing you can only apply a screen of a certain size. If you want a screen that is meticulous, which will catch every one of those things down to the last dollar, you can have it, but you will have to take with it the delays and the impediment to business which it will entail.

We can lose billions of dollars through delay in getting into production when this war is over. Every week that a termination is delayed is expensive to the government, not only with respect to that termination, but with respect to the loss of productive activity of war contractors. For instance, the automobile people will be very anxious to get back into production and get some of their automobiles in the hands of people while they still have money, and unless the war agencies can tell them promptly what to do with the masses of materials in their plants, they are stopped.

Perhaps the Comptroller might take the position that he will not dabble with that phase of it; he will leave that to the war agencies, and he will review their action. Well, there again it means that for every subcontract settlement which you make, somebody has a second look at it, and I wonder how many of us have ever looked twice at anything and believed after the second look that we saw the identical thing which we saw in the first place.

The role of the accountant appears to be about as follows: He can assist in the preparation of accounting information which will be part of the basis for a negotiated settlement. I don't see how he can certify to very much. I don't

think it would be proper for him to do so, because his role will be to assist the contractor and the contracting officer in negotiating a settlement. It seems to me that what he should do is to make crystal clear the accounting implications of the facts and the figures which have been developed, so that when it is all over no one can accuse him of having sold someone a bill of goods.

I think the profession will have to be very watchful, as well, in the matter of professional ethics, because if we are to have rough justice in this matter in order to get speed, there may be the temptation for professional people to get fees which perhaps are not justified by the work which they have done.

I feel certain that the matter of professional fees will be reviewed, and I think when that day comes, we want the accounting profession to be able to stand a rather microscopic examination. You may observe that this is somewhat a disjointed discourse; it is somewhat like the Scotchman who was on his way from Edinburgh to London. He kept getting off the train about every station to buy a new ticket and thereafter getting on again. Somebody said to him, "Sandy, what's the idea? Why didn't you buy a through ticket and save money?"

"Well," he said, "I couldn't be sure. Before I left Edinburgh, I had an examination by a physician. He told me I had heart trouble and might die any minute."

Another direction in which the profession can help tremendously is in educating industry and the public. There is an educational campaign which must be conducted and the services cannot do it alone. Last week I heard one of the representatives of the Navy Department say that the real burden of contract termination is going to fall on industry. Up to now there has been a feeling that perhaps you could look toward the services or the government to do the entire job. That is impossible.

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There is another idea that there will be a day known as V day when folks will throw their hats in the air and the war will be over and the war agencies will begin terminating contracts. It does not appear as though it will work that way. In my opinion, contract termination is going to be a staggered affair. It is already started, and it will continue as the procurement needs of the several war agencies are adjusted to meet the changing war needs.

You may have wondered why the Navy Department has not yet issued a pronouncement or publication in respect to this matter of contract termination as the Army has. I think that is understood by those who are close to the picture, and I would just like to get it straight now. The Army was faced with a much more urgent situation, having I don't know how many contracting officers—I have been told 12,000 by some people, others say 20,000. In any case, in view of the larger number of contracting officers which the Army has and the terminations already effected, it was essential that it get instructions in the hands of its contracting officers and the public.

The Navy has not been faced with any such need because it is much smaller and the control is much more centralized. Speaking of centralized control, it is going to be absolutely necessary in the interest of speed that the control be decentralized and the people in the field be given a right to make final determinations in these settlements.

The Navy has been working with the Army, particularly the lawyers, in trying to evolve a uniform termination

clause. That work has been in process for over a year. It looks as though finally there is an agreement as to what a termination clause should embody, and I feel that before too long there will be a uniform clause which will be adopted by both the Army and the Navy. You may have seen the War Production Board's proposed clause. The principal criticism of that appears to have been that it included much that was administration, and I think you will agree that any attempt at that may put us all in a strait jacket.

The particular thought I would like to leave with you is whether or not you believe that the procurement attitude should be the proper one to be taken by the war agencies in terminating these contracts. Personally, I believe it is the only way we can get the job done. There may be a better way; possibly the Comptroller General has it. In what I have said to you I have tried to steer clear of formulating any opinion as to whether the Comptroller has the ability to do this job. You accountants have enough familiarity with contractors' experience and the Comptroller's setup in the General Accounting Office to form some judgment for yourselves. I think you should examine the situation carefully and, in my opinion, if you do examine it the conclusion which you will reach will be pretty clear.

In conclusion, it is all-important that the people most concerned, that is, the contractors and the laboring people of this country, make themselves heard now so that the bottleneck to industry, which can be worse than any we have seen, can be avoided.

CHAIRMAN BAILEY:

I think I will pick up the program for a moment to give you some background data. A little historical recital may be beneficial at this point.

It is only very recently that there has been any public evidence of what the termination policies of the services

might be. There was an issue in the spring of an accounting manual. It was issued for the use of the Ordnance Department, and was largely an Ordnance Department document. The Ordnance Department procedures for the guidance of its contracting officers were

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not made public. The result was that all of the ground rules relating to termination were uncertain, and business was being asked to prepare termination claims with little, if any, knowledge of what constituted proper allowances, or what were the ground rules for those claims. Perhaps I should use the term "proposed termination settlements" instead of claims. I understand that the word "claims" has some bad connotations. Nevertheless, around the first of August the War Department over-all termination accounting manual was issued, and about the same time Procurement Regulation No. 15 was issued. Procurement Regulation No. 15 contained the general policy instructions of Headquarters, Army Service Forces, on termination problems. It represented the War-Department policy and was the work, in part at least, of Colonel Houston, who was to have addressed us today. The termination accounting manuals were, to a very large extent, the work of members of the Institute who have given up their practice and are giving their entire time to the War Department; also, they were in part the result of extended interdepartmental conversations, so, as Commander Stewart said to you, there is no wide difference of opinion as to the basic principles between the two services. I am sure you were all glad to have that message from him.

We are not going to try today to cover the Termination Accounting Manual or PR 15. Each one would require at least a full afternoon by itself. The only satisfactory way the contents can be absorbed is to spend continuous time on the manuals and give them real study. Both of the manuals are comprehensive and, to the extent that seemed practicable, they go into detail.

There are a number of things, however, that we might touch on, because they will come back to plague us later on during the afternoon. First, let me explain what I believe to be the difference between the negotiated settlement

and the formula settlement. The theory, as it was developed within the services, as Commander Stewart said, was to reverse the procurement policy. At the same time it was realized that in reversing the procurement policy it was necessary to have a great deal more data for the handling of termination claims than was possible for the writing of the original contracts, partly because events had happened in the one case, and in the other case were still to happen. Perhaps basically that was the reason the services planned for investigations, decentralized investigations, by engineering people, production people, legal people, and accounting people. It was laid down that each case would be different and each case would have the kind of study that was dictated by the needs of that particular case, that there would be no elaborate system laid down to be followed in all cases, and that any contracting office could then take that advice gathered from all those sources, deal with the contractor himself and reach what was called a negotiated settlement.

I do not need to explain to you accountants how that particular policy cut around some of the greatest accounting difficulties. It made it possible to deal with those accounting matters, at least, where there was an area of disagreement, on a practical basis instead of going on squabbling for months to decide meticulously which was the right answer. It had the same effect on many other things. The question of allowances for material, which are not accounting matters, the question of profit, and others, all could be pointed up by discussion, and settled by negotiation. The result might be, perhaps, arbitrary decision on the part of the government, but it would at least have the advantage of being prompt. Without promptness and without finality, of course, the negotiated settlement has no advantage.

The services were concerned with

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what to do in case those decisions were too arbitrary. I might pause here a moment to say that this idea that the services could be expected to be too liberal, leaves me a little cold. In thirty years of practice, I have yet to deal with a government department that in my opinion is liberal to a contractor or businessman who is having a dispute with it. The very fact that a negotiated settlement provides a club for prompt settlement, in my opinion, will also make it a club for low settlement. Of course, that is only a personal opinion but it is based on a great many years' experience. However, it was necessary to bring into the philosophy of termination a procedure on what to do in the event that the negotiation power was too arbitrarily exercised. In the first place, there was brought in, within the Army at least, a different level of review. Settlements aggregating a million dollars got one sort of treatment, settlements aggregating up to five million dollars got another sort of review, and settlements beyond five million dollars got a different treatment, always different in the sense of adding another layer of inspection and review.

I should pause again to say that this business of the contracting officer might be looked at a moment. I, in my own thinking, consider that the contracting officer is a fictitious person, a good deal like a corporation, but every time I make that statement in public, the Army majors in the audience all shake their heads, and the Navy people make equal signs of disapproval but, nevertheless, it is a good way to look at it. As far as the decentralization is concerned, some one man may sign an agreement, but that agreement is a distillation of the decisions and opinions of a group of people, different kinds of people, with different approaches, so that seldom is a decision arrived at by one man with all the authority that seems to be given, under these termination manuals, to one person. In my own

thinking, I consider contracting officers to be a group of people rather than one, and I think it will help your appreciation of the Army and Navy procedures to look at it that way.

Now, if the contractor does not like what he is getting out of these officers, he can elect to go on what is called the formula basis, which is explained in the manuals, but is, in effect, the correct determination of all costs and the correct determination of the indicated profit that was being earned on the contract, all of which is subject to review by the general accounting office under the procedures which are now under controversy, and from that are subject to appeal to the courts.

That is a rather rough description, but all I am trying to do is give those of you who haven't had a close familiarity with it, a working background for the discussions that follow.

This question of accounting in many respects is the least important of all the settlement problems there are in contract termination. The question of getting a plant clear so it can go back to business is even more important. There are going to be ways developed so money can be paid over in some quantities to permit business to continue. I do not know what they will be yet, but I think it is very safe to say that there will be some method developed. There must be developed a method whereby the plants can be cleared of material, it can be moved out, and machinery that belongs to the government can be transferred to other places, and the work that is being done by the small manufacturer for the big one can be cleared out in the same way—all the things generally that are necessary so that a factory can get back to producing. That is the point where speed is so important, and the termination manual and PR 15 and the Navy policies constantly refer to that.

There is a philosophy of cost indicated in PR 15 and the termination

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manual, which, if I may be very rough in describing it, is in general, allowance of proper business costs of the kind that a man would ordinarily incur in keeping his business going. It is the same kind of cost allowance that appears to be allowed in renegotiation decisions.

There are two cost problems. Certain specific costs are not allowable. They are very clearly set forth. There are other costs that are to be determined in accordance with recognized accounting practices and, as far as the Army Manual is concerned, that is about as far as they go.

Profit is to be determined on a reasonable basis. There is not much said about it, except that in the formula settlement profit is to be on the indicated rate. The indicated rate, of course, will have some influence even on a negotiated settlement, but that is a point that must be left pretty much to the judgment of a so-called contracting officer.

Neither manual disposes of the subcontractor problem. Many of the problems that are unsettled in this whole matter of termination procedure revolve around the subcontract. You will hear more about that today. But the subcontract problem is being experimented with, I believe, in both services. The War Department, I am told, is trying out a number of ways of avoiding the tremendous duplication that might be in the examination or treatment of subcontractors making parts of contracts for a lot of different people, experimenting with the idea of trying to find a way of cutting around the prime contractor in legitimate cases. Of course, the foundation of the problem is that the prime contractor is the only one who has contract relationships with the subcontractor. The government has no relationship in most cases. So if there is to

be a substitution of the government for the prime contractor, it would have to be done by legislation, and I for one have found it a little early to feel such assurance of the final answer that I want to suggest particular legislation right at this time. But the subcontract problem has as its basic difficulty, the right of the prime contractor to make a settlement with the subcontractor. The manual has a philosophy that is good—that there can be delegation of authority to prime contractors to deal with subcontractors within certain limits without having to get prior approval for settlements from the contracting officer. How far that works, or the technicalities of it, I am not going into at this time, but there must be freedom in that particular phase. I will come to it later in the recommendations of the Institute.

Before we get into the Comptroller General problem—and we *are* going to get into it—I think it is well for you to have for background a discussion from our next speaker. We have been extremely fortunate not only in having one of our own members, Harold Stewart, give us some picture of the Navy approach—I think we will all agree that he spoke rather frankly on the Navy position—but we are perhaps even more fortunate in having here today the financial adviser to the Senate Committee on Small Business, better known as the Murray Committee. The Murray Committee, if you remember, has before it the question of how to get payments over to the small contractor, and at the same time they had on their doorstep this whole question of the request of the Comptroller General to have his authority extended to review and approve all termination claims. I take great pleasure in introducing Mr. Eugene E. Thompson, of the staff of the Senate Committee on Small Business.

War Contract Terminations

BY EUGENE E. THOMPSON, WASHINGTON, D. C.

Financial Adviser to U. S. Senate Special Committee to Study Problems of American Small Business

I APPRECIATE very much indeed the opportunity of coming and saying a few words to you. First of all, let me tell you something that might be of interest to you. On the train last evening coming over I was asked why I was going to New York, because it was such a crowded place. I discovered that after I got here, I assure you, when I found that the hotel reservation promised to me had been given to someone else. The gentleman said, "So you are going to talk to the accountants, the people who are always trying to find out how much money you have made, or how much you have lost?" He said he was reminded very much of the story of the old darkey that was employed by a friend of his on a farm near Raleigh, North Carolina, who came up every Monday morning and said, "Boss, let me have a dollar, will you? Let me have a dollar."

The boss said to him, "Mose, what's the matter with you niggers? Every Monday morning you come in here asking me for a dollar. You never save your money. Why don't you save your money like the white folks do, then you will always have money?"

The old darkey scratched his head and said, "Boss, I guess you ain't never been a nigger on Saturday night."

So maybe there wouldn't be any job for the accountants if we were all niggers on Saturday night.

The subject that you have before you today is one of great interest to the Senate Small Business Committee, and also to the Military Affairs Committee of the Senate, which, through its subcommittee, of which Senator Murray is chairman, is holding hearings both tomorrow and Friday, and held hearings last week, and will probably continue

hearings for the balance of this month. I assure you that the committee and its staff are endeavoring to arrive at what would be the best kind of legislation to meet what seems to me to be the most troublesome and annoying problem to be settled that has faced the Congress during the whole autumn. I cannot predict what Congress may or may not do. We have had many, many suggestions. Gladly do we receive them. Please do not feel that they are not wanted. They are. We have extended an invitation to your organization, and Mr. Bailey is coming down to Washington to testify before our Committee on Friday, giving the point of view of the American Institute of Accountants, and perhaps some suggestions as to how we might weave the legislation in to meet this complicated situation.

Let me assure you, just as sincerely as I can possibly put it, that the problem which is facing you, is facing the Congress, and is facing the whole country today, and is probably as serious a matter as we have ever had to deal with. The seriousness of this situation will greatly develop at the time of V day. It is already in progress. There have been a number of contracts terminated which have been settled. There are many—some of which you will probably hear about today—that are in the process of settlement.

I am not going to speak critically of the Comptroller General, nor am I going to speak critically of the Acting Secretary of War, who wrote to Senator Murray. Both of these letters, from the Comptroller General and the Acting Secretary of War, were directed to Senator Murray, who is the Chairman of our Small Business Committee dealing with this question of auditing terminated

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contracts. I want to say, however, that it has been the thought of the staff of our Small Business Committee, and also the thought of Senator Murray, that in order to arrive at some compensation to the terminated contractor, so that he might continue to live, we must have a mandatory payment. The mandatory payment has its complications, quite true, and I am not divulging any secret when I say that mandatory payments are not looked upon by all of the governmental agencies as the proper thing. They don't want mandatory payments. On the other hand, we have preponderance of letters and messages from business interests which tell us definitely, positively, that the only way to treat this matter is with a mandatory payment, at least in part settlement. Those of you who had the privilege of reading Senator Murray's proposed bill issued last summer will recall that that bill, had it been introduced, would have called for a 75 per cent mandatory payment on the claim of the contractor of the amount due to him; and, of course, it included the subcontractor as well.

We have so many variations to this problem that the average person can hardly see them. I am quite sure that you who are accountants are aware—perhaps as much as, if not more than, those in ordinary walks of life—of the many variations. There is the inventory problem. In many cases the government

owns the inventory; in many, the inventory has been partially worked to government scale or to government specifications. It is good for nothing other than government work. In other cases, the inventory is owned by the contractor. In many cases he has an inventory which in his ordinary business he probably could not consume for years to come.

There is also the problem, perhaps, of a government stock pile of scarce raw materials to reckon with; also the question of how we can take care of the prime contractor, the subcontractor, the sub-sub-contractor, the sub-sub-sub-contractor, and so on down to the supplier of raw material who has no contract but merely a purchase order, maybe a telephone order.

There are many angles to this complicated question, and I do want to say briefly in closing that if any of you have any suggestions as to how we can best meet the situation, we will gladly welcome a letter from you addressed to Senator Murray as Chairman of the Committee, giving us the benefit of those suggestions. You may have just the ideal thought that would help in this situation, which none of us has, up to this time, been able to master.

We deeply appreciate your sending Mr. Bailey down to us, and we are hopeful that his coming will result in great help to our Committee.

The Place and Responsibility of Independent Public Accountants in Connection with Contract Termination Statements

BY CHARLES W. JONES, ILLINOIS

Member, American Institute of Accountants

THE importance of war contract terminations from the standpoint of their possible effect on this country after the war cannot be over-emphasized. If very serious losses of a

social and economic nature are to be avoided, the closest possible coöperation between government and business will be required in order to effect a prompt and orderly reconversion of our

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industrial facilities to the production of civilian goods.

One of the major steps in this reconversion process will be the reimbursement of contractors and subcontractors for their costs and commitments relating to the uncompleted portion of terminated contracts and subcontracts. The statement of these costs is strictly an accounting statement. It reflects a substantial number of accounting determinations, many of which are of a complex character and all of which must be made in accordance with recognized accounting practices. One of the most important factors involved in contract terminations at the conclusion of the war will be the time factor. It will be essential as a part of the reconversion to peacetime operations that termination claims be settled as promptly as possible in order to free working capital now tied up in the production of war goods and make it available for use in the production of peacetime goods. It is said that there are approximately 100,000 prime war contracts of importance and several times as many important subcontracts. In view of these facts, it is obvious that the preparation of termination proposals and the necessary reviews and audits of them at the end of the war will require all the accounting and auditing talent available, and that the available supply will not be adequate without a maximum effective use of that talent. The members of our profession face an opportunity for service to the public and to business on a national scale that is of tremendous significance. It will for a time exceed in importance our participation in income-tax determination and become substantially more urgent. It will require service of a highly proficient character performed on a strictly independent basis that impartially considers the interests both of the government and of clients.

Our first obligation as a professional group and as individuals is to make a

thorough and detailed study of the accounting and auditing problems and of the policies and procedures involved in termination work. The American Institute of Accountants fully recognizes its responsibility to assist its members in every possible way in this educational process. Several articles on the subject have been published; more will follow. Appropriate committees of the Institute will continue to cooperate fully with government representatives engaged in termination work. All the talent that is represented in our membership is available for consultation, advice, and assistance of any kind needed in working out fair and satisfactory solutions to the accounting and auditing problems that will continually arise. Out of these contacts undoubtedly will come information of significance that can and should be passed on, and ways and means of making such information available to all of our members will be devised.

Of far greater importance, however, will be the efforts that we as individuals make to inform ourselves thoroughly regarding war contract terminations. We should not rely solely upon what we read on the subject in our Institute publications nor upon what we hear spoken on the subject by well informed members of our profession. This job will require diligent, aggressive, and continuous and detailed study of the rules and regulations comparable to that undertaken by an income-tax practitioner. By way of specific illustration, very careful study should be made of releases on the subject by government departments. There have been two such releases by the War Department within the last few months. I refer to the War Department Termination Accounting Manual for Fixed-Price Supply Contracts, released July 7, and Procurement Regulation No. 15 relating to termination of contracts. Each of these documents should be studied most carefully. The manual, as most of you know, contains accounting and

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auditing instructions and Procurement Regulation No. 15 contains statements in some detail of the policies and procedures to be followed in connection with terminations of contracts. It is anticipated that each of these releases may be amended or revised from time to time. The published amendments and revisions should be carefully noted. In addition, the War Department will issue cost memoranda for use by War Department personnel in connection with the determination of costs and other matters. These should be of particular interest and significance to public accountants.

Partners of public accounting firms have an important responsibility in connection with this educational activity in the direction of assisting and encouraging members of their staffs to familiarize themselves with termination problems and procedures. The pertinent manuals and other data should be made available and in many cases it may be desirable to conduct discussion groups or classes within the respective organizations.

It is very directly in the interests of the government, of course, that businessmen who will be concerned with termination problems, acquire as accurate and authentic information on the subject as is practicable. Government representatives have written papers and made addresses on this subject and we hope that this practice will be continued. These papers will be of substantial value in our study of the subject.

We frequently hear references made to experiences of contractors with respect to terminations of contracts at the close of World War I. While most of these reports greatly exaggerate conditions and results of that period, many mistakes were made and many difficulties were encountered which can, and in most instances probably will, be avoided in the termination of current war contracts. A study of experiences of that earlier period will prove helpful and in

this connection attention is directed to Historical Study No. 57 on the subject, "Termination of Ordnance Contracts 1918," published by the U. S. Department of Labor.

Much can be done by public accountants in the months ahead in an advisory capacity, well in advance of terminations, by counseling clients regarding steps that can and should be taken to simplify and expedite the work of preparing termination statements of costs. One broad objective, of course, is the maintenance of records that will readily provide the information that will be required in the event of a termination. Procurement Regulation No. 15, paragraph 15-110, which emphasizes the importance of an understanding by contractors of the principles and procedures applicable to terminations, contains these comments: "It is particularly important that these contractors, subcontractors, and suppliers understand:

- "1. The significance of the termination articles in their respective contracts.
- "2. The necessity of keeping accounting and other records in such manner and in such detail, and of maintaining such adequate cost accounting systems as will enable them to produce the cost and other figures necessary to prove their rights under the termination articles in the event of termination."

The paragraph last quoted does not contemplate drastic changes in otherwise satisfactory accounting systems, nor does it mean that the accounting systems should be directed primarily toward the contingency of termination. Procurement Regulation No. 15, paragraph 15-411, states with respect to lump-sum supply contracts, "Contractors and subcontractors, however, are held to the standards of good commercial practice as to possession and maintenance of records." The same paragraph continues ". . . in those cases where a lump-sum supply contract is terminated

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for the convenience of the government, the contractor should not be required to state his costs in unreasonable detail. There is no justification for obliging a contractor to maintain an otherwise unnecessarily elaborate cost accounting system merely because of the possibility that his lump-sum contracts may be terminated for the convenience of the government." The manual provides two methods of computing costs applicable to the unfinished portion of a contract, the inventory method and the total-cost method. While many contractors may be able to determine in advance just which method will be adopted in computing their claims, many others will probably not decide that question until their contracts have actually been terminated or at least not far in advance of that time. In any event the contractor should make a careful study of the information needed, both from the standpoint of his own interests and from the viewpoint of the government requirements, and should make such changes in his accounting system as are reasonably required to furnish such information. Samples of the questions that may arise in this connection are:

- (a) Are the purchase order, inventory, and production records sufficiently related to specific contracts so that in the event of termination inventories applicable to the terminated contract can be readily determined and located and can unfilled orders applicable to the contract be readily ascertained and promptly canceled?
- (b) Do property records adequately reflect the contracts to which facilities of various types, including tools, dies, jigs, patterns, etc., are applicable?
- (c) Do methods of allocating factory overhead produce reasonably accurate results and what are the most equitable bases for allocating administrative expenses?
- (d) Have preproduction expenses been properly earmarked or recognized?

- (e) What effect do renegotiation settlements have upon termination problems?
- (f) What treatment can be made of rehabilitation plant costs in a termination statement?
- (g) Are engineering and development expenses applicable to contracts being properly recorded?
- (h) Is it desirable to attempt to lessen the financial effect of contract terminations by means, for example, of securing advance payments on contracts or "VT" loans?

A well informed public accountant can, with a reasonable expenditure of time, if he performs such work on an independent and professional basis, render his clients a substantial service of an advisory character regarding such questions. Thousands of smaller contractors, particularly, will be greatly in need of such counsel. Constructive work conscientiously done in this connection will be of vital effect after the war.

In connection with the procedures to be followed after the termination of a client's contract the public accountant can be of substantial service to his client in one or more of several capacities; by acting as an advisor, by undertaking the preparation of the cost data required or reviewing such data after preparation by the contractor and by examining his statement of costs and reporting thereon. The experience to date indicates that the majority of contractors in the event of terminations require much advice and assistance from their public accountants regarding the various steps to be taken to insure a prompt and fair settlement of the matters involved in their terminations. These types of service should be of particular significance after the close of the war. It seems certain that at that time both large and small contractors will be very much in need of aid. By that time public accountants should become thoroughly familiar with termination procedures both on the basis of their study of the subject and the basis of their experience

with terminations made prior to the conclusion of hostilities. The responsibility of the public accountant in this connection will be to give his client all the assistance that he can to enable the client to submit, as promptly as possible, a fair and equitable statement of costs applicable to the uncompleted portion of the contract. All such work by public accountants must be done on a strictly professional basis and is subject to the same requirement as to impartiality and independence as any auditing work.

A prime contractor with important or numerous subcontractors ordinarily will require assistance from his independent accountants in reviewing settlement proposals submitted by subcontractors. If independent audits are desired in support of these claims, it appears logical that the accountants regularly employed by the subcontractor should be selected to make such examinations. The review of such audits by the prime contractor's accountants ordinarily will involve a review of the claim and the bases upon which prepared and the related auditors' report, and in some cases it may also include an examination of working papers of the independent accountants.

In some instances contractors may wish their public accountants to do the detail work of preparing their cost statements. Such assignments may properly be undertaken but should not be encouraged unless it is not practicable for the contractor to perform that work. The preparation of these statements requires not only adequate information regarding the rules, policies, etc., governing such statements but also thorough knowledge of the contractor's costs and of his manufacturing operations. The contractor, in most cases, has a much more intimate knowledge of his costs and operations than his public accountants have and it is essential that the contractor's knowledge be utilized in the preparation of the statement.

In addition, if the public accountant both prepares the statement and issues a report with an opinion covering it, there will be absent some of the elements of independent relationship that normally should exist. It is highly desirable, therefore, in those cases in which it is necessary that the public accountant prepare the statement, that the contractor participate in the work or that he review what is done to the full extent possible in order that full advantage be taken of his intimate knowledge of his costs and operations and to afford the maximum element of a dual check. The responsibilities of the public accountant in the performance of such work are very great. It requires the exercise of very special care to make certain that the statements fairly reflect the pertinent costs and that all material facts are disclosed. Such work requires the exercise of a particularly high degree of independence and impartiality.

In many cases the client may conclude that a review of one or more specified portions of his statement of costs is all that is required of his public accountants. Very frequently, after the war, such conclusions will be dictated by a consideration of the very limited amount of time available. These reviews may vary widely in scope. They may include a general review of the accounting practices and the bases of determinations and allocations of costs followed or adopted by the contractor in his preparation of the settlement proposal, without a check of the general accuracy of the underlying figures, or they may relate to specific items in the statement. For example, a contractor may feel confident that the factory costs applicable to the unfinished portion of his contract are correctly stated but may wish an independent check of his allocation of administrative expenses. One of the important questions with respect to limited reviews is that as to the report that may be rendered. If the work done does not result

in conclusions of substantive value, considering the claim as a whole, ordinarily no report should be submitted. Generally reports covering limited reviews should be in the form of informal letters and should, of course, clearly explain the limitations in the scope of the work. Frequently this will require a brief statement of what *has not* been done as well as of the things that *have* been done. The opinion expressed should be definitely limited to the particular portion of the statement reviewed and if the opinion is in part based upon assumptions as to the correctness of portions of the statement not checked, that fact should be explicitly stated. The primary objective should be not to protect the auditor but to make certain that the contracting officer who will review the report or letter gets a clear, understandable picture of just what the independent accountant has done and of the value of that work.

It seems certain that in a great many instances both prime contractors and subcontractors will request that their public accountants examine their statements of proposed settlement and submit a certificate or report. It is understood that there will be no general requirement on the part of the government departments that contractors or subcontractors furnish reports by independent public accountants in this connection and it is not anticipated that such reports, if furnished, will be accepted as final or conclusive evidence of the fairness of settlement proposals. Procurement Regulation No. 15 contains the following references to reports by independent accountants. In paragraph 15-424.3 are enumerated the factors that a contracting officer should consider in determining what further examination he should make of the contractor's proposed settlement. Examinations of available reports of independent public accountants are included in this list. In discussing the reviews of settlement proposals to be made by the

contracting officer in connection with his determination of the amount of partial payments that may properly be made to a contractor, this regulation, paragraph 15-501.3, contains the following: "Ordinarily in making such limited review the contracting officer should rely on the certifications of independent public accountants where such certified statements are available with respect to accounting information submitted by the contractor and should act promptly upon the basis of other types of financial data which he deems reliable. Usually in connection with the making of partial payments it should not be necessary for the contracting officer to require that accounting data be certified by independent accountants." Similarly in connection with a determination of the amount of partial payment to be made to a subcontractor the regulation states that the contracting officer "should place suitable reliance also upon any relevant reports which may be available, prepared by independent public accountants."

Notwithstanding these seemingly cautious references to the possible use by contracting officers of reports of independent accountants, there seems to be considerable basis for the belief that such reports will be of major assistance in the settlement of termination proposals. Much may depend upon the experience of contracting officers with such reports in the period prior to the close of the war. To date there have been hundreds of terminations, and before the war ends there will unquestionably be substantially more. The extent to which the services of public accountants are availed of in connection with contract terminations at the conclusion of the war and the extent to which their reports are accepted by contracting officers will be influenced substantially by the degree of professional skill, impartiality, and independence reflected in the work done and in

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the reports rendered on contract terminations during the war period. If such work and reports during that period are found to be reliable and helpful, there should be a growing tendency to increase the reliance upon them. This is important—not because it may mean additional work for public accountants—but for the reason that after the close of the war, because of the tremendous volume of terminations and the necessity for prompt settlements, it will be essential that there be the full possible utilization of all available means of preparing, reviewing, and auditing termination proposals.

A contractor's termination proposal, in addition to the statement of his costs, includes a statement of the profit that the contractor believes he should be allowed by reason of the work done by him with respect to the unfinished portion of the contract. The Institute's committee on auditing procedure gave consideration to the question as to whether the work of an independent public accountant and his report should relate to the amount of profit requested as well as to the costs included in the settlement proposal. Since the profit element is purely a matter for negotiation between the contractor and the government, it was concluded that the opinion of the independent public accountant should relate only to the costs reported and should not cover the reasonableness of the amount of profit requested. The contractor is requested also to submit data regarding the profit that he estimates would have been earned if the contract had been completed. Considering the unknowns that must be taken into account in making such an estimate, it seems apparent that such data should also be excluded from the public accountant's opinion.

An important subject to be considered in connection with audits of termination settlement proposals by independent public accountants is the scope

of these examinations. Obviously, it must be sufficiently extensive to afford the accountant an adequate basis for the opinion expressed in his report. In view of the vital significance of the time element in termination cases, it is highly important that the independent accountant's examination should not involve any unnecessary detail work and that programs for such examinations should be most carefully planned and directed to make certain that his activities are restricted to essential phases of such an examination.

Part III of the War Department manual outlines the audit procedures appropriate in the case of an administrative audit of a contractor's termination settlement proposal by government auditors. The purpose of the administrative audit is stated in paragraph 3101 as follows: "The purpose of the administrative audit of a contractor's statement of a proposed settlement is to determine that the settlement proposed is in accordance with the termination provisions of the contract and is substantiated by the contractor's records and other supporting evidence. The role of the auditor is to carry out appropriate auditing procedures to establish the reliability and accuracy of the data submitted by the contractor and thus to provide the contracting officer with a factual basis for making a settlement. The major audit objective should be to determine that the costs included in the contractor's statement are accurately stated."

Although accountants might hesitate to use the words "accurately stated" in this manner, for the reason that the word "accurately" implies a degree of exactness that normally cannot be ascribed to financial statements, the three sentences quoted constitute a fair statement of the purpose of a similar audit by an independent public accountant.

The audit procedures in the manual are designed to minimize detailed check-

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ing; they contemplate reliance upon the contractor's system of internal control to the extent that such reliance is warranted; they emphasize the importance of giving special attention to the accounting practices followed by the contractor; and they prescribe the use of selective methods of audit. Thus, fundamentally, the auditing principles set forth in the manual conform to those established by the accounting profession. In view of this and of the similarity of objectives, we reach the conclusion that the audit procedures outlined in the manual may be accepted as a fair, general pattern of the scope of examination that should be followed by independent public accountants. There will of necessity be required numerous changes in adapting these procedures to particular cases either by way of curtailment or amplification. Those accountants who have been regularly employed by a contractor, because of their familiarity with the contractor's accounts in general, and particularly in view of their knowledge of the contractor's accounting procedures and practices and system of internal control, will be able to omit certain of the steps and procedures outlined in the manual without impairing the effectiveness of their work. Full advantage should be taken of every practicable means of properly curtailing the audit procedures on the basis of work previously done in connection with regular annual examinations. It is of equal importance, however, that independent accountants properly adapt their program to recognize any recently developed weaknesses in the contractor's cost systems. In many cases because of loss of personnel, the manufacture of new products, and the greatly increased rate and volume of production under war demands, cost systems have broken down and do not now produce as dependable results as formerly.

As a part of the program to limit detailed auditing and to restrict the

work to essential phases, full use should be made of all the practicable over-all checks of the propriety of important items. The War Department manual (paragraph 1107), in discussing the scope of an office review, indicates a number of matters to which special attention should be directed. These are principally over-all tests of reasonableness of items in the contractor's statement and illustrate the type of tests that may quite profitably be given careful attention by public accountants in making up their audit programs and in forming their opinions with respect to the reasonableness of the statement of costs.

There has been considerable discussion of the subject of the form and content of an independent public accountant's report on an examination of a contractor's statement of costs. As a minimum, such a report to be of value should contain a brief summary of the scope of the examination, and a clearly expressed opinion regarding the statement of costs, including an opinion as to whether or not the statement has been prepared in accordance with recognized accounting practices. If the accountant believes the statement is wrong in some material respect, his report must, of course, contain a plainly stated exception or qualification.

It was suggested in regard to a recent termination case that the accountant's report, to be useful, should contain full comments regarding the claim, including disclosure of all material facts, together with information with respect to such matters as the system of accounting applicable to each item shown on the summary of the claim, the basis of determining the amount of each item of cost, and the methods of allocation of indirect charges.

There can be no question as to the pertinency and usefulness of such information and, if it is not included as part of the contractor's statement, it should be submitted by the independent accountants. Generally, it is considered

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preferable to incorporate explanatory comments regarding financial statements in the statements themselves, usually in footnotes forming a part of the statements, rather than in the auditors' report. This same rule would appear to be applicable in the case of termination statements. Inclusion of such data as part of the contractor's statements makes them his representations, which are, in turn, examined by the independent accountant and covered in his report along with the balance of the statement. It is recognized that, particularly in the earlier experiences in dealing with settlement proposals, there will be areas of uncertainty with respect to the treatment of some items and that there will be other items regarding which governmental policy will not have been clarified. In those cases the pertinent facts regarding the items in question should be clearly set out. If such items in the opinion of the independent accountant constitute necessary costs applicable to the contract that are reasonable in amount and that have been determined in accordance with accepted accounting practice, the facts regarding them may be included with other explanatory comments as a part of the contractor's statement without reference to them in the auditors' report. If, however, such items fail to meet one or more of those tests, they should be covered by the independent accountant in his report. By way of illustration of the latter type of item, a determination of the loss of useful value of fixed property in excess of an allowance for depreciation based on wear and tear, will frequently involve a determination of the fair value of such property to the contractor after termination. The accountant will not be in a position, ordinarily, to pass upon the reasonableness of the fair value factor and consequently under those circumstances such an item should be covered in his report. The important point in this matter of disclosures is

that in the interest of making it possible for the contractors, subcontractors, and government representatives to effect fair settlements promptly, the data furnished must be as complete and informative as possible, particularly with respect to material facts. This requires that both the contractor and independent accountants have a clear-cut understanding of the purpose of statements and reports submitted.

Generally it may be said that a long-form report will be more useful than a short form. By this I do not have in mind a twenty- or thirty-page report, but something modeled after the usual long-form certificate which discusses briefly the scope of examination of the principal or more important items and states briefly the auditors' conclusions with respect to them.

Contract termination work is difficult to perform. By reason of the importance and complexity of it and the conditions under which most of it will be done, a high degree of skill and proficiency is required. This demands that such work be done by men of ability and experience and that we continually recognize the obligation to maintain a high level of quality in the performance of it.

In conclusion, may I again refer to the fact that the magnitude and character of the public interest in war contract termination settlements place particular emphasis upon the necessity that all public accountants who participate in this work exercise extreme care to insure not only that they are adequately informed on the subject and that work of a high quality is done, but also that their participation is on a wholly objective and independent basis. A conscientious application of high principles, together with effective and intelligent work throughout all of our participation in termination matters, will result in substantial service to our clients, to the government, and to the public.

CHAIRMAN BAILEY:

We come down now from the general to the specific. We had a speaker yesterday afternoon who talked about the ten-dollar ideas. I think perhaps what follows now will be rated even higher.

Our next speaker is Mr. John W. Queenan of Chicago. As the memorandum in front of you states, he is an alumnus of the University of Illinois, which conferred upon him the degree of bachelor of science in accounting in 1927. He is a

resident partner of the firm of Haskins and Sells in Chicago. He has been a member of the Institute since 1936. This is, I believe, his first appearance on an Institute program. He has been in a particularly favorable position, because of some engagements that he has been connected with in Chicago, to find out about the workings of the termination policies at first hand, and the relationship of the public accountant to those policies. Mr. Queenan—

Treatment of Specific Expenses, Other Than Initial Expenses, Upon Termination of War Contracts

BY JOHN W. QUEENAN, ILLINOIS

Member, American Institute of Accountants

A TERMINATED war contract generally presents a big problem to the prime contractor, subcontractor and, in some instances, to suppliers furnishing standard materials. The problems of the prime contractor are the most severe as, in addition to his own claim, the prime contractor must arrange to obtain and settle claims of subcontractors and suppliers. Although the statements of charges submitted by subcontractors and suppliers may be subject to audit by government auditors, it is the responsibility of the prime contractor to determine, in accordance with reasonable business practice and prudence, the propriety of the claims. In the case of a large contract involving many subcontractors and suppliers this responsibility presents a serious problem, requiring considerable thought, organization, and capable personnel. The thoroughness with which this phase of the termination is organized and conducted will determine to a great extent how expeditiously the entire termination will be settled, and may have a material effect upon the prime contrac-

tor's future relations with his suppliers. The importance of this phase of the problem cannot be overemphasized since it is likely to be the "bottleneck" in many termination settlements.

Accounting in connection with claims under terminated war contracts requires new thinking and a new approach from the usual accounting procedure. Methods of distribution of expenses which are reasonable and practicable for corporate accounting may, and in many instances do, result in incorrect costs for terminated contracts. Unlike CPFF contracts, accounting for terminated fixed-price supply contracts is not hedged about by special cost specifications and does not require the submission of documentary evidence, such as copies of invoices; of course, the contractor's records are subject to audit.

In lieu of the "formula" type of settlement specified in early war contracts, the present standard termination article of the War Department provides as an alternative the negotiated "lump sum" settlement, which is being followed in most cases. A negotiated settle-

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ment does not mean a "horse trade" proposition where the contractor asks for a ridiculously high settlement in order to have an ample margin for bargaining. The contractor is entitled to payment at the contract unit prices for all completed units delivered or deliverable at the termination date. The settlement for the uncompleted portion of the contract is to be based on unreimbursed cost as indicated by the contractor's records in accordance with the terms of the contract, plus a profit allowance. In accounting for doubtful items it is important to keep in mind that the settlement will be made on a basis negotiated with the contracting officer.

The definition of costs set forth in War Department Procurement Regulation No. 15, and in the Termination Accounting Manual, is very general and not restrictive in character. It "is intended to include those costs incurred which are necessary for the performance of the contract, are reasonable in amount, are properly allocable to the contract or the portion thereof under consideration, and are stated in accordance with recognized accounting practices." Items specified as "excluded costs" are few, some of which will be discussed later. The regulation provides that the contracting officer has the sole authority to negotiate a settlement and the definition of costs does not limit his range of action in such negotiations. The contractor, therefore, has the opportunity of presenting for negotiation items of expense that may be unallowable or doubtful for other government contract purposes. The important point seems to be that items of costs included in the claim should be based upon sound accounting practices, and all arguments for inclusion of the item should be presented to the contracting officer for consideration.

It is probable that few companies have designed their accounting for fixed-price supply contracts to provide

readily the information necessary in preparing a claim for a terminated contract. For their own protection, it probably will be necessary for them to reappraise their cost systems in the light of the requirements for determining costs on a contract basis. *Any system followed also must be based upon specific provisions of the individual contract.* As an example, intracompany transfers between plants or divisions generally must be made at cost, but in certain instances provision is made in contracts for transfers from certain plants or departments, such as foundries or steel mills, at market prices. Obviously, two contracts, one containing such a provision and one not, require different treatment in the cost determination.

The contractor's claim may be prepared on the inventory basis or the total-cost basis. On the inventory basis the costs to be included are determined by pricing the inventory in detail; on the total-cost basis the costs on the entire contract are summarized, a profit allowance is added, and billings for completed units are deducted. Because of the limited time, I intend to confine my remarks to claims prepared on the total-cost basis. If the claim is prepared on the inventory basis, the additional problem arises of allocating expenses properly chargeable to the contract between the completed portion and the uncompleted portion or inventory.

The following remarks as to specific expenses are intended only as a brief discussion of a few of the problems incident thereto:

The element of overhead costs to be included in the claim presents many problems. Care must be exercised that the amortization of expenditures applicable to the contract, and carried as deferred charges or other assets, is properly accelerated upon termination of the contract. Contract overhead costs should be adjusted for variations in inventories of supplies. Overhead rates and the bases of distribution should be

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reviewed to determine that they result in equitable distribution to the contract. In connection with a canceled contract, it is important to consider whether any significant costs applicable to the contract, in whole or in part, may have been charged to general overhead in a year prior to production on the contract and, because of distribution of overhead on production costs, may not have been charged against the contract. As an example, where a company follows the practice of charging items to expense that might properly be carried as deferred charges, it is easily possible that a contract canceled in its early states might not bear its proper proportion of overhead costs unless careful consideration is given to such costs included in overhead of the fiscal year prior to production. In another case, expenses applicable to a terminated contract may have been included in general overhead in the current year, to be apportioned to all production. An allocation of general overhead may not result in an adequate charge to the terminated contract unless the direct charges included therein are considered separately. Of course, if direct charges, applicable to the terminated contract, have been included in general overhead and are segregated for termination purposes, then substantial direct charges applicable to other contracts should be eliminated before allocation. Also, overhead expenses may include charges for expenses not yet incurred which, of course, should be eliminated from the amount to be allocated, such as where a contractor provides for the cost of re-sinking dies by a unit charge based on production.

A contractor's status in relation to renegotiation proceedings must be considered in connection with any adjustment of prior year's expenses.

It is recognized as important that cost accounts be controlled by the general accounts. So too, in anticipation of contract terminations, the general ac-

counting should be controlled by cost considerations; that is, the general accounts should be kept in such manner as to preserve and make available cost items and information for cost determination. For instance, in the case of a contractor who acquired a plant in a run-down condition, the government may agree by contract to reimburse the contractor up to a specified amount for the cost of rehabilitating the plant for production of war materials. Where it becomes apparent that the rehabilitation cost will exceed the specified reimbursable amount, the contractor, impelled by conservatism, may not charge the rehabilitation jobs with their proper share of overhead items or other costs, on the theory that such costs would not be collectible since the aggregate costs exceed the reimbursable amount. However, the rehabilitation charges in excess of the reimbursable amount, to the extent that they represent reasonable costs, should be considered in production costs on some reasonable basis of amortization, some portion of which may be a proper overhead charge against supply contracts. If such excess rehabilitation costs were buried in operating accounts as incurred they might be overlooked in determining costs of the contract to which they apply, especially if production did not begin until several months later.

The cost of dies, patterns, special tools, etc., which are usable only on the terminated contract presents little difficulty providing such costs applicable to the contract have been segregated in the accounts. Frequently, this is not the case and the costs are charged to overhead expense as incurred and without segregation by contracts. Where such costs are material, the accounts should be analyzed so that the proper cost may be charged to the contract. Where dies, patterns, special tools, etc., were acquired for the contract but are usable on other contracts, the amortization should be allocated to the canceled

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contract, as well as to the other contracts to which it applies, on the basis of all the facts, particularly the provisions of the contracts. If the price in the terminated contract was based on estimated costs which provided for full amortization, and it can be demonstrated that prices specified in the other contracts were based on cost estimates which did not include any amortization of dies, patterns, tools, etc., then there seems to be justification for charging the full unamortized cost at termination as an element of cost of the terminated contract.

The definition of costs included in Procurement Regulation No. 15 provides that there may be included as an element of cost, to the extent properly allocable to the contract, a reasonable allowance for depreciation based on wear and tear (including obsolescence due to progress in the arts), but that with respect to facilities covered by Necessity Certificates the rate of amortization allowed under section 124 of the Internal Revenue Code shall not be controlling and is not relevant for the purpose of computing rates of depreciation or obsolescence. However, the cost definition further provides that the claim may include an amount in excess of normal depreciation, which may be described as wartime obsolescence, for any machinery, equipment, or other facility acquired for the performance of the contract, or the contract and other contracts, where there has been a loss of useful value occurring during the performance of the contract or arising from its termination for convenience of the government. In such cases, the contracting officer must protect the interest of the government by requiring transfer of title to the government, by stand-by agreement, or any other manner judged to be appropriate by the contracting officer. In other words, the definition of cost requires that, where applicable, the charge for use of facilities be divided between the

portion representing wear and tear and the portion representing loss of useful value by reason of the fact that the facilities are not usable for other purposes. The contractor cannot expect to recover the full cost of a building or facility from the government and at the same time have that facility available for future civilian operations without cost. On the other hand, where the facts are clear that there has been a definite loss of useful value, it is principally a problem of stating those facts in such way as to convince the contracting officer that the loss in value in excess of depreciation allowed is actual, and is properly allocable, in whole or in part, to the terminated contract. In such case, if the facilities were acquired for, and were used in the performance of, the terminated contract only, then the cost, less salvage, should be included in the claim in two items, i.e., depreciation to date of termination and wartime obsolescence. It should be remembered that the total costs to date of termination, including allowable wartime obsolescence, and engineering, development and special tooling, plus the estimated cost to complete the contract, cannot exceed the total contract price. For example, if there is indicated wartime obsolescence of \$250,000 chargeable to a contract for \$1,000,000, but it is estimated that, to complete the contract, the other costs would be \$800,000, then the amount of wartime obsolescence would be limited to \$200,000. If the facilities were acquired for, or are being used in the performance of, other contracts, as well as the terminated contract, depreciation and loss of useful value or wartime obsolescence should be allocated to the various applicable contracts on some reasonable basis, consistent with the provisions of the various contracts, including any cost estimates therein. Unless the other contracts are near completion, that is apt to be quite an assignment, but the contractor generally cannot afford to

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proceed on the assumption that the wartime obsolescence will be recovered entirely on the remaining contracts, which, in turn, also may be terminated.

A proper proportion of general and administrative expense is allowable as an element of the claim. In most cases allocation of administrative expenses will require considerable analysis and study and an examination of all the facts and circumstances relating to the various classifications of expense. Contractors should not overlook the fact that considerable administrative time and expense may be required prior to actual performance of the contract. In fact, frequently more administrative time and expense is required before production begins than during the actual execution of the contract. Where a contract is terminated in its early stages, the contractor's customary method of allocation might result in a considerable understatement of administrative costs properly applicable to the contract.

The element of administrative expense included in the claim, as well as all other overhead elements, should be based upon actual expenses and represent a reasonable proportion of the total. The contractor should be prepared to explain and justify unusual increases in administrative expenses as compared with those of previous years. In submitting a claim it is necessary to attach a schedule showing the detail of the total expenses and the methods of allocation to the particular contract. Many claims are received in which the administrative and other overhead expenses obviously bear no relation to proper actual expenses. For example, a prime contractor recently received a claim from a subcontractor somewhat as follows:

Raw material and work-in-process.....	\$100,000
Administrative expense....	120,000
Engineering expense.....	80,000
Profit	450,000
	<hr/>
Total.....	\$750,000

The subcontractor did not submit information as to the items of administrative expense, engineering expense, and profit, which would permit the prime contractor or the contracting officer to judge the reasonableness of items, which in the summary appear to be entirely unreasonable.

Failure to discontinue production, and related costs, of the prime contractor or subcontractor within a reasonable time after notice of termination may result in the exclusion of such costs from the allowable items of the settlement. If for some reason it is not practicable to discontinue all production immediately or if the termination notice provides certain exceptions not subject to termination, it is well to have an early conference with the contracting officer to arrive at a mutual understanding and to obtain proper authorization for any work beyond the suspension date. The accounts should be kept in such manner as to indicate that the terms of the understanding have been followed.

One item in the definition of costs included in PR No. 15 which apparently is causing some concern is the provision that allowed costs shall not include costs incurred in respect to facilities, materials or services purchased, or work done, in excess of the reasonable quantitative requirements of the contract, after fair allowance for spoilage in manufacturing. I do not believe that contractors who file fair and reasonable claims and who have used ordinary good business judgment need be concerned about this item. Certain contracting officers have indicated that they do not believe that a negotiated settlement should be used to police industry for violations of such regulations as the sixty-day inventory limitation of the Controlled Materials Plan. It would be an endless task to follow through the quantitative requirements of items required in the manufacture of a tank, airplane, or other similar prod-

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uct. It seems reasonable to expect that exclusions will be made on the "quantitative requirements" basis only in extreme or obvious cases. Usually there can be little argument against excluding the cost of materials purchased in excess of the *total* material requirements for the contract, unless the contractor had a reasonable basis for expecting an increase in total production requirements under the contract.

Another "excluded cost" is stated to be cost of items (in excess of normal spoilage in manufacture) undeliverable because of destruction or damage, whether or not because of the fault of the contractor. Paragraph 15-444.2 of PR No. 15 states, however, that this provision is strictly applicable only to formula settlements, but should be given consideration in connection with negotiated settlements. Here again, it seems to me that, at least on a negotiated basis, exclusions will be made only in cases where destruction or damage is clearly due to negligence on the part of the contractor. Obviously, where a contractor is manufacturing products never before manufactured by him, spoilage, at least in the early stages, must be expected to be larger than the normal peacetime spoilage.

The expense of conversion of the contractor's facilities to uses other than the performance of the contract is mentioned as an "excluded cost." In some cases, where the expenses are reasonably definite in amount and where all the facts would ordinarily justify their inclusion in cost, the expenses should be included in the claim and set out separately, with a presentation of all the facts so that the contracting officer can give adequate consideration to their allowance as an element of cost, or at least in determining the profit allowance. For example, a contractor may have removed various walls in his plant in order to produce units efficiently under a contract, later terminated. The cost of removing the walls might be

negligible, but the cost of replacing the walls might be substantial. If the contract were carried to completion it is assumed that the profit realized would compensate for the expense of replacement, assuming that were necessary. However, the contract may have been terminated in its early stages before a sufficient margin of profit could be realized to cover the replacement cost.

In addition to the contract costs, the contractor's claim may include post-termination costs such as for the protection, removal, storage, transportation, sale, and disposal of property which the contractor acquired or produced for the purposes of the contract. In general, such costs should be approved by the contracting officer before they are incurred. The expense of storage of government-owned equipment should be considered in connection with the provisions of the contract which, in most cases, until recently required the contractor to store the equipment for a period of one year at his expense. That provision, I understand, is being amended to provide that the equipment will be maintained in position in the plant for ninety days pending a possible need and that for the next nine months the equipment will be stored if space is available. If storage space is not available in the contractor's plant, it will be stored at government expense.

Post-termination costs allowable in the claim also include accounting, legal, clerical, and other expenses necessary in connection with the discontinuance of the contract and its subcontracts, other than in connection with litigation of claims against, or asserted by, the government. Inasmuch as procurement regulations provide that all costs incurred subsequent to the termination date shall be presented as a separate element of the claim, it would facilitate the preparation and audit of the claim if provision were made to segregate these charges, as well as credits for disposal of inventory, in the general ac-

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counts as incurred. Fees of independent public accountants for assistance in the preparation of, or for auditing, the claims are an allowable element in the cancellation charges if reasonable in relation to the size and complexity of the claim and to the assistance the accountant's report gives to the contracting officer or other reviewing officials.

Procurement regulations require that the contractor furnish an inventory of raw materials, materials in process, and finished products on hand. Although it may appear desirable to delay taking a physical inventory until the inventory has been reduced by disposals, a physical inventory taken as soon as possible after termination will facilitate the settlement and eliminate many problems that may arise otherwise. An early physical inventory will make available more reliable information in connection with inventory disposition and can be taken during the lull which is bound to follow any sizable termination, using employees who otherwise might be unemployed during that period. A delayed physical inventory, on the other hand, might conflict with production on other war contracts which, in the meantime, may have replaced the terminated contract.

The question of disposition of inventories presents one of the most difficult problems in connection with termination settlements. This problem will be greatly aggravated on "V" day. It is not practical for the government to take title to the inventories and store them while attempting disposal. The various services have given a considerable amount of thought to the problem, but the procedures still require many improvements to effect speedy and efficient disposal. At the present time, certain critical materials and parts can be disposed of to other contractors, arsenals, or the various services. At best, however, piecemeal disposition is a slow process, even though in some

instances the government may give the contractor blanket authority for disposals within certain limits. In view of the importance to the government, it would appear reasonable that an allowance should be made in determining the profit element for a contractor who has performed an efficient job of disposing of inventories incident to the terminated contract.

Too frequently, independent public accountants' reports on audits of termination claims are of little use to the contracting officer. The claim I mentioned previously, in discussing administrative expense, was accompanied by a public accountant's certificate indicating no exceptions, although subsequent examination by the prime contractor indicated that the administrative expense included was the amount that might have been properly allocated had the contract been completed. In other cases, contracting officers have excluded accountants' fees, in whole or in part, on the ground that the audit, or report thereon, was not such as to contribute to the determination of the settlement. I am not concerned as to the possibility of accountants' fees, in general, being excluded, since the government needs the assistance of independent public accountants in handling this enormous termination problem. I am concerned, however, by the fact that many accountants' reports do not serve the purpose for which they are required. It should be remembered that the settlement of termination claims generally is not on the basis of a formula but on the basis of negotiation. The purpose of the report of independent public accountants should be to assure the contracting officer as to the general reliability of the figures, and to furnish him with information as to the composition of, and methods of determining, the various amounts in the claim, on the basis of which a conclusion may be reached as to their reasonableness and propriety. The information

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furnished, except for the underlying working papers, should be substantially that which would be available to the contracting officer if the examination had been made by government auditors. Adequate information can scarcely be given in a one-page certificate. The requirements and purposes of the audit report are clearly set forth in the War Department Termination Accounting Manual. One of the principal justifications for allowing accountants' fees is that their work is in lieu of audit work that would otherwise be required of government auditors.

Industry and the government face a tremendous job in settling claims on terminated contracts, now and to an even greater extent on "V" day. The facility with which settlements will be

made will depend upon a high degree of coöperation. The system of negotiated settlements should contribute to the success of the transition to a peacetime economy depending, of course, upon the reasonableness of businessmen and of the government representatives responsible for the settlements. We should all remember that although a negotiated settlement should be based on a reasonable determination of cost, speed is to be preferred to meticulous accuracy. The extent to which public accountants meet squarely the problems of terminated contracts, and prepare their clients to meet the practical problems connected therewith, will, undoubtedly, have a considerable bearing on the standing of the profession in the postwar period.

CHAIRMAN BAILEY:

We have one more treatment of the specific phase of this problem. Mr. Dennis is also a newcomer, I believe, to the Institute programs. He is a resident partner in Cincinnati of Lybrand, Ross

Bros. and Montgomery, with which firm he has been connected since 1916. Mr. Dennis will talk to us on the problems of starting-load and initial expenses.

Treatment of Initial Expenses on Termination of Fixed-Price Supply Contracts

BY FRED C. DENNIS, OHIO

Member, American Institute of Accountants

CONSIDERATION of the accounting for starting-load costs or initial expenses in fixed-price supply contracts is particularly important at this time because of the possibility of termination of any war supply contract. Termination is generally due to changes in the supply requirements of the armed forces normally occurring because of strategic changes, development of new projects, invention of new items of war material, reallocation of scarce raw materials, and other similar factors arising under the changing circumstances of modern war.

Starting-load costs or initial expenses

may be defined as nonrecurring expenditures made in the early stages of contract performance, the benefits of which extend throughout the life of the contract. It is important to keep in mind that starting-load costs, as the term implies, are nonrecurring. There are several types of starting-load costs or initial expenses, and we shall discuss some of them in detail later on.

If it were not for the possibility of termination of a supply contract during its early stages there would be little need for devoting time to the discussion of the proper accounting for starting-load costs. Such expenditures have been

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made in material amounts in connection with many contracts which have been completed or are now nearing completion. It is assumed that these items have been treated in the accounts and in the published reports of contractors in accordance with generally accepted accounting practices applicable in the circumstances.

We are concerned here only with the proper accounting for these costs in order that the contractor may be prepared for the possible termination of his war supply contracts. References herein to contractors are generally equally applicable to subcontractors. There can be little doubt, based on the regulations and manuals issued by the service departments of the government, that it is hoped that termination claims relating to supply contracts can be settled in the main by negotiation. Since the negotiated settlement of a terminated contract on a basis satisfactory and fair to the contractor may depend largely on how convincingly his claim can be presented to the contracting officer, the importance of properly determining starting-load costs or initial expenses cannot be overemphasized. If these items are not properly determined, the contractor's claim will be reduced and he will thereby suffer the loss of expenditures made in connection with the contract. Also, if at the time of termination the contract is in its early stages, it will be necessary to prorate properly the starting-load costs in order to determine whether or not the contractor might reasonably have expected to realize a profit on the contract if it had not been terminated.

If it can be demonstrated that a profit could reasonably have been expected, then the contractor will be allowed a profit on expenditures made to date of termination on account of the contract. Such expenditures would include all proper starting-load costs. It would appear that in the case of a supply contract terminated in its early

stages, having starting costs representing expenditures requiring a high degree of skill with respect to engineering work, production scheduling, technical study, and supervision or other services, a higher percentage of profit should be allowed the contractor on such expenditures than in the case of a contract requiring comparatively little skill or ability. Careful consideration should be given to the compilation of data to support such a contention.

It should be noted that the importance of starting-load costs decreases as completion and delivery of supplies under the contract progress. However, in view of the fact that no contractor can be sure at what time a contract may be terminated, either in whole or in part, it is necessary that such steps be taken as will enable him to prove to the satisfaction of the contracting officer the amount of the starting-load costs and that such expenditures are properly applicable to the contract.

In view of the fact that starting-load costs will generally be material only in those instances where a contractor is undertaking the production of a supply, the manufacture of which is new to him, it would appear advisable that in the case of each such contract the contractor's accounting officer undertake the preparation of supporting data and certain detailed records with respect to each contract. The method of such record-keeping will depend largely on accounting records and other data available and on the available manpower. Although it is true that this will in many instances place an added burden upon the already overburdened accounting organizations of contractors, nevertheless it would seem that, if the contractor desires fully to protect his right, he can ill afford to keep records containing data insufficient to satisfy the contracting officer. This is another challenge to industrial accountants, to comptrollers, and to certified public accountants.

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Before considering specific types and examples of starting-load costs, let us consider carefully the definition of and provision for the allocation of starting-load costs as contained in Procurement Regulation No. 15 (15-496):

“Starting-load costs’ on supply contracts, in appropriate cases are properly to be spread, in accordance with recognized accounting practices, over the contract as a whole and allocated in part to the uncompleted portion of the contract. (See paragraph (b) of PR 324 and paragraph 15-451.1.)”

“Starting-load costs’ are nonrecurring although the benefits of the expenditure are spread throughout the life of the contract. The mere fact that a non-recurring cost has been incurred during the period in which completed articles were produced does not mean that the whole amount of that cost must be absorbed in the cost of such completed articles. Only a proper portion of such costs allocated in accordance with recognized accounting practices need be attributed to the cost of such completed articles. The remainder may be allocated over the uncompleted portion of the contract and such portion of that remainder may be regarded as a cost on termination. The foregoing also applies, within reasonable limits as determined by the contracting officer, to an initial high rate of rejects or of machine break-downs and similar factors of expense and delay in the early stages of a contract, nonrecurring in nature, where such factors, in the opinion of the contracting officer, are reasonably due to the contractor’s unfamiliarity with the work, the complexity of the work, or other factors warranting such allocation over the whole contract.”

It should be noted that starting-load costs on supply contracts in appropriate cases are properly to be spread, in accordance with recognized accounting practices, over the contract as a whole and allocated in part to the uncompleted portion of the contract. Note, however, the last sentence of the above quotation.

Note also that, in order that a contractor may secure the proration over the life of the contract of “an initial high rate of rejects or of machine break-downs and similar factors of expense and delay in the early stages of the contract,” the contractor must convince the contracting officer that such costs are “reasonably due to the contractor’s unfamiliarity with the work, the complexity of the work, or other factors warranting such allocation over the whole contract.”

Starting-load costs include factory rearrangement, employee training, engineering, and other technical services, expenses in connection with the placing of subcontracts, and any other non-recurring expenditure applicable to and occurring during the early stages of the contract. Factory rearrangement costs usually include labor, material, engineering, and other supervisory expenses. Employee training expenses in many instances have represented substantial sums. Special facilities have been provided with instructors, machinery, tools and equipment such as will be used by the employee when he or she joins the production line. In many instances, however, such a program is not considered practicable. It is then necessary to measure as accurately as possible the cost of such training which is undertaken concurrently with production. Expenses in connection with subcontracts generally consist of time of the prime contractor’s technical staff and certain key executives, and expenses incurred by them in connection with the subcontracts.

Experience with contracting officers negotiating settlements leads to the conclusion that they are not particularly interested in form but are concerned primarily with the substantial accuracy of the accounting records and supporting data and the justification for including such costs in the contractor’s claim.

One case which involved several of

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the above starting-load costs may be of interest to you. A Midwest contractor undertook a supply contract for a government agency. It was necessary that considerable rearrangement of machinery and equipment be made and that new equipment be installed. It was also necessary that new employees be added and trained in the operation of these machines, that special tooling be undertaken and that engineering studies be made. Although it was estimated that the performance of this contract would require several months, nevertheless it was not of such magnitude as to justify the establishing of a special training course for new employees. Accordingly, in the early stages of production, spoilage was high and output was relatively small. The contractor maintained at the outset what might be described as job-cost sheets in considerable detail, setting forth expenditures for factory rearrangement, engineering, and other special services. As production got under way, time studies were made frequently, and diligent efforts were made to increase efficiency. Before the contractor had proceeded far enough to eliminate operating inefficiencies the contract was terminated for the convenience of the government. In a short time, however, a similar product was contracted for by another government agency and its manufacture undertaken in the department previously established by the contractor. It was necessary, of course, that the contractor present his claim to the first government agency, as the expenditures made on the first contract could not be properly carried over to the subsequent contract with the other government agency. Fortunately for the contractor, before the time arrived for presenting his claim to the first government agency, the efficiency of his operating department had increased to such a point that he was then showing a satisfactory profit on the new product which was very similar to the

one on which the contract had been terminated. He was now in the position of having maintained complete records of his starting-load expenses and also was in a position to show that had the contract not been terminated he would have been able to absorb the starting-load costs and would have made a profit. The claim was presented and allowed by the first government agency, so that the contractor recovered his expenditure for starting-load costs and also was allowed a profit on such costs as well as on other costs in connection with the contract which had been terminated.

In another instance a supply contract was terminated in its early stages. The circumstances were comparable with those in the preceding example — substantial expenditures for factory rearrangement and engineering services, a large proportion of new workers with little if any mechanical skill, a large quantity of rejects in the early stages of production, and many other difficulties. Employees were trained concurrently with production. Fortunately, time studies had been made shortly before notice of termination was received and these studies, together with other cost data, indicated that the contractor was then producing the item at a profit. The contractor contended that costs in excess of unit costs at date of termination represented starting load. His contention was allowed. Starting-load costs were prorated to total units in the contract. Units completed were charged with their prorata share and the balance was included in the uncompleted portion of the contract.

In this and the preceding example, costs of completed units were first determined exclusive of starting-load costs, which were then added to ascertain whether or not the contractor was making a profit at date of termination.

In addition to the foregoing examples of starting-load costs, let us consider

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a few examples of expenses which have been rejected by contracting officers as improper starting-load costs. In one case the contractor had a substantial amount of idle plant expense prior to commencement of production on his government contract. This idleness was caused by government restrictions on production of his consumer goods. The contracting officer took the position that such idle plant expense was not applicable to the contract. In another case loss on consumer goods inventory displaced by war production was rejected as not properly chargeable to the contract.

If at date of termination it does not appear that the contractor is making a profit, diligent efforts should be made to ascertain the reasons. A review of cost estimates made concurrently with placing of the contract should be helpful. If it can be shown that current labor, material, and overhead costs are in line with estimates, it would appear that the absence of a profit may well be due to starting-load costs. Such costs might include high rate of rejects, labor inefficiencies, expenses incident to machine breakdowns, and other unusual expenses in the early stages of contract performance.

In the manufacture of newly designed supply items, rejects and other costs may be high and the period of unsatisfactory and unprofitable contract performance may extend far beyond that contemplated by the contracting officer or the contractor. This may be caused by the changing of designs or production methods, or both.

The question has been raised as to the proper reporting of starting-load costs or initial expenses in the event that a supply contract has been terminated. Prior to termination some of these expenditures would be properly includable in inventory, whereas others would be included under prepaid expenses and deferred charges. On termination, however, it would appear that these expenditures should be eliminated from

the foregoing asset accounts. The generally accepted definition of inventory is, "merchandise bought for resale, finished and partially finished goods manufactured for sale in the normal course of business, and materials and supplies purchased for use in production." It would appear that, inasmuch as the unamortized portion of starting-load costs of a terminated contract would not be includable in future work in process, they should be eliminated from the inventory. Prepaid expenses and deferred charges represent the residual amounts of an expenditure or accrual made prior to the balance-sheet date which should be allocated between two or more fiscal periods. Prepaid expenses or deferred charges applicable to a terminated supply contract are not chargeable against the income account in subsequent periods.

It would appear that the unamortized balances of starting-load costs or initial expenses previously carried either in inventory or in prepaid expenses and deferred charges should be transferred to a special claim account appropriately described. This account might also include the balances of other expenditures for which a claim has been or is to be filed. Such an account should be shown as current or noncurrent depending on the probable date of settlement subsequent to the balance-sheet date.

In conclusion it should be kept clearly in mind that starting-load costs are nonrecurring and the benefits thereof are expected to extend throughout the life of the contract. It is to be hoped that most supply contracts will be settled by negotiation between the contracting officer and the contractor. If this be so, it is presumed that the contracting officer will give due weight to accounting records and data which show that such starting-load costs are properly applicable to the contract and will not be unduly technical as to the form of such records. Although the compilation and segregation of data in

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support of starting-load costs is an added burden on the contractor's accounting department, nevertheless, the possibility of termination makes it imperative that every effort be made to build up a record of these starting-load costs as they are incurred. Experience indicates that data accumu-

lated and records made at the time an expenditure is incurred are much more convincing than conclusions arrived at months afterwards by the application of percentages or theoretical computations.

Now is the accepted time; tomorrow may be too late.

**RECOMMENDATIONS OF THE COMMITTEE ON TERMINATION OF WAR CONTRACTS
AMERICAN INSTITUTE OF ACCOUNTANTS**

(1) Definite recognition, by legislation if necessary, for negotiated settlements after adequate investigations appropriate in the circumstances. Such negotiated settlements should be final in the absence of fraud or misrepresentation.

(2) Review of negotiated settlements by the Comptroller General for fraud, on misrepresentation, with right of access to all data relied upon by the contracting officers in making the settlements, and full rights of examination of contractor's data in case of suspected fraud, but with no right to set aside negotiated settlements in the absence of fraud or misrepresentation.

(3) Decisions on recognized accounting practices to be published in sufficient detail to serve as criteria to both government personnel and the public in the development of termination proposals. When such decisions are to involve fundamental problems of wide application, independent accountants should be given the opportunity of expressing opinion on questions of recognized accounting practices.

(4) Trained auditing and accounting personnel should be conserved in every possible manner to avoid breakdown of procedures due to shortage of manpower, which, if it became acute, would seriously delay settlements and thereby impede resumption of normal business activity by the contractor. Policies which are recommended in this connection are as follows:

- (i) Where examination of contractor's records is necessary, the audit or examination of records should be handled by one service.
- (ii) There should be authority for treatment of all terminated contracts of one contractor at one time by one service where such procedure is feasible and appropriate.

(iii) There should be assigned at once to corporations having large numbers of contracts or subcontracts an accounting representative of the service most interested, to furnish to all services or prime contractors necessary accounting and auditing reports on any terminated contracts.

(5) Uniformity of procedures to be followed by the various procurement agencies. The necessity for uniform rulings on cost allowances and on accounting decisions is particularly to be emphasized.

(6) A planned program of education and enlightenment on termination requirements for

- (a) Contractors.
- (b) Contracting officers.
- (c) Government officers.
- (d) Public accountants.

The American Institute of Accountants has pledged itself to do what it can in such a program.

(7) Many matters of policy can be decided prior to termination, and policies should be adopted which permit advance agreement between government and contractor wherever possible. This is particularly important with respect to disposal of material, removal of equipment, termination expenses, delegation of authority, procurement agency to be responsible, examination of subcontractors' claims, etc.

(8) There must be adequate machinery for partial payments, and payments must be made mandatory to as large an extent as possible and, if necessary, disbursing or contracting officers of the government should be held personally harmless for payments made in good faith, or approved in good faith, to prime contractors.

RESOLUTION OF COUNCIL OF THE AMERICAN INSTITUTE OF ACCOUNTANTS

WHEREAS, The American Institute of Accountants, as the national organization of certified public accountants, takes cognizance of the proposal that settlements of terminated war contracts be subject to audit and approval by the General Accounting Office before becoming final; and

WHEREAS, said proposal entails auditing and accounting procedures that are complex and highly technical, and also relate directly to postwar problems of the greatest public interest, involving as they do the conversion of industry from a war to a peacetime economy; and

WHEREAS, by the very nature of their profession and attendant obligations to the public as the result of their training, experience, and independence of viewpoint, independent public accountants have a direct responsibility to give expression to their views upon such public affairs as come within their professional experience; and

WHEREAS, it is desirable to have adequate examination of termination proposals before final payment thereof, to such extent as is necessary in the circumstances of each case sufficiently to protect the broad public interest; and

WHEREAS, promptness and finality of termination settlements are essential to the unhampered transition to a peacetime economy,

NOW THEREFORE BE IT RESOLVED BY THE COUNCIL OF THE AMERICAN INSTITUTE OF ACCOUNTANTS, as follows:

1. That adequate examination of termination proposals can be made only by access to the books, records, physical properties, and

inventories of the contractor, and that the decisions required in passing upon termination proposals involve trained accounting and business judgment of a high order;

2. That where satisfactory audit and review have been carried out by one agency of the government in the determination of the amount of settlement, no useful purpose is served in having a second audit by other agencies of the government;

3. That the present or reasonably prospective number of accountants sufficiently trained for the type of accounting examinations required under the negotiated procedures is such as to require the maximum possible use of trained personnel, and that the additional requirements if there are to be duplicate audit procedures cannot possibly be met;

4. That the preparation of data required by present procedures of the General Accounting Office would impose an extreme burden upon small companies who have not been able to anticipate the requirements of such an examination, and do not have the staff organization necessary therefor;

AND THEREFORE IT IS THE FIRM CONVICTION OF THIS COUNCIL

5. That negotiated settlements should be permitted with proper safeguards;

6. That settlement should be made promptly and once made should be final and binding in the absence of fraud; and

7. That proper records relating to all such settlements should be kept and be available for such examination as the Comptroller-General may wish to make to determine whether or not fraud exists.

The Comptroller General and Termination Audits

Washington is boiling with controversy over the proposal, in a letter from the Comptroller General to Senator Murray, dated September 20, 1943, that the General Accounting Office "make a proper audit and review of the claims asserted in connection with the settlement of the government's obligations under terminated contracts." The Undersecretary of War, in a letter to Senator Murray dated October 8th, maintained that the War Department has the right under contract provisions and under the law to make negotiated settlements which are conclusive upon the General Accounting Office, in the absence of fraud or mutual mistake.

The first impulse of war contractors, who dread the possibly fatal delay in termination settlements which review by the General Accounting Office would cause, is to launch a violent attack upon the Comptroller General. The instinctive impulse of many members of Congress would be to defend him, inasmuch as his office is the creation of Congress, is responsible to Congress alone, and is entirely independent of the executive branch of the government. The result might be a most unhappy solution of the problem, reached in a highly emotional atmosphere without full understanding of the facts.

The legal rights of the Comptroller General and the War Department in this matter are obscured by apparently ambiguous or inconsistent provisions of the Budget and Accounting Act of 1921, and the first War Powers Act. The importance of the subject warrants specific legislation by Congress to resolve the dilemma. In considering such legislation, Congress should guard against misunderstanding which may arise from careless use of the word "audit"—a word which may have varied implications. One meaning of "audit" is an examination of a claim for payment or credit and of supporting evidence, such as a voucher, for the purpose of determining whether the expenditure is properly authorized. Another meaning of the word is an examination of financial statements of an enterprise, such as a statement of costs and profits, reflecting not only actual transactions but valuations, estimates, and opinions, for the purpose of determining

whether such statements fairly reflect the matters with which they purport to deal. This type of audit commonly involves reference to the underlying books and records of the enterprise to test the credibility of the financial statements.

Let us apply these two meanings of the word "audit" to the functions of the Comptroller General and the War Department, respectively, in relation to termination settlements.

The Comptroller General, in the following statement which he submitted to a Congressional committee last spring, has clearly indicated that the first type of audit is his main concern: "The primary purpose of the audit of expenditures is to determine whether they are within the scope of the appropriations sought to be charged, and not in contravention of any law enacted by the Congress for the control and limitation of expenditures from public moneys."

It is entirely fitting that the General Accounting Office should periodically review the expenditures of all contracting agencies, including the War Department, regardless of the purpose for which such expenditures are made, to determine whether or not they are in accordance with the law and the terms of budget appropriations.

It would be a violation of common sense, however, if this duty of the Comptroller General were so interpreted, when a government agency had terminated a contract for its own convenience and had negotiated a settlement with the contractor, as to require the Comptroller General to audit the accounts of the contractor. This type of examination, if necessary, should be made by the contracting agency itself. Termination settlements do not involve "claims" by contractors in the ordinary sense of the word, but are rather adjustments of price arising from a reduction of the amount of goods originally ordered by the government. The change in the original order is entirely at the government's discretion, and common justice requires that the contractor be paid for what he has already done in good faith to fulfill the terms of the original contract. No one has suggested that the Comptroller General should audit costs incurred under completed fixed-price supply contracts. Why then should he audit costs incurred under

Accounting Problems in War Contract Termination

partly completed fixed-price contracts? It may be that the common but inaccurate use of the phrase "termination claims" has introduced an element of confusion.

In determining the amount due to a contractor when his contract is terminated, the contracting agency must obviously examine or "audit" his books and records to whatever extent may be necessary to satisfy the agency that the amount proposed as a settlement is fair. The War Department's Procurement Regulation No. 15 and its Termination Accounting Manual for Fixed-Price Supply Contracts make it clear that whatever accounting investigation may be necessary to protect the government's interest will be made.

It should be understood by all concerned, however, that no amount of auditing could determine with precision the exact amount of a fair settlement. There are many elements of judgment involved in estimating costs properly attributable to a partly completed contract. Material and labor costs may be estimated with relative accuracy, but allocation of joint costs and indirect expenses (such as overhead, depreciation, engineering and development, obsolescence, experimental and research expense, and other costs) is one of the most complex of accounting problems and inevitably involves an element of opinion which no amount of auditing can eliminate.

Contracting officers in many cases may be sufficiently familiar with the affairs of contractors, or may find sufficient evidence of costs already available, to dispense with the detailed auditing which in other cases may be necessary.

The accounting profession naturally favors adequate audits in all matters of this kind, but it knows better than most that what is adequate in a given case depends on the circumstances. Accountants are highly sensible of the enormous waste of time and manpower that can result from requirement of detailed audits according to a precon-

ceived program without regard for the facts of individual cases. It is a basic principle of auditing that the cost of conducting an audit should be commensurate with the risk of loss against which it purports to afford protection. Accountants, again, are aware of the common fallacy, engendered by the human craving for certainty, that meticulous accuracy can be guaranteed by "auditing the auditor." Two audits are not necessarily better than one, and the game is not worth the candle.

A requirement that the Comptroller General audit the costs of contractors in termination settlements would make the General Accounting Office the most disastrous bottleneck in history. Where would he get the manpower? Settlements involving billions of dollars and thousands of contractors and subcontractors have already been effected. Vastly larger amounts and vastly greater numbers of contractors will be involved in terminations at the end of the war.

In his statement before a Congressional committee last April, the Comptroller General said that the present personnel of the General Accounting Office is not adequate to the performance of its actual work load, and that at February 28, 1943, the backlog of unaudited vouchers had increased to 14,956,072. The statement mentions the rapid turnover of personnel and the inability to recruit sufficiently qualified and trained replacements.

All informed students of this subject agree that speed in settlements of terminated contracts is essential to prompt reconversion of industry to peacetime production after the war. Delay may induce unemployment and raise the gravest economic and social problems.

It would be most unfortunate if misunderstanding of the purposes of two types of audits should result in legislation which might throttle our economy. The accounting profession can help to clarify this issue, and it should lose no opportunity to do so.