

1975

Audits of government contractors (1975); Audit and accounting guide:

American Institute of Certified Public Accountants. Task Force on Defense Contract Agencies

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_indev

Part of the [Accounting Commons](#), and the [Taxation Commons](#)

Recommended Citation

American Institute of Certified Public Accountants. Task Force on Defense Contract Agencies, "Audits of government contractors (1975); Audit and accounting guide:" (1975). *Industry Developments and Alerts*. 267.
https://egrove.olemiss.edu/aicpa_indev/267

This Article is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Industry Developments and Alerts by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

AICPA

American Institute of Certified Public Accountants

INDUSTRY AUDIT GUIDE

AUDITS OF GOVERNMENT CONTRACTORS

PREPARED BY THE TASK FORCE ON
DEFENSE CONTRACT AGENCIES

NOTICE TO READERS

This audit guide is published by the auditing standards division for the guidance of AICPA members in audits of the financial statements of government contractors. The guide presents the considered views of the task force on defense contract agencies and has been reviewed by other members of the auditing standards division. Thus, it contains the best thought of the profession as to the conduct of audits of financial statements of government contractors.

An audit guide is not as authoritative as a pronouncement of the auditing standards executive committee, but members should be aware that they may have to justify a departure from an audit guide if the quality of their work is questioned.

Audit guides may, of necessity, include descriptions of current financial accounting and reporting practices. Such descriptions are not intended to represent conclusions as to which practices are preferable. Establishing financial accounting and reporting standards is the responsibility of the Financial Accounting Standards Board.

Task Force on Defense Contract Agencies

GERALD E. GORANS, <i>Chairman</i>	<i>AICPA Staff:</i>
F. JAMES AHLBERG	D. R. CARMICHAEL, <i>Director</i>
WILLIAM H. DUDLEY	<i>Auditing Standards</i>
WILLIAM G. FINDLEY	EDWARD M. MUSHO, <i>Manager</i>
C. RICHARD GUNZER	<i>Auditing Standards</i>
WILLIAM J. MCHUGH	MARY LYNN O'NEILL, <i>Manager</i>
JOHN S. MOORE	<i>Auditing Standards</i>
JOSEPH E. STRICKLAND	
JERRY E. WALKER	
THOMAS R. WARNER	

Table of Contents

	<i>Page</i>
Chapter 1—Contract Procurement	
Introduction	1
Methods of Procurement	2
Formal Advertising	2
Negotiated Procurement	2
Types of Contracts	3
<i>Fixed-Price Contracts</i>	3
<i>Firm fixed-price contract</i>	3
<i>Fixed-price contract with economic price adjustment</i>	3
<i>Fixed-price contract providing for prospective periodic redetermination of price</i>	4
<i>Fixed-price contract providing for retroactive redetermination of price</i>	4
<i>Fixed-price contract providing for firm target cost incentives</i>	4
<i>Fixed-price contract providing for successive target cost incentives</i>	4
<i>Fixed-price contract providing for performance incentives</i>	4
<i>Fixed-price level-of-effort term contract</i>	4
<i>Cost Contracts</i>	4
<i>Cost-sharing contract</i>	4
<i>Cost-without-fee contract</i>	5
<i>Cost-plus-fixed-fee contract</i>	5
<i>Cost-plus-award-fee contract</i>	5
<i>Cost-plus-incentive-fee contract (Incentive based on cost)</i>	5
<i>Cost-plus-incentive-fee contract (Incentive based on performance)</i>	5

	<i>Page</i>
Contract Financing Assistance	6
Progress Payments	6
Advance Payments	7
Guaranteed Loans	7
Other Rules, Regulations, and Requirements	7
Chapter 2—Government Contract Accounting and Financial Reporting	
Introduction	9
Summary of Accounting Principles and Practices.....	10
Revenue Recognition	10
Expense Recognition	11
Accounting Methods Followed for Government Contracts.....	12
Percentage-of-Completion Method	12
Completed-Contract Method	12
Unit-of-Delivery Method	13
Selection of Appropriate Accounting Method	13
Type of Contract	13
Duration of Contract	14
Dependability or Reliability of Contract Cost Estimates.....	14
Nature of Product or Services	15
Application of Accounting Methods	15
Contract Cost Estimates	18
Provision for Anticipated Losses	20
Contract Incentives	21
Contract Costs Included in Inventory	21
Other Contracts and Arrangements and Related Accounting Considerations	22
Financial Statement Reporting and Disclosure	23
Accounting Policies	24
Balance Sheet Items and Disclosures	24
Receivables	24
Inventories and Partial Payments	25
Income Statement Items and Disclosures	26

	<i>Page</i>
Other Reporting Matters	27
Defective Pricing	27
Unusual Contracts	28
Cost Limitations	28
Contract Disputes and Other Claims	29
Chapter 3—Contract Terminations	
Introduction	30
Termination for Convenience of the Government	30
Termination for Default	33
Financial Statement Presentation	34
Chapter 4—Renegotiation	
Introduction	36
Scope and Purpose of Renegotiation	36
Renegotiation Process	39
Accounting and Reporting Considerations	41
Chapter 5—Government Contracting Audit Considerations	
Introduction	43
Contract Provisions and Regulations	44
Internal Control	46
Accounts Receivable	48
Retained Amounts	49
Claims Receivable	50
Liabilities	50
Evaluation of Contracts in Process	51
Change Orders	55
Contingent Liabilities	55

	<i>Page</i>
Other Contract Audit Considerations	55
Contract Termination	56
Renegotiation	58
Defective Pricing	59
Reporting	60
Appendixes	
A. Securities and Exchange Commission, Accounting Series Release No. 138 of January 12, 1973	61
B. Securities and Exchange Commission, Accounting Series Release No. 164 of November 21, 1974	68

Chapter I

Contract Procurement

Introduction

The purpose of this audit guide is to provide a general background in government contract auditing for the independent auditor who has clients rendering services under government-related contracts (either prime or subcontracts) with the U.S. Government.

Contractors performing under government contracts are governed, depending upon the contracting agency, by the provisions of the Armed Services Procurement Regulations (ASPR), the Atomic Energy Commission Procurement Regulations, the National Aeronautic and Space Administration Procurement Regulations, or the Federal Procurement Regulations (FPR). These regulations have been issued to establish uniform policies and procedures relating to the procurement of supplies and services under the authority of Chapter 137, Title 10, of the United States Code or under other statutory authority.

It is the policy of the federal government to procure supplies and services from responsible sources at fair and reasonable prices calculated to result in the lowest cost to the government. It is also the stated policy of the federal departments and agencies to utilize profit incentives to stimulate efficient contract performance. Procurement regulations caution contracting officers that negotiation of arbitrarily low profits, the use of historical averages, or the automatic application of predetermined profit percentages to the total estimated cost of a product does not provide the motivation to accomplish effective and economical contractor performance. Furthermore, regulations state that unreasonably low aver-

age profit rates on government contracts overall are detrimental to the public interest. The government recognizes that effective procurement in a free enterprise economy requires that the best available talents and resources be attracted to government contracting. Contracts are generally awarded in the following categories:

1. Contracts for items to be delivered or services to be performed.
2. Research and development contracts.
3. Construction contracts.
4. Facilities contracts for the acquisition, construction, or operation of plant and production equipment.

Methods of Procurement

The two basic methods of government procurement are by formal advertising and negotiation. By law, the preferred method of procurement is formal advertising. Negotiated procurements are permitted only under certain defined exceptions to the preferred method, although these exceptions are used in a significant number of procurement actions.

Formal Advertising. Procurement by formal advertising covers four phases of government involvement: (a) preparation of invitation for bids, (b) publication and distribution of invitation for bids to companies appearing on qualified bidders listings, (c) receipt of bids in response to the invitation, and (d) award of contract to the lowest responsive and responsible bidder whose bid is most advantageous to the government, price and other factors considered.

Negotiated Procurement. "Negotiation" pertains to procurements made without the use of formal advertising. Requests for quotations or requests for proposals (commonly referred to as RFQs and RFPs) for the item to be procured are mailed to contractors whose names appear on qualified bidders listings. Contractors responding to an RFQ submit only total item contract price quotations; contractors responding to an RFP usually support the total price by submitting cost and pricing data (usually DD Form 633), or other evidence of reasonable price, and in

certain instances data regarding technical and management plans and capabilities for the job. The contracting officer may accept price quotations or proposals without negotiation, or he may conduct price negotiations with those firms whose offer falls within a competitive range. He may analyze, question, require audit, and bargain in vital areas of the proposals including costs and profit, performance requirements, delivery schedules, methods of payments, and so forth.

Types of Contracts

Generally contracts may be classified within two broad categories, namely, fixed-price contracts and cost contracts. Fixed-price contracts provide for a stated contract price, a specified scope of work, and a specified performance schedule but may be subject to adjustment based on the application of economic price adjustment (escalation), redetermination, incentive, or other pricing provisions. Cost contracts provide for reimbursement of allowable or otherwise defined costs incurred plus a fee (profit) in most cases. Such a contract requires only that the contractor use his best efforts to accomplish the scope of work within a specified time and within the stated contract dollar limitation.

It should be noted that an important distinction between the two basic categories of contracts defined above is that a fixed-price contract obligates the contractor to a firm responsibility for performance whereas a cost contract obligates the contractor on a best-efforts basis. Within these two broad categories there are presently a number of variations, the more common of which are described below.

Fixed-Price Contracts

Firm fixed-price contract—A contract in which the price is not subject to any adjustment by reason of the cost experience of the contractor or his performance under the contract.

Fixed-price contract with economic price adjustment—A contract which provides for upward or downward revision of contract price upon the occurrence of specifically defined contingencies, such as increases or decreases in material prices or labor wage rates.

Fixed-price contract providing for prospective periodic redetermination of price—A contract which provides a firm fixed-price for an initial number of unit deliveries or for an initial period of performance and for prospective price redeterminations either upward or downward at stated intervals during the remaining period of performance under the contract.

Fixed-price contract providing for retroactive redetermination of price—A contract which provides for a ceiling price and retroactive price redetermination (within the ceiling price) after the completion of the contract, based on costs incurred, with consideration being given to management ingenuity and effectiveness during performance.

Fixed-price contract providing for firm target cost incentives—A contract which provides at the outset for a firm target cost, a firm target profit, a price ceiling (but not a profit ceiling or floor), and a formula (based on the relationship which final negotiated total cost bears to total target cost) for establishing final profit and price.

Fixed-price contract providing for successive target cost incentives—A contract which provides at the outset for an initial target cost, an initial target profit, a price ceiling, a formula for subsequently fixing the firm target profit (within a ceiling and a floor established along with the formula, at the outset), and a production point at which the formula will be applied.

Fixed-price contract providing for performance incentives—A contract which incorporates an incentive to the contractor to surpass stated performance targets by providing for increases in the profit to the extent that such targets are surpassed and for decreases to the extent that such targets are not met.

Fixed-price level-of-effort term contract—A contract which usually calls for investigation or study in a specific research and development area. It obligates the contractor to devote a specified level of effort over a stated period of time for a fixed dollar amount.

Cost Contracts

Cost-sharing contract—A contract under which the contractor is

reimbursed only for an agreed portion of costs and under which no provision is made for fee.

Cost-without-fee contract—A contract under which the contractor is reimbursed for costs with no provision for a fee.

Cost-plus-fixed-fee contract—A contract under which the contractor is reimbursed for costs plus the provision for a fixed fee.

Cost-plus-award-fee contract—A contract under which the contractor is reimbursed for costs plus a fee consisting of two parts: (1) a fixed amount which does not vary with performance and (2) an award amount based on performance in areas such as quality, timeliness, ingenuity, and cost-effectiveness. The amount of award fee is based upon a subjective evaluation by the government of the contractor's performance judged in light of criteria set forth in the contract.

Cost-plus-incentive-fee contract (Incentive based on cost)—A contract under which the contractor is reimbursed for costs plus a fee which is adjusted by formula in accordance with the relationship which total allowable costs bear to target cost. At the outset there is negotiated a target cost, a target fee, a minimum and maximum fee, and the adjustment formula.

Cost-plus-incentive-fee contract (Incentive based on performance)—A contract under which a contractor is reimbursed for costs plus an incentive to surpass stated performance targets by providing for increases in the fee to the extent that such targets are surpassed and for decreases to the extent that such targets are not met.

Under cost contracts statutory limitations have been imposed on fees negotiated at the outset of the contract as follows:

1. Fees for experimental, developmental, or research work cannot be more than 15 percent of estimated cost.
2. Fees for architectural or engineering services for a public work or utility cannot be more than 6 percent of estimated cost.
3. Fees on other cost contracts cannot be more than 10 percent of estimated cost.

It should be noted that fixed-price and cost incentive contracts may include a combination of both cost and performance incentives.

In addition to the two broad categories of contracts described above, there is a *time and material contract*. Under this type of contract the contractor is paid on the basis of direct-labor hours, expended at fixed hourly rates (that include direct-labor, indirect expenses, and profit), and the costs of materials or other specified costs.

There is a preliminary contractual instrument (*letter contract*) which may be used to authorize immediate manufacture of supplies or performance of services. The letter contract must be superseded by a definitive contract at the earliest possible date, but usually not later than the expiration of 180 days from the date of the letter contract or completion of 40 percent of the production or services called for under the contract, whichever occurs first. All letter contracts are required to contain a stated maximum government liability that generally does not exceed 50 percent of the total estimated cost of the procurement.

Contract Financing Assistance

In the interest of national security the government provides contracting firms with financial assistance, if needed, under contracts for the procurement of supplies or services or for research and development contracts. It is the stated policy of the government not to consider the need for financing a deterrent in awarding contracts. The types of financing available in a specific situation depend upon the nature of the contract, the need of the contractor, and in some instances, the statutory restrictions imposed by Congress. For additional information relating to defense contract financing see Appendix E of the Armed Services Procurement Regulations and Part 1-30 of the Federal Procurement Regulations.

The more common methods of financing are as follows:

Progress Payments. The most common method of making funds available to the contractor is by means of payments during performance of the contract according to specified progress. The government acquires title to the work in progress.

Advance Payments. Advance payments are available to contractors whose developmental or preliminary costs prior to performance under the contract are such that the contractor would be under undue financial hardship before earning any return on the contract. This type of payment is only available to prime contractors; however, they may be made to the prime contractor for the purpose of making similar advances to subcontractors.

Guaranteed Loans. The government will enter into an agreement with a private financial institution whereby it will guarantee all or a part of a loan made to a contractor engaged in national defense. The government becomes obligated to share the losses on the loan with the lender to the extent of the guarantee percentage.

When a contractor prefers to deal with a private lending institution without government aid, he can assign payments aggregating \$1,000 or more due under the contract to a financial institution as security for a loan pursuant to the Assignment of Claims Act of 1940, as amended.

Other Rules, Regulations, and Requirements

Companies engaged in government contracting are subject to certain rules and requirements set forth in the applicable procurement regulations. Sections of these regulations covering contract clauses, terminations, and contract costing principles are of particular importance to the accountant. In addition, general familiarity with the pronouncements of the Cost Accounting Standards Board and regulations of the Renegotiation Board is important.

The government has significant rights in the award and control of government contracts and related subcontracts not generally found in contracts between commercial enterprises. Some of the more important rights permit the government to do the following:

1. Negotiate contract price adjustments depending on contract type or specific contract clauses.
2. Disallow specific costs and expenses.
3. Require advance agreements by contractor before sharing in certain costs and expenses.

4. Provide government-furnished material or equipment.
5. Terminate contracts at convenience of the government.
6. Provide certain incentives or assess penalties based on performance.
7. Direct changes at any time within the general scope of the contract subject to an equitable adjustment of the contract price.
8. Subject the contractor to preaward and postperformance audits of costs of certain contracts.
9. Require contractors to disclose their cost accounting practices and to agree to consistently follow those practices in advance of submitting a price proposal on a contract.

Chapter 2

Government Contract Accounting and Financial Reporting

Introduction

This chapter explains the accounting principles and practices and financial reporting characteristics of government contractors, which are not generally applicable to other types of business enterprises. Government contract accounting and financial reporting are influenced by unique aspects of the industry. Important among these unique aspects are (1) the long-term nature of many government contracts, often extending over more than one reporting period; (2) the necessity for estimating contract costs often for products or services not previously provided; (3) the rights and obligations of the government contractor not often found in other business activities; and (4) the cost accounting and various other requirements imposed on the government contractor by law or government procurement regulations.

It is, of course, not practical to discuss in detail the many different situations that may arise having accounting and financial reporting significance. This chapter provides basic information on government contract accounting and reporting matters. This information should be helpful to accountants who have not had experience in government contract accounting, and it may also serve as a reference point in considering accounting and financial reporting questions which will arise in situations not specifically covered.

The American Institute of Certified Public Accountants and the Financial Accounting Standards Board have, over the years, issued pronouncements on generally accepted accounting principles. Some of these pronouncements have an important bearing on government accounting matters and are cited in this chapter.¹

Summary of Accounting Principles and Practices

The Accounting Principles Board, in its Statement No. 4 (October 1970), discussed in a descriptive, rather than prescriptive, sense basic concepts and accounting principles underlying financial statements of business enterprises. The board stated that it believed the accounting principles described in that statement were those that were generally accepted at that time but cautioned that it had not evaluated or approved the then present generally accepted accounting principles except to the extent that principles had been adopted in board opinions. Nevertheless, portions of two of the pervasive measurement principles described in Statement No. 4 relate directly to the discussion in this chapter on government contract accounting matters and are summarized here for reference purposes.

Revenue Recognition. Revenue is conventionally recognized when the activity surrounding the sale of products or rendering of services is complete or virtually complete. However, revenue is sometimes, as in the case of long-term contracts, recognized as performance progresses. This exception is based on the consensus that a better measurement of periodic income results.² Accounting Research Bulletin No. 43, chapter 11, section A, paragraph 13, states:

It is, however, a generally accepted accounting procedure to accrue revenues under certain types of contracts and thereby recog-

¹ The Committee on Accounting Procedure issued its pronouncements in Accounting Research Bulletins. The successor body, the Accounting Principles Board, issued its pronouncements in Opinions and Statements. The Financial Accounting Standards Board replaced the APB as of July 1, 1973 and issues its pronouncements in Statements of Financial Accounting Standards.

² Accounting Principles Board Statement No. 4 (New York: American Institute of Certified Public Accountants, 1970), paragraphs 150-152.

nize profits, on the basis of partial performance, where the circumstances are such that total profit can be estimated with reasonable accuracy and ultimate realization is reasonably assured. Particularly where the performance of a contract requires a substantial period of time from inception to completion, there is ample precedent for pro rata recognition of profit as the work progresses, if the total profit and the ratio of the performance to date to the complete performance can be computed reasonably and collection is reasonably assured. Depending upon the circumstances, such partial performance may be established by deliveries, expenditures, or percentage of completion otherwise determined. This rule is frequently applied to long-term construction and other similar contracts; it is also applied in the case of contracts involving deliveries in instalments or the performance of services. However, the rule should be dealt with cautiously and not applied in the case of partial deliveries and uncompleted contracts where the information available does not clearly indicate that a partial profit has been realized after making provision for possible losses and contingencies.

Expense Recognition. Expenses (costs associated with revenue) are recognized on the basis of presumed direct association with revenues or indirect association through allocation in a systematic and rational manner among the periods benefited.³ Notwithstanding such conventional treatment there is precedent under certain conditions for allocating certain of such expenses to contract costs rather than period income. One such exception to conventional practice is stated in Accounting Research Bulletin No. 45, paragraph 10, as follows:

When the completed-contract method is used, it may be appropriate to allocate general and administrative expenses to contract costs rather than to periodic income. This may result in a better matching of costs and revenues than would result from treating such expenses as period costs, particularly in years when no contracts were completed. It is not so important, however, when the contractor is engaged in numerous projects and in such circumstances it may be preferable to charge those expenses as incurred to periodic income. In any case there should be no excessive deferring of overhead costs, such as might occur if total overhead were assigned to abnormally few or abnormally small contracts in process.

³ Accounting Principles Board Statement No. 4 (New York: American Institute of Certified Public Accountants, 1970), paragraphs 154-159.

Another exception may occur in connection with cost contracts where reimbursable costs (which would include general and administrative expense) and fees are the determinants for the amount of recorded revenue: "Under a true cost-reimbursement contract, unbilled accumulated costs determined in accordance with contract terms generally represent an acceptable basis for inventory accounting purposes."⁴ In such cases, all unbilled costs often are included in contract costs rather than some portion of unbilled costs being charged to period income.

Accounting Methods Followed for Government Contracts

There are three generally accepted methods of accounting for government contracts—percentage-of-completion, completed contract, and unit-of-delivery. Each of these methods is briefly described in the following paragraphs together with a discussion of some of the circumstances under which they are used and the reasons ordinarily cited for their application.

Percentage-of-Completion Method. The percentage-of-completion method recognizes income on work as a contract progresses. This method provides for recognition of income on a periodic basis rather than deferral of recognition until a contract is completed. This approach to income recognition has the advantage of recording income over the life of a contract as costs are incurred and effort is expended, thereby avoiding irregular fluctuations in results of operations sometimes associated with completed-contract accounting. The principal disadvantage of this method is that its use is dependent upon obtaining reliable estimates of total costs at completion and a sound assessment of the current stage of completion of the contract. A contractor's reported results can be misstated if such data is unreliable.

Completed-Contract Method. The completed-contract method defers recognition of income while a contract is in progress. Upon completion, or substantial completion, of a contract the total revenues and costs associated with the contract are recog-

⁴ Horace G. Barden, Accounting Research Study No. 13, *The Accounting Basis of Inventories* (New York: American Institute of Certified Public Accountants, 1973), p. 155.

nized. Current provision must be made, however, if a contract loss is indicated. The principal advantage of this method of recording income is that while the level of uncertainty regarding total contract cost estimates may not be reduced, the possible misstatement of the effect on periodic earnings is lessened. On the other hand, this method has the disadvantage of deferring recognition of income until completion of a contract. It does not reflect current performance when the period of a contract extends through more than one accounting period. In the case of an enterprise engaged in a small number of long-term contracts, completed-contract accounting may result in rather pronounced fluctuations in the levels of revenues, costs, and income. Such fluctuations may be less significant when short-term contracts are involved or when greater numbers of contracts are involved and a number of contracts are being completed or substantially completed in each financial reporting period.

Unit-of-Delivery Method. Under the unit-of-delivery method sales and cost of sales are recorded as units are delivered, thus paralleling income recognition practices generally associated with manufacturing enterprises not involved with government contracts. It offers the advantage of consistency in contract accounting methods when an enterprise is involved with commercial and government contracts that are similar in nature. It also permits periodic income recognition; however, under this method (as contrasted with the percentage-of-completion method) income would not be recognized before deliveries commence. To the extent a contract requires extensive lead time before deliveries commence, this method has the same disadvantage of income deferral associated with the completed-contract method.

Selection of Appropriate Accounting Method

There is a selection of acceptable contract accounting methods; thus, choosing the most appropriate method may be influenced by such factors as the type and duration of the contract, dependability or reliability of contract cost estimates, or the nature and complexity of the product or services to be provided.

Type of Contract. Cost contracts are described in chapter 1 as those which provide for reimbursement of allowable, or other-

wise defined, costs incurred plus a fee in most cases. This type of contract lends itself particularly to percentage-of-completion accounting as opposed to other acceptable methods. Fixed-price contracts in general provide for a stated contract value (which may be subject to adjustment) and do not by nature necessarily lend themselves to a particular accounting method.

Duration of Contract. The problems and questions associated with accounting for government contracts arise particularly in connection with long-term contracts since they extend over several accounting periods. Short-duration contracts present fewer problems and judgmental situations in the application of accounting method. From a theoretical standpoint the duration of a contract would not generally be expected to influence the selection of an appropriate accounting method. However, duration may be a factor leading to selection of a particular method. For example, in accounting for contracts of short duration, use of the completed-contract method may be considered to be a reasonable expedient over percentage-of-completion accounting even though the latter method might otherwise be considered appropriate.

Dependability or Reliability of Contract Cost Estimates. Estimating costs is inherent in government contracting, and this process normally starts before or at the time of preparation of a contract bid or proposal. Notwithstanding estimated expectations, the resulting cost estimates might be subject to varying degrees of dependability or reliability because of such factors as the estimating techniques employed or their degree of sophistication, the complexity of the contract, the scope of work (particularly on contracts that are advancing the state of the arts), or problems which may arise in the performance of a contract. In the selection of an appropriate accounting method to be followed in long-term construction contracts, Accounting Research Bulletin No. 45, paragraph 15, states:

In general when estimates of cost to complete and extent of progress toward completion of long-term contracts are reasonably dependable, the percentage-of-completion method is preferable. When lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed-contract method is preferable.

This statement should importantly influence the choice of accounting method for long-term government contracts.

Nature of Product or Services. The nature of the product or services to be provided under a government contract may also influence the choice of an appropriate accounting method. For example, the unit-of-delivery method would seem inappropriate for a contract requiring the design and development of a single item as contrasted with a production contract for the manufacture of many items. On the other hand, a contract calling for the production of many items, particularly where a contractor has had previous experience, might be more appropriately accounted for by either the unit-of-delivery or percentage-of-completion methods rather than the completed-contract method. The completed-contract method would be appropriate for a long-term contract where reliable cost estimates could not be developed because of the nature of the contract or some other reason associated with contract performance.

When conditions permit, the selection should preferably be based on a concept of periodic recognition of income over the term of the contract. This conclusion is supported by the position expressed in Accounting Research Bulletin No. 45 quoted above. A company could use more than one acceptable method in different contract situations if well-defined criteria for differentiation exist. However, a company should not use different methods in substantially similar circumstances.

Application of Accounting Methods

Of the three basic accounting methods described earlier, the completed-contract method is the least complex to apply and is not affected in its application by the type of contract for which it is used. Under this method, revenue is not recorded until the contract is completed; costs of performance are then usually known, and there are no particular problems associated with the recording of sales and cost of sales. During the period of performance some difficulty may occur in estimating the total cost at completion for the purpose of establishing that the contract will not result in a loss since any such loss must be recognized as it becomes known regardless of the accounting method used.

The percentage-of-completion and unit-of-delivery methods are more complex and may present a number of problems in application. Practices in the application of these two methods are discussed in the remainder of this section. Some of the related accounting problems which may be encountered because of variations in each basic type of contract and because of incentive features often included in government contracts are also discussed.

In applying the percentage-of-completion method, the AICPA Committee on Accounting Procedure recommended in Accounting Research Bulletin No. 45 that the amount of income to be recognized as work progresses should be determined on the basis of (a) the percentage of estimated total income that *incurred costs* to date bear to *estimated total costs* after giving effect to estimates of costs to complete *based upon most recent information*, or (b) the percentage of estimated total income that may be indicated by *such other measure of progress* toward completion as may be appropriate *having due regard to work performed*. [Emphasis added.]

ARB No. 45 indicates a possible need to adjust "costs" if alternative (a) is used, and the following comments from the AICPA Industry Audit Guide for Construction Contractors (p. 15) are applicable to government contracts as well.

. . . since work performed is the primary basis for income allocation, certain costs may be disregarded as a measure of performance in the early stages of a contract for the purposes of determining income allocation. The bulletin qualifies the statement relative to "incurred costs to date" by saying as follows:

Costs as here used might exclude, especially during the early stages of a contract, all or a portion of the cost of such items as materials and subcontracts if it appears that such an exclusion would result in a more meaningful periodic allocation of income. . . .

The above qualification takes into account situations in which substantial quantities of materials may have been accumulated on a job site but not used, or situations in which engineering or architectural fees have been incurred, which may, for example, represent 15 percent of total estimated costs when, in terms of work performance the contract was only 5 percent completed. In these circumstances income recognized as allocable to the period should be related fully to only 5 percent of the total, and not the extent of 15 percent.

Regarding alternative (b), the use of "such other measure of progress toward completion as may be appropriate," merely allows for situations when a more meaningful income allocation would result by using a basis other than costs for determination of "percentage-of-completion." The stage of completion of engineering contracts, for example, might be more appropriately measured by engineering estimates of progress rather than the relationship of costs incurred to total estimated costs.

Under the unit-of-delivery method of income recognition, unit sales values and costs are determined for use in recording sales and cost of sales. A number of practices in determining sales may be observed in applying this method. For example, sales may be recorded as deliveries are made at the unit sales value stated in the contract or sales may be recorded based on an average unit sales value determined by dividing the contract sales value by the number of units called for by the contract. Cost of sales for units delivered may be based on actual unit cost, if the contractor's cost system provides such information, or on average cost, which is usually determined by dividing total estimated cost at completion by the number of units to be produced. In the performance of production contracts it is not uncommon for the actual cost per unit to decline over the life of the contract. For this reason some contractors prefer the average-unit-cost approach. Other contractors prefer to use actual costs for purposes of determining cost of sales. If in the early stage of deliveries actual unit cost is higher than unit sales value, unit cost of sales sometimes is recorded at an amount not in excess of unit sales value. The excess of such actual costs over sales recorded is deferred and spread over units remaining after the break-even point is reached. However, an estimated loss on the overall contract should not be deferred.

The costs of various operating activities are often treated differently within a contract. For example, manufacturing or assembly costs may be charged based upon actual costs of identified units, whereas the cost of engineering, manufacturing, planning, and tooling, considered applicable to all units, may be allocated ratably over all units to be produced. The variations that may be encountered are too numerous to cover in this chapter. Mention is made here to alert the reader to the existence of such differ-

ences and to suggest the need for a full understanding of the contractor's cost accounting practices.

Price-redeterminable and economic price adjustment contracts provide for price adjustments based on cost or other considerations. The probable effects of such adjustments should be reflected in total revenue estimates as they are revised from time to time based upon current information and expectations.

Contract Cost Estimates

The task of estimating total costs to be incurred in the completion of a contract at any given date requires evaluation of all available data and is affected by many factors including, but not limited to, such matters as these:

1. Changes in cost of materials to be purchased in the future that are not covered by firm purchase orders.
2. Changes in cost of labor, including fringe benefits, which may be experienced in the future.
3. Changes in indirect costs such as manufacturing and engineering overhead and general and administrative expenses.
4. Advance agreements and cost-sharing arrangements with the government, including recoverability of company-sponsored research and development expenses.
5. Production efficiencies (i.e., the effect of the "learning curve").
6. Fluctuations in the total production activity and the resulting effect on allocation bases for the various indirect costs.
7. Specific contract provisions regarding such items as performance requirements, warranties, and damages.
8. Changes in costs of subcontracts.
9. Technical problems encountered in performance of the contract.
10. Contract changes.

Because of the complexities involved in estimating contract costs, the participation of financial, engineering, manufacturing, and other technical departments will normally be necessary to

reasonably determine the remaining costs to be incurred in the performance of the contract.

Contract cost estimates should be reviewed and updated regularly over the term of performance of the contract. The frequency of such review and updating may depend upon contractual or other reporting requirements.

Assuming that percentage-of-completion accounting is used, a change in the estimate of total contract cost would for financial accounting purposes cause a change in the fee accrual rate for a cost contract or a change in the profit accrual rate for a fixed-price contract. In such circumstances, two general practices are used for recognizing the effect of such change.

One method recognizes the change to the full income effect in the accounting period in which the change is made. This is accomplished by adjusting the total amount of fee or profit recorded to date to bring that amount into agreement with the amount that would have been accrued had the newly determined fee or profit rate been applied in all earlier accounting periods. The proponents of this method believe that the amount of accrued fee or profit on a contract at any point in time should be in accord with the then current cost estimate for that contract. They point out that this method is consistent with the percentage-of-completion method based upon the relationship of incurred costs *to date* to estimated total costs *after giving effect* to estimates *based upon most recent information*.

The other method does not recognize the full income effect of the change currently but defers a portion of such effect to future periods. Under this method, the newly determined fee or profit rate is based upon the relationship of the amount of the fee or profit yet to be accrued to the estimate of the cost to complete the contract. Those who favor this method believe that the amount of fee or profit accrued in earlier periods (in absence of an error) was appropriately based upon reliable contract estimates at such times and that the effect of a change based upon current estimates should be recognized in future periods over the remaining life of the contract.

Either method can produce unusual results if radical changes in contract cost estimates (not occasioned by changes in the scope of work under the contract) occur from time to time, and accordingly, this matter should receive thoughtful consideration.

In some instances, a revision in the estimate of cost to complete a contract may have resulted from a significant change (extension or redirection of the scope of work) in the contract. In these circumstances it may be appropriate to recognize the resultant profit adjustment only prospectively over the remaining life of the revised contract. Careful analysis of the circumstances and exercise of judgment will be required in such situations.

Provision for Anticipated Losses

At such time as the estimate of total cost for a contract indicates that a loss will be sustained, the loss should be recorded in full. Losses on contracts should not be allocated to future periods by spreading them over the remaining life of the contract. Neither should losses be deferred in expectation of future contracts or in anticipation that the government will exercise options for the delivery of additional units, components, or spare parts. In determining the need to provide for an anticipated loss, it is acceptable to treat several profitable and unprofitable contracts which are closely related, such as parts of the same project, as a single contract. (See Accounting Research Bulletin No. 45, paragraph 6.) Once such a provision for loss is made with respect to one or more contracts, it should not be later adjusted by reason of addition of a new profitable contract.

In situations where a contractor manufactures quantities for inventory in excess of contract requirements, the costs of production should be appropriately allocated to the contract and to inventory. The costs associated with this inventory must be evaluated for realizability under conventional inventory valuation practices.

Some government contractors may incur research and development costs in connection with products which may be sold both commercially and under government contract. In the past it was acceptable practice to defer and amortize research and development costs against income from a contract. However, the Financial Accounting Standards Board in its Statement of Financial Accounting Standards No. 2 concerning the accounting for such costs, states that all research and development costs not directly reimbursable by others shall be charged to expense when incurred. Consequently, a determination should be made concerning whether research and development costs attributable to govern-

ment products are allowable under terms of the contract in question. Such costs may not be allowable under the provisions of chapter 15 of the Armed Services Procurement Regulations unless the government contract or some other agreement specifically provides for them.

Contract Incentives

The incentive features of a contract may provide for upward or downward incentive adjustments to fee (cost contract) or target profit (fixed-price contract) based upon cost or other performance by the contractor in relation to established targets. In general, where performance (cost, schedule, or technical) betters the target, there is an upward incentive in the form of increased profit allowance; where performance does not meet the target, there is a downward incentive in the form of a reduction in the profit allowance.

When a basis for reasonable prediction of performance in relation to established targets exists, the effect of the upward or downward incentive adjustment should be recorded in a manner consistent with the accounting method in use for the contract. However, when a reasonable prediction of performance cannot be made, the revenue effect of the related upward incentive adjustment should not be recorded until such time as there is sufficient information to relate actual performance to targets or other criteria. In the event downward incentive adjustments would be required for failure to meet certain criteria and a reasonable prediction as to performance cannot be made, the total contract revenue, after being reduced for the effect of such potential downward adjustments, should be recorded on a basis consistent with the method of accounting for the contract.

Situations when performance may not reasonably be predictable might involve a single opportunity to accomplish a test or demonstration in accordance with established performance criteria or involve award fees which are determined solely by the U.S. Government and which may be subject to retroactive adjustment following evaluation of contractor performance.

Contract Costs Included in Inventory

Practice varies among government contractors as to the extent to which costs are included in inventory. Some contractors in-

clude all direct costs and only certain indirect costs (such as allocated manufacturing and engineering overhead expense) in inventory accounts. This practice is consistent with the belief of many accountants that certain expenditures do not fall within the definition contained in Accounting Research Bulletin No. 43, chapter 4, statement 3, which describes inventory costs "generally as the price paid or consideration given to acquire an asset." In the discussion of statement 3, the Bulletin states, "general and administrative expenses should be included as period charges, except for the portion of such expenses that may be clearly related to production and thus constitute a part of inventory costs (product charges)."

Other contractors record in inventory accounts all costs identified with the contract including allocated general and administrative, research and development, and bidding and proposal expenses. This practice perhaps derives its support from the concept of matching of revenues and costs. Accounting Research Bulletin No. 45, paragraph 10, states, "When the completed-contract method is used, it may be appropriate to allocate general and administrative expenses to contract costs rather than to periodic income. This may result in a better matching of costs and revenues than would result from treating such expenses as period costs, particularly in years when no contracts were completed." Many accountants believe this practice may be appropriately extended to government contracts accounted for by other methods. They point out that all costs under the contract are directly associated with the contract revenue, and both should be recognized in the same period.

Periodic income results should be approximately the same under either approach when the percentage-of-completion method is used. However, under completed-contract and unit-of-delivery methods, substantially different periodic income might result under each of the practices described above. A contractor's accounting practice with respect to costs included in inventory should be disclosed in the notes to financial statements.

Other Contracts and Arrangements and Related Accounting Considerations

Under some contracts the contractor may act in a capacity which makes it inappropriate to report reimbursable costs as sales

or revenues in the contractor's income statement. For instance, a contractor may operate a government-owned facility in an agency capacity for which the contractor will be reimbursed for costs of operations and receive a fee for performing the management service. In this situation the contractor should record only the fee in sales or revenues.

Contracts which call for the government to furnish materials or equipment may also present questions whether the costs of the items furnished should be included in the contractor's sales and cost of sales. Generally, the cost of such materials or equipment should not be included in the contractor's sales and cost of sales.

More difficult questions of accounting may arise when sub-contract costs or the cost of special equipment to perform the contract, even though included in the contract price, represent such a substantial amount in relation to the contractor's other costs of performance that inclusion of such costs in sales and cost of sales might significantly distort the contractor's volume of activity. How such costs should be reported by the contractor must be decided based on the terms of the contractual arrangements and a determination as to the approach which will give the most useful financial information.

Financial Statement Reporting and Disclosure

The financial statement reporting and disclosure practices of companies engaged in government contracts do not basically differ from practices followed by other business enterprises. A discussion of reporting and disclosure practices is included in this chapter because certain practices may be unique to government contracting activity. Some of the described practices may be applicable only to government contractors. They are intended to apply when sales or revenues made under U.S. Government contracts and subcontracts constitute an important portion of the contractor's operations.

Pronouncements of the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, and regulatory bodies having jurisdiction over reporting companies give guidance on financial statement disclosure requirements. The Securities and Exchange Commission, in their Accounting Series Release No. 138 of January 12, 1973 and No. 164 of November 21, 1974, give special guidance to publicly held companies in matters

of disclosure regarding long-term contracts and programs and extraordinary or material unusual charges and credits to income or material provisions for losses. It is anticipated that the SEC will continue to consider disclosures in this area.

Accounting Policies. Disclosure of significant accounting policies is required in the presentation of financial statements in conformity with generally accepted accounting principles (Accounting Principles Board Opinion No. 22). In adhering to this requirement, disclosures by government contractors generally include a description of the accounting practices employed with respect to government contracts including such matters as:

1. Basis for stating amounts related to contracts in progress (including practice with respect to accounting for indirect costs).
2. Basis for determining sales or revenues and related costs (including practice with respect to recognition of contract performance incentives).
3. Methods of accounting for adjustments resulting from changes in contract cost estimates and losses on contracts.

Balance Sheet Items and Disclosures. Balance sheet items directly associated with government defense contracts include receivables, inventories (accumulated contract costs), progress payments, and advance payments.

Receivables. Receivables from the U.S. Government under government contracts may represent billed or unbilled amounts. Unbilled amounts arise when sales or revenues, though appropriately recorded, cannot yet be billed under terms of the contract or when unit prices for items shipped have not been determined. U.S. Government receivables, where material, are usually shown separately from other receivables in the balance sheet (or otherwise appropriately disclosed). Unbilled amounts are often also stated separately when the amounts constitute a significant portion of the U.S. Government receivables. Examples of captions for such receivables are as follows:

Amounts receivable under U.S. Government contracts
U.S. Government receivables (including unbilled items
of \$___ net of progress payments of \$___)

Accounts receivable:

United States Government

Other, less allowance for doubtful accounts

Receivables:

United States Government—

Billed amounts of \$—

Unbilled amounts (less progress payments received)
of \$—

Commercial customers

Accounts receivable from customers other than the U.S. Government often arise from prime contractor-subcontractor activity in connection with government contracts. These receivables require many of the same considerations concerning allowable costs, billable amounts, and other related matters as do receivables from the U.S. Government under prime contracts. However, receivables of a subcontractor from a higher tier contractor will also involve the usual credit and collection problems (which do not exist with respect to amounts receivable from the U.S. Government) associated with normal commercial receivables.

Inventories and Partial Payments. Inventories related to U.S. Government contracts generally represent costs accumulated under fixed-price contracts accounted for under the completed-contract and unit-of-delivery methods. Costs under cost contracts or fixed-price contracts accounted for under the percentage-of-completion method, even though accumulated in contract inventory type accounts, are generally classified as billed or unbilled receivables.

Most contractors bill contract amounts as promptly as practicable. Costs incurred under cost contracts are usually reimbursable and therefore are billed on an incurred basis. In many fixed-price contract situations the contractor receives some payment as work progresses. Such payments may be in the form of progress payments or payments made on the basis of partial delivery. Procurement regulations and contract provisions govern the form and timing of such payments.

The specific balance sheet description for accumulated costs under fixed-price contracts will depend on the method of accounting employed by the contractor. For example, under the

completed-contract method and assuming the contractor has received partial payments for work performed under the contracts, a description such as "costs incurred under U.S. Government contracts in excess of payments received" might be used. Where the unit-of-delivery method is used the caption might be modified to read "costs incurred under U.S. Government contracts less amounts applied to units delivered and unapplied progress payments."

Progress payments received on fixed-price contracts are usually applied by individual contract to amounts carried in unbilled receivables and then to accumulated costs of contracts in progress (inventory), in that order. Amounts representing progress payments billed but not yet received by the contractor are not usually shown in the balance sheet because it would be incorrect to show uncollected progress payments as an offset to inventories. Advance payments (which differ from progress payments in that they are not related to progress of work on a contract) are reported in a manner similar to progress payments. However, advance payments received in excess of unbilled receivables and accumulated costs are classified as a liability, and if material, are described by such captions as "advance payments on U.S. Government contracts" or "amounts received in excess of costs incurred under U.S. Government contracts."

Where progress or advance payments have been received on contracts, the nature, amount, classification, and the existence of protective title to inventories under the contracts to which the payments relate are usually disclosed in the financial statements.

Income Statement Items and Disclosures. The form and content (including descriptive captions) of the income statement for an entity involved in government contracting are in all respects the same as for an entity involved solely in commercial transactions. Revenues, costs, and expenses are not usually segregated in the income statement between government and nongovernment business. However, there are certain matters related to operations of an enterprise involved in long-term government contracts which may require disclosure in notes to the financial statements.

The proportion of the contractor's revenues arising from U.S. Government contracts and subcontracts is customarily disclosed in a note to the financial statements (if not otherwise ap-

propriately disclosed in the income statement). Frequently this disclosure will include quantitative information, by broad category, as to the type of contracts (such as cost or fixed-price) under which such revenues are generated.

The government contractor can be faced with significant problems in the performance of long-term contracts and in the estimating of contract costs and profits (or losses). Such problems are often more severe for the contractor performing contracts which call for complex systems or involve significant technological advances. It is not possible to describe the many situations which may be encountered or to indicate the specific financial statement disclosures that might be appropriate in each instance. In broad terms, the obligation exists to make adequate disclosure, either in the body of the financial statements or in related notes, of information that might affect the conclusions formed by a reasonably informed reader. The following examples illustrate situations or types of information respecting the income statement which may affect comparability or future operations and therefore may indicate a need for amplification in notes to the financial statements.

- Contract price adjustments that are abnormal in amount or unusual in that they do not occur regularly
- Provision for loss that is a substantial amount
- Recognition of incentive income that is a substantial amount
- Significant problems encountered in the performance of contracts that may materially affect future operations

Other Reporting Matters

Additional disclosures of significant information may be appropriate with respect to government contract activities and should be considered in light of the circumstances and conditions which may arise from time to time. Reporting considerations with respect to contract terminations and renegotiation are discussed elsewhere in this audit guide.

Defective Pricing. Public Law 87-653, known as the "Truth in Negotiations Act," permits the government to make contract price reductions if a contractor fails to submit accurate, current, and

complete cost or pricing data prior to award of certain negotiated contracts or contract amendments. When defective pricing exists, contract prices (including profit or fee) may be adjusted and disclosure may be required if the amounts involved are material. Instances may occur where defective pricing may be alleged by the government but disputed by the contractor. In these cases careful analysis of the circumstances and judgment may be required. If the potential amounts involved are material, disclosure in notes to financial statements would usually be made.

Unusual Contracts. A government contractor may on occasion enter into a contract or subcontract which may be so unusual either as to type, amount, or other condition, in comparison with other contracts with which the contractor is concerned, that disclosure would be warranted. For example, a contractor may customarily engage in firm fixed-price contracts which are relatively consistent in amount. Should the contractor undertake a fixed-price incentive contract which is substantially greater in amount and subject to substantial added risks, additional disclosure of the new contract may be warranted. The terms of a contract might also be sufficiently unique to warrant specific disclosure. Again, by way of example, if a contractor could earn a substantial award fee, or be subject to a substantial penalty to be determined at the conclusion of the contract, this information, including estimated amounts, should be provided in notes to the financial statements.

Cost Limitations. Cost contracts provide for payments to a contractor for all allowable costs (plus fee, if applicable). In most instances, the government will fully fund the estimated contract price, and the contract will contain a clause entitled "Limitation of Cost." In some instances total funding may not be available at the outset of the contract and the total estimated contract price will only be incrementally funded by the government; in this instance, the contract will contain a clause entitled "Limitation of Funds." In either event, it is the duty of the contractor to notify the contracting officer, in writing, any time the contractor has reason to believe the costs expected to be incurred within the next 60-day period, when added to all previously incurred costs, will exceed 75 percent of the estimated contract cost, or if the contractor has reason to believe the total cost (exclusive of

fee) will be greater or substantially less than the estimated cost. The contractor's revised estimate of that total cost should accompany this written notification. Unless the contracting officer takes action on the notification and provides additional funding, where necessary, the government will not be obligated to reimburse the contractor for costs incurred in excess of the amount funded, nor is the contractor obligated to continue performance once he has incurred costs up to the level of funding. A contractor who incurs costs in excess of the amount funded by the government does so at his own risk, and if the amount of such excess spending is material, the matter may require disclosure in notes to the financial statements.

Contract Disputes and Other Claims. Contract disputes and other claims, either against the contractor or the government, often arise in connection with government contracts and subcontracts. Most often such situations are considered as a normal consequence of business and are not of sufficient importance to warrant reporting except when amounts involved become significant to the overall financial statements. Disclosure such as that customarily accorded significant contingent matters is warranted if any such situation could materially affect financial position or future results of operations.

Chapter 3

Contract Terminations

Introduction

Government contracts contain clauses which provide for termination of the contract by the government. Termination clauses are necessary to give the government the means to terminate a contract when conditions arise in which termination would be in the government's best interest (called termination for convenience) or to minimize the loss to the government because of non-performance by the contractor (called termination for default). Generally the same termination clauses contained in the prime contract apply to the subcontracts (purchase orders).

This chapter is intended to generally describe termination settlement procedures and practices, accounting for contract terminations, and recommended financial statement disclosures arising from terminations.

The financial impact of contract terminations differs depending upon whether the termination is for the *convenience* of the government or because of a *default* by the contractor. It is therefore necessary that the independent auditor understand these two basic types of terminations.

Termination for Convenience of the Government

Contracts are terminated for convenience generally for the following reasons: (1) to avoid technological obsolescence (and to take advantage of technological advancements in weapons, equipment, or services); (2) because of subsequently imposed budgetary restrictions which preclude or substantially limit the

availability of contract funds and thereby limit performance; (3) because of diminishing demand for the contracted product or service (arising, for example, from the end of a war or from de-escalation of war effort); or (4) because of an inability to produce a product in accordance with desired specifications.

As has been noted elsewhere in this audit guide, various regulations have been issued by the government dealing with the procurement of supplies and services.¹ These governmental regulations, together with the contract provisions, the law, and related court decisions, set forth detailed rules to accomplish the objectives of convenience terminations. When the government terminates contracts for convenience, it must compensate the contractor for work performed (including a reasonable allowance for profit) and settlement expenses. Anticipated profits on work not to be performed due to the termination are not reimbursed.

The contractor obtains payment for amounts due in connection with convenience terminations by presenting a "settlement proposal" or claim to the government for allowable contract costs, proportional profit (or loss) and settlement expenses, less payments already received. In the instance of a terminated cost reimbursement contract, a termination claim may be either prepared in voucher form via normal billing procedure or by means of a formal settlement proposal. In the instance of a terminated fixed-price contract, a formal settlement proposal is always used; there are two basic methods under which this settlement proposal can be prepared—the *inventory* method and the *total-cost* method.

Under the inventory method (usually preferred by the government), the cost of inventory on hand (excluding finished goods approved for shipping and billing) at the date of termination is determined; general and administrative expenses, an applicable profit (or loss) factor, subcontractors' claims, and allowable settlement expenses² are then added to the claim.

¹ Of particular significance in connection with government contract terminations are the following sections of the Armed Services Procurement Regulations (ASPR): Section VII—Contract Clauses, Section VIII—Termination of Contracts, Section XV—Contract Cost Principles (Allowable and Unallowable Costs), Section XXIV—Disposition of Property, and Appendix F—Forms.

² Refer to ASPR Section 15-205.42 for specific instructions on allowable settlement expenses.

Under the total-cost method (use of which must be approved by the termination contract officer), all costs incurred are claimed by type rather than by identification with a list of parts, products, and other items. General and administrative expenses, an applicable profit (or loss) factor, subcontractor's claims, and allowable settlement expenses³ are then added to the claim. The total-cost method may be appropriate where accumulated costs represent planning and preproduction expenses or where the contractor's accounting system or the inventory on hand does not readily lend itself to unit costing.⁴

Methods of cost allocation that produce results in accordance with generally accepted accounting principles and practices, government agency procurement regulations, and Cost Accounting Standards Board standards, rules, and regulations are acceptable for termination cost determination as long as the allocation results are fair, reasonable, and equitable in the circumstances. Allocations of special items of costs, such as start-up costs expensed prior to the termination date, are appropriate provided they are supported by fact and reason. No production costs incurred after the termination date will be allowed unless specifically authorized by the termination contracting officer. However, certain costs continuing after the date of termination, such as the cost of idle facilities, unexpired leases, ongoing unabsorbed fixed overhead, and settlement expenses may be claimed.

If the contractor would have suffered a loss had the entire contract been completed, no profit may be claimed. Moreover, the contractor must accept a proportionate part of the loss by reducing his claim.

Accounting for convenience terminations must reflect the rights established in the contracts and in the procedural rules for such terminations, that is, the right of the seller to payment for work completed plus reimbursement for settlement expenses. Such rights result in claims under the contract which require recognition for accounting purposes in a manner which is substan-

³ Ibid.

⁴ Detailed explanations of the procedures followed in preparation of a settlement proposal may be found in several termination manuals, such as *Defense Contract Termination Guide*, Electronic Industries Association, 1969.

tially equivalent to percentage-of-completion accounting (refer to p. 12 in this audit guide).

The effects of a significant contract termination should be disclosed and accounted for by the contractor as soon as possible after it occurs. Contractors should record the amounts anticipated to be recovered from their termination claims in income as soon as those amounts can be reasonably determined rather than at the time of final settlement. All costs applicable to a termination claim should be charged as an offsetting expense concurrently with the recognition of income from the claim. It is important to recognize that claimed amounts should be computed and recorded as income, using as a basis those costs which are defined as allowable under procurement regulations. On the other hand, when recording expenses related to the termination, all contract costs should be recognized whether or not such costs are allowable under applicable regulations.

Subcontractor and other vendor claims should be recorded as liabilities at the estimated amounts payable. To the extent such amounts are recoverable by the prime contractor, they should be included as part of his claim.

Termination for Default

A default termination may result from alleged or actual failure of the contractor to perform in accordance with the contractual terms by (1) not delivering the supplies or performing the services within the time specified in the contract; (2) not making sufficient progress, thereby endangering the ultimate contract performance; or (3) not performing other provisions of the contract.

Under fixed-price contracts terminated for default, the contractor is not entitled to reimbursement for costs incurred on undelivered work, and the government is entitled to repayment of advances and progress payments previously paid for such work. Furthermore, the contractor is liable to the government for any "excess procurement costs" or increased costs incurred in procuring equivalent supplies and services in lieu of those to be furnished under the terminated contract. Considerable time may elapse before a claim for these excess procurement costs is asserted against the contractor.

In the case of a cost-type contract terminated for default, a reduction is made in the fee to eliminate profit on work not accepted by the government. The contractor is not entitled to reimbursement for costs of preparing the settlement proposal. However, all other allowable costs are recoverable.

Since the rights of the contracting parties in a default termination differ significantly from those in a convenience termination, the accounting must reflect these differences. Accordingly, contractors should record, in addition to normal contract liabilities, those liabilities arising from a default termination, for example, damages, excess procurement costs, and progress payments to be repaid. Termination for default may result in a reduction of previously recorded income. In such cases, adjustments of prior period amounts would not be appropriate, but the resulting income effect should be included in the loss on termination of the contract in the current period. If material in amount, such loss should be reported as a separate item in the income statement or otherwise disclosed in notes to financial statements. (See Accounting Principles Board Opinion No. 30.)

Contractors generally try to convert a default termination to one for convenience through discussions with the contracting officer. If unsuccessful, advice and assistance of legal counsel is particularly important because of the possibility of legal recourse to the Armed Services Board of Contract Appeals or the Court of Claims.

Where the outcome of a contractor's attempt to convert a termination for default to a termination for convenience can be reasonably predicted, the accounting should be appropriate for the type of termination predicted. However, in many cases, it may not be possible to predict the outcome with reasonable assurance, and it would not be proper in such cases to adjust the financial records except to provide for a known contract loss which would be incurred even if the termination were to be converted to one for convenience. In any event, appropriate disclosure should be made in the notes to the financial statements.

Financial Statement Presentation

Generally, the effect of a contract termination should be reflected in the financial statements of the contractor in the period in which the termination occurs. If, however, sufficient informa-

tion is not available to predict the effect of a very recent termination, then the best information available should be disclosed in a note to financial statements.

Full disclosure should be made in the notes to the financial statements of significant items of a known controversial nature even if estimates of ultimate amounts to be realized cannot be determined. The government contracting business is subject to a different degree of risk than its commercial counterpart because of the unilateral contract right of the government to terminate a contract. Where there are indications (1) that a contract termination may occur, such as notice of a possible termination, contract performance problems, procurement cut-backs, and so forth, and (2) that the termination would have a material effect on the contractor's operations, disclosure of the circumstances and the potential effect should be made in the notes to the financial statements.

Significant uncertainties may exist as to the recoverability of costs in a termination claim, particularly in cases of termination for default. Such terminations may create additional uncertainties regarding possible liabilities for damages or excess reprocurement costs.

Chapter 4

Renegotiation

Introduction

Certain accounting and reporting problems may arise because of the provisions of the Renegotiation Act of 1951, as amended. Renegotiation is a complex area in government contracting and this chapter highlights certain important aspects of renegotiation. If a more comprehensive knowledge is required, reference should be made to the Renegotiation Board Regulations and, for interpretations and explanations thereof, to the Board's Renegotiation Rulings and Bulletins. Those materials are available, on a subscription basis, from the Superintendent of Documents, Washington, D.C. 20402, and from various business reporting services.

Scope and Purpose of Renegotiation

Renegotiation has existed under various formats since World War II and is currently administered under the Renegotiation Act of 1951, as amended, which, although intended to be temporary legislation at time of enactment, has been extended numerous times. The act applies to contracts and related subcontracts with the following departments and agencies named in the act:

Department of Defense	Atomic Energy Commission
Department of the Army	General Services Administration
Department of the Navy	Federal Aviation Agency
Department of the Air Force	Maritime Administration
National Aeronautics and Space Administration	Federal Maritime Board

The Renegotiation Act is administered by the Renegotiation Board and its two regional boards. Each board has a supporting staff.

It is the Renegotiation Board's function to evaluate the aggregate annual profits earned from contracts with the named departments and agencies and related subcontracts in accordance with criteria set forth in the act (commonly referred to as the statutory factors) and, to the extent that some portion of the profits are considered to be excessive, to eliminate such excessive profits through agreement with the contractor or by issuance of a unilateral order.

Each company having annual sales of \$1 million or more, or brokers or agents having annual commissions of \$25,000 or more, from contracts and subcontracts covered by the act, is subject to the renegotiation process. In determining these amounts, renegotiable sales must be aggregated, less intercompany sales, for all companies under common control. Further, if the fiscal year of the company is less than twelve months, the \$1 million and \$25,000 minimum amounts must be prorated accordingly. In determining whether or not subject renegotiable sales must be reported to the Board on the Standard Form of Contractor's Report (RB Form 1), it should be noted that the Renegotiation Act provides for certain mandatory exemptions from renegotiation and authorizes the Renegotiation Board, in its discretion, to provide permissive exemptions. Each of the exemptions is narrowly applied and the Renegotiation Board Regulations should be reviewed to determine the applicable criteria which must be met to qualify for the exemption.

If renegotiable sales are less than the minimum amount, the company is not required to file a report but may elect to file a Statement of Nonapplicability (RB Form 90), which may be desirable, since it will serve to start the running of the one-year statute of limitations. The appropriate form is due on or before the first day of the fifth calendar month following the close of the fiscal year; however, extensions of the due date may be obtained with the approval of the Renegotiation Board.

Renegotiation is conducted on a fiscal year basis (corresponding to the company's federal income tax fiscal year) and is applied to the aggregate renegotiable sales within that fiscal year, and not to sales by individual contracts or subcontracts. The

method of accounting for renegotiable sales, and determining costs and expenses applicable to them, is generally that used in the conduct of the company's normal business adjusted to conform to reported federal taxable income.

It is the company's responsibility to determine if its sales are subject to the Renegotiation Act. The board has set forth in its regulations criteria to be followed as a guide in this determination. Renegotiable sales can be identified by reference to government contract numbers, presence of the renegotiation clause, defense priority ratings, the company's own knowledge of the end use of the product, or direct inquiry from the customer. The existence of a renegotiation clause in a purchase order is not controlling, although it is evidence that the order may be subject to renegotiation.

Costs and expenses are attributable to renegotiable business in accordance with the company's normal accounting policies and the allowability of such costs is governed by the Renegotiation Board Regulations. Allowable costs, as enumerated for contracting cost purposes in such regulations as the Armed Services Procurement Regulations, have no direct bearing on renegotiation. Normally, those costs allowable for federal tax reporting are considered allowable for renegotiation. There are circumstances under which the board will permit reporting on a basis different from that used for federal income tax purposes, but only when the tax basis is considered manifestly unsuitable for renegotiation purposes. In such instances, the board will enter into a special accounting agreement with the company.

Renegotiation filings assigned to the regional board for review are classified as either Class A or Class B cases, depending upon whether the renegotiable profits reported are over or under \$80,000. The regional boards have the authority to enter into a final settlement with the contractor in a Class B case; whereas in a Class A case, they make a recommendation to the Renegotiation Board and agreement can be reached only with that board.

Generally, refunds of excessive profits will not be required if the amount of excessive profits (before adjustment for state taxes measured by income) is less than \$80,000 (\$20,000 for brokers or agents).

Should the overall result of the year's renegotiable business show a loss, such loss may be carried over as a cost against fu-

ture renegotiable business for up to five years. There is no provision for carrying losses back to prior years.

The statutory factors upon which the evaluation of the company's performance is based are the following:

- Efficiency of the contractor or subcontractor, with particular regard to attainment of quantity and quality production, reduction of costs, and economy in the use of materials, facilities, and manpower.
- Reasonableness of costs and profits with particular regard to volume of production, normal earnings, and comparison of war and peacetime products.
- The returns on net worth and capital employed with particular regard to the amount and source of public and private capital employed.
- Extent of risk assumed, including the risk incident to reasonable pricing policies.
- Nature and extent of contribution to the defense effort, including inventive and developmental contribution and cooperation with the government and other contractors in supplying technical assistance.
- Character of business, including source and nature of materials, complexity of manufacturing technique, character and extent of subcontracting, and rate of turnover.

Renegotiation Process

The renegotiation process for companies with renegotiable sales less than the statutory minimum is generally completed with the filing of the Statement of Nonapplicability (RB Form 90). Renegotiation proceedings for companies with renegotiable sales in excess of the statutory minimum must be commenced within one year from the date the Standard Form of Contractor's Report (RB Form 1) is submitted, and such proceedings must be completed within two years from the date of commencement of review by the board. The Renegotiation Board, however, is authorized to enter into agreements with the company to extend the period of time for completion of the renegotiation process and it is not uncommon for it to do so.

The major steps in the renegotiation process are as follows:

- RB Form 1 reporting the operating results of the company segregated by renegotiable and nonrenegotiable business is submitted. The Renegotiation Board reviews the data and either issues a Notice of Clearance Without Assignment or assigns the case to one of the regional boards for further processing.
- A regional board reviews the case. That board conducts an accounting review of the data submitted and may request additional data. The regional board evaluates the company's performance in accordance with statutory factors and may visit the company's facilities to observe the operations.
- Conclusion resulting from the review. If it is concluded that no excessive profits were realized, the company will be notified to that effect and receive a Final Opinion stating the basis of the findings. If, however, it is concluded that excessive profits were realized, an Accounting Report and a Renegotiation Report will be prepared and furnished to the company. Thereafter, the assigned regional board personnel will hold a renegotiation conference with the company (at its option) at which time any information regarding matters considered pertinent to the case, whether or not previously submitted, may be discussed, and the possibility of reaching an agreement for the elimination of excessive profits will be explored.
- At the option of the company, an official meeting with the panel of the regional board members will be held at which time the company can orally present data it feels is pertinent to the case and the possibility of reaching an agreement will be explored. If a determination of excessive profit (which can be higher, lower, or the same as the tentative conclusion) is made, it is communicated to the company together with a Proposed Opinion stating the basis for its findings.
- If the company does not agree with the regional board's determination, a request must be made for reassignment of the case to the Renegotiation Board and a hearing before its members at which time it may present any data it feels pertain to the case.
- A final determination will be made by that board (higher,

lower, or the same amount as that of the regional board). At that time a Proposed Opinion will be received from the Renegotiation Board.

- The company agrees with the Renegotiation Board's determination, or with its issuance of a Final Order to the company, to pay the amount so designated.
- If the company does not agree and wishes to contest the board's determination, a petition is submitted to the U.S. Court of Claims, within 90 days of the issuance of the order.
- A hearing is held before the U.S. Court of Claims and a final determination reached by that court whose determination can be higher, lower, or the same as that determined by the Renegotiation Board.

Accounting and Reporting Considerations

When renegotiable sales exceed the statutory minimum it is necessary to review profits of these operations for the existence of potential renegotiation liability. Generally accepted accounting principles (Accounting Research Bulletin No. 43, chapter 11, section B) require that provision be made in the financial statements for all liabilities, including reasonable estimates for liabilities not accurately determinable. A company's prior renegotiation experience, or that of comparable companies, if available, may provide a basis for making such an estimate.

The provision for renegotiation liability should be related to, and calculated on the basis of, renegotiable income recognized during the period. Renegotiation involves an adjustment of the original selling price and, therefore, the provision before income tax effect should preferably be treated in the income statement as a reduction of the sales amount. The amount accrued should be included in current liabilities in the balance sheet.

The situation may arise where a final renegotiation determination applicable to a prior year is materially different from the provision in the financial statements originally issued for such year. In such cases, the difference should be reported as a prior period adjustment in accordance with Accounting Principles Board Opinion No. 9.

Whether or not a provision in the accounts is made, disclosure in a note to financial statement, or otherwise, may be required

because of the significance of renegotiation to the company's business, or uncertainty of the outcome of renegotiation proceedings. Several illustrations of notes follow:

1. A substantial portion of the Company's sales for the year is subject to the Renegotiation Act of 1951, as amended. Renegotiation proceedings have been concluded for all preceding years through _____ with the exception of _____. In the opinion of the Company's management,
 - (a) no excessive profits have been realized in this year and accordingly no provision for renegotiation refunds has been made.

or
 - (b) renegotiation refunds, if any, for this year will have no material effect on the accompanying financial statements.

or
 - (c) adequate provision for renegotiation has been made in the accompanying financial statements.
2. A substantial portion of the Company's sales in the current and prior years is subject to the Renegotiation Act of 1951, as amended. Renegotiation proceedings for the year(s) _____ to _____ are in process; however, the amount of excessive profits, if any, cannot be reasonably estimated at this time since the Company has had no prior experience on which to base an estimate. Accordingly, no provision has been made in the accompanying financial statements.
3. The Renegotiation Board has determined that for the year _____ the Company made excessive profits on renegotiable business, net of applicable taxes, of approximately \$_____. The Company does not agree with this determination and has petitioned the Court of Claims for a redetermination of the board's findings. Since the Company believes that no excessive profits were realized, no provision for refund has been made in the accompanying financial statements. Renegotiation proceedings for the year(s) _____ through _____ (are in process) (have not commenced); however, management is of the opinion that the effect of any determination of excessive profits on the financial statements would be immaterial.

Chapter 5

Government Contracting Audit Considerations

Introduction

Generally accepted auditing standards are applicable in the examination of financial statements of companies which are government contractors. This chapter deals primarily with auditing procedures peculiar to government contracts.

The examination of a government contractor's financial statements may require the application of auditing procedures different from those employed in the examination of financial statements of a typical commercial enterprise. These procedures may be necessary because (1) contract provisions and regulations have a significant impact on the rights of the contracting parties and (2) substantial estimating (preliminary stages of completion and cost to complete) is generally required as a result of the long duration of many contracts. The procedures selected by the independent auditor reflect these characteristics of the government contracting environment.

An auditor's selection of procedures to follow in the audit of a government contract is influenced by a wide variety of considerations. The relative significance of a particular government contract, or of all government contracts, when viewed as part of the client's entire operation, will influence the auditor's decision as to whether, or to what extent, he will use a particular procedure discussed in this chapter. An independent auditor may conclude that a matter for which a procedure discussed in this chapter has been designed is not significant, even though it relates to

a contract that is relatively significant. Also, an independent auditor may conclude that he can accomplish the objective of a procedure discussed in this chapter by using another such procedure or by using a procedure not discussed here. Such considerations must be borne in mind in reading this chapter. Particular expressions such as “the auditor should” or “the auditor will,” that are used for simplicity in discussing auditing procedures, ought in all instances to be read as if they were preceded by a limiting expression such as, “. . . if the auditor concludes that it is appropriate and necessary to do so. . . .”

Contract Provisions and Regulations

Companies engaged in government contracting are subject to special provisions and conditions contained in the contractual agreement, applicable procurement regulations and other regulatory requirements. Some contractual provisions and regulations associated with government contracting permit the government to do the following:

1. Not include in contract costs and expenses those expenditures which are not considered to be allowable, allocable, or reasonable. Some costs are specifically disallowed under procurement regulations. The government may also enter into agreements covering the extent to which certain costs and expenses will be allowable for contract purposes. Such allowable costs may affect the anticipated contract sales value and the resultant recovery of actual contract costs incurred to date.
2. Direct changes at any time in a contract, subject to an equitable adjustment of the contract price and delivery schedule. (See “Change Orders” in this chapter.)
3. Adjust contract price in accordance with specific contract clauses. (For example, see “Defective Pricing,” chapter 2.)
4. Terminate contracts at the convenience of the government.
5. Furnish material or equipment. Although such materials or equipment would not normally be recorded on the company’s records, they become the custodial responsibility of the contractor and must be accounted for upon completion of the contract.

6. Have access to and review the contractor's accounting and other records. The Defense Contract Audit Agency (DCAA) and the General Accounting Office (GAO) generally perform such reviews. The DCAA is primarily responsible for advising procurement personnel on the acceptability of contractor's estimated or incurred costs as allowable contract costs. The DCAA is also responsible for ascertaining compliance by contractors with legislation relating to defense contracts. The GAO conducts studies and investigations of procurements to determine that such procurement actions were made in conformity with the applicable laws and regulations. In certain instances both the DCAA and the GAO, within three years after final contract payment, may review those books and records of a contractor involving transactions related to a contract. The independent auditor should inquire about the status of audits performed by government agencies.

In addition to the matters discussed above, the Cost Accounting Standards Board promulgates cost accounting standards which must be adhered to by affected contractors. The board's regulations also provide that contractors meeting certain requirements must file a disclosure statement of their cost accounting practices. The practices so disclosed must then be followed by the contractor in his cost estimating, recording, and reporting.

The independent auditor should be cognizant of the differences between accounting principles for financial reporting and those required for contract pricing. He should determine the effect of such differences on the financial statements he is examining. Various procurement rules and regulations may require that costs be allocated and classified in a specific manner (such as direct or indirect, and allowed or unallowable costs) for determining contract pricing, whereas such requirements are not relevant when accounting for these costs for financial reporting purposes.

The independent auditor should ascertain the status and amount of contract funding (appropriations of funds by the government for the particular contract) since costs incurred in excess of funding could result in realization problems to the contractor. The amount of funding is disclosed in the contractual document.

The independent auditor should review the contractor's major prime contracts, subcontracts, and related change orders for special provisions and terms. Pertinent details observed in this review may be extracted from the contract and the related contract files and maintained in the independent auditor's working papers or permanent file for reference during the current and subsequent examinations, if appropriate.

Internal Control

The independent auditor's review and evaluation of internal control of a government contractor is performed in order to establish a basis for reliance thereon in determining the nature, extent, and timing of audit tests to be applied in his examination of the financial statements. Some important elements of internal control which should be present in a government contractor's procedures, as well as certain weaknesses sometimes noted, are discussed in the following paragraphs.

Ordinarily, a contractor's personnel responsible for the accounting for, and the administration and performance of government contracts should be informed of contracts and subcontracts in process, change orders thereto, and termination notices. The system of internal control may include procedures for providing cost information in support of requests for progress payments, for the release of cost information to affected personnel, and for measurement of cost and physical performance of contracts.

The accounting system should ordinarily provide for classification of costs and expenses by direct and indirect charges, accumulation of overhead costs into specific pools, and identification of costs clearly defined as unallowable in applicable procurement regulations. Procedures should result in consistent application of allocation procedures and practices.

In addition to the accounting system and controls, particularly as they relate to costs of contract performance, the independent auditor might consider the contractor's procedures for estimating, bidding, and budgeting controls established by the contractor over expenditures, program performance, and so forth. Where the contractor has an internal audit department, the independent auditor may read the internal audit program and related reports

for indications of weaknesses. The auditor may also wish to review the contractor's adherence to pronouncements of the Cost Accounting Standards Board, including, where applicable, a review of the contractor's disclosure statement.

The independent auditor will usually find it desirable to accumulate pertinent details of the internal control system and maintain them in a permanent file for reference.

Weaknesses and deficiencies in accounting procedures and internal control which may be encountered in a contractor's operations include the following:

1. Failure to develop realistic budgets and budgetary controls and to periodically evaluate contract performance and profitability on a realistic basis.
2. Inadequate control over estimating and bidding on contracts.
3. Failure to comply with requirements with respect to submission of current cost and pricing data.
4. Inadequate control over cost accounting records and cost control procedures.
5. Weaknesses in billing procedures.
6. Lack of effective communication among personnel involved in operations, estimating, bidding, administering, and accounting for contracts.
7. Inadequate procedures for the control of contract changes and modifications.
8. Noncompliance with Cost Accounting Standards Board's standards, rules and regulations, and disclosure practices, where applicable.

Significant weaknesses and deficiencies in internal control may cause the independent auditor to conclude that he cannot place sufficient reliance upon the contractor's accounting system to justify continuing further his preliminary review (including tests of compliance). In these cases, the auditor may decide to expand his substantive tests of government contract accounting including the review of contracts and other data supporting the determination of current contract status.

Accounts Receivable

A contractor's receivables may include billed and unbilled amounts, retention, and claims. The contractor's records ordinarily include separate accounts for these types of receivable (and related reserves) because of the differing circumstances under which they arise.

Billed receivables under government contracts differ from commercial trade receivables in certain aspects. Amounts due from the U.S. Government under a prime contract relationship may ordinarily be considered collectible from the standpoint of the customer's ability to pay. Nevertheless, the independent auditor will ordinarily undertake procedures to determine that the amount included in the contractor's records represents the amount billed to the procurement office on the contract(s) stated. The independent auditor may attempt direct confirmation of the amount; however, the likelihood of receiving a reply is not as great as for commercial trade receivables because government disbursement offices seldom reply to these requests. Consequently, the independent auditor will often employ alternative audit procedures.

Alternative procedures may include direct confirmation with the contract disbursement officer of the individual amounts billed, and possibly confirmation of subsequent payments received by the contractor. It may also be appropriate to compare selected receivables with subsequent recorded cash collections, approved billing documentation, shipping records, delivery schedules, government inspection and acceptance documents, and so forth.

In a commercial enterprise these procedures would ordinarily serve to satisfy the independent auditor that the billed amounts were fairly stated because he would expect that confirmation or payment would not be forthcoming if the receivables were incorrect. This is not always true with the government, however, since confirmation or payment does not necessarily mean that the amount is correct but only that the amount has been billed. Thus, the independent auditor's evaluation of the propriety of the outstanding amounts may include a review of individual contract provisions and a comparison of total amounts billed with the amounts which are billable in accordance with contract terms.

Inquiries of contractor management personnel and other evalu-

ations as to the possibility of subsequent adjustments may also be made. Such adjustments could result from overbilling of the contract amount, disallowances, billings without proper authorization, or billings not in accordance with contract terms.

Billed receivables due from other contractors (where the company being audited is a subcontractor) can generally be confirmed by direct correspondence. In the absence of direct confirmation, alternative procedures should be applied similar to those employed for prime contracts. However, the government's credit standing does not pass to the prime contractor or higher-tier subcontractor and, therefore, they must be evaluated with respect to their own credit status.

Unbilled receivables arise when sales or revenues have been recorded but the amounts (or portions thereof) cannot yet be billed under the contract terms. Specifically, such balances may represent (1) unbilled amounts arising from the use of the percentage-of-completion method of reporting income; (2) incurred cost to be billed under cost reimbursement type contracts; (3) estimated billing prices to be made final at a later date for items shipped and accepted; and (4) differences between provisional overhead billing rates and actual allowable overhead rates. Since direct confirmation is generally not possible, the alternative audit procedures applied would ordinarily be similar to those applied for billed receivables. The auditor will be concerned with possible overbillings, unauthorized shipments of goods, and so forth. In addition, he will consider whether the amounts may be or have been converted to billed receivables at a later date and whether management has given adequate consideration to possible unallowable costs.

The auditor may decide to investigate receivables (billed and unbilled) not collected subsequent to the examination date since noncollection may indicate existence of disputed costs, potential or unrecorded contract modifications, credit difficulties, legal problems, and other matters which may have a bearing on ultimate collectibility.

Retained Amounts

Retained amounts may be provided for by contract arrangements which permit the customer to hold back a defined amount

or percentage of a contract price until certain contract conditions are satisfactorily met. These conditions may relate to such things as uncompleted overhead rate negotiations, disposal of government-owned materials, fulfillment of contract guarantees or warranties, or the total completion of contract performance. In some instances, the duration can be lengthy. The independent auditor should ascertain that the conditions giving rise to the retained amount are progressing in a manner which will result in its ultimate realization.

Claims Receivable

Claims receivable, other than those arising from contract terminations, usually arise from unilateral contract changes by the government (see Change Orders in this chapter) or disputes. An evaluation of the likelihood of settlement under terms which will result in collection of the recorded amount can sometimes be accomplished by review of the contract terms and documentation of the claim and by discussion of the basis for the claim with knowledgeable contractor personnel and legal counsel.

Often claims are settled only after prosecuting through the Armed Services Board of Contract Appeals or the Court of Claims. Many of these claims are not recognized in the contractor's accounting records until settled. Disclosure of the existence of any material claims should be made in the financial statements (including the notes thereto). If collectibility of material claims is uncertain, the independent auditor may decide to modify his opinion.

Liabilities

Liabilities of the government contractor will not differ substantially from those of a commercial firm, but may often include payables to subcontractors (including retained amounts), advance payments received from the government, and guaranteed loans.

Amounts due subcontractors, like other accounts payable, should be supported by invoices and other appropriate documents. In some instances, contractors retain a portion of amounts due subcontractors until the subcontractor's work is completed

and accepted. The retained amount may be a percentage of the subcontract price or a fixed amount, as provided in the subcontract. The independent auditor might also confirm such amounts with the subcontractor to satisfy himself of their propriety.

Advance payments from the government (as distinguished from progress payments) and guaranteed loans should ordinarily be confirmed.

Evaluation of Contracts in Process

Examining financial statement amounts associated with contracts in process may present certain difficulties. Reviewing a contractor's determination of the status of contracts in process often includes (1) ascertaining that incurred costs have been properly classified, accumulated, and recorded; (2) reviewing estimates of costs to complete performance; and (3) comparing the estimate of total contract costs with the contract price to determine the projected recovery of the related contract costs. The auditor may find that this review will also enable him to evaluate income recognition to date under the contract.

Many contractors make extensive contract reviews similar to those described above in preparing interim and year-end financial statements. The documentation supporting these reviews may be utilized by the independent auditor in his examination. The independent auditor may test the accuracy of detailed cost records in connection with his tests of actual costs incurred.

Contractor's cost estimates should be prepared in a manner which will facilitate comparison with actual cost. The estimates of cost to complete should be prepared in a similar manner. The independent auditor should review the contractor's methods used in developing information for the preparation of the estimates of cost to complete. This review may begin with an evaluation of the contractor's procedures of estimating and bidding, control of contract changes and modifications, including communication between production, engineering, and other personnel involved in performing, estimating, and accounting for contract costs. The independent auditor may also refer to data obtained in his review of contract status to determine that all work to be performed under the contract, including change orders, have been included in the latest estimate of both cost to complete and contract price.

Depending upon the circumstances, the independent auditor may select various auditing procedures to determine the propriety and reasonableness of the estimates to complete. Some of the procedures the independent auditor may use are the following:

1. Comparison of current cost estimates with preceding estimates as well as comparison of actual costs incurred on similar previous contracts with original estimates for such contracts.
2. Discussion with contractor personnel responsible for preparing underlying data upon which the estimates were developed and personnel responsible for the performance of the work.
3. Comparison of the delivery schedule set forth in the contract against actual progress to date.
4. Comparison of actual experience on the contract to date with learning curves used by the contractor in preparation of the original cost estimate and subsequent estimates to complete.
5. Comparison of material estimates to bills of materials, purchase order commitments, subcontracts, vendor quotes, and other such data.
6. Comparison of labor rates for work to be performed in future periods with actual rates, taking into account changes which may result from anticipated union contract negotiations and company policies regarding pay increases.
7. Comparison of projections of indirect cost rates used for estimating purposes with projections of revenues and with budgets.
8. Review of quality control reporting and customer acceptance to determine that production meets contract requirements.

Following the review and evaluation of the latest estimate of cost to complete, the independent auditor may ordinarily be able to compare the total estimated contract cost with the total estimated contract price. This comparison may serve as a basis for estimating profitability upon which the ultimate recovery of contract cost is dependent. The total estimated contract price used by the contractor should generally—

1. Exclude those costs which may not be allowable in accordance with procurement regulations.

2. Not exceed appropriated funds shown in the contract.
3. Not exceed the cost or price limitations contained in the contract.
4. Give effect to (a) contract changes, (b) incentive (penalty) provisions, and (c) liquidating damages, if any.

The above-described review may also provide data necessary for testing the recording of sales and cost of sales.

The methods and calculations used by the contractor to record sales and cost of sales should generally reflect the most current information available.

The following illustration demonstrates the impact on the recognition of income of differences between actual costs and contract allowable costs.

	<i>Cost Data Used for Negotiation of Contract Price</i>	<i>Actual</i>
Material	\$1,000	\$1,000
Labor	200	200
Overhead ¹	250	300
	1,450	1,500
General and Administrative ²	145	180
	1,595	1,680
Profit	160	75
Contract price	\$1,755	\$1,755

¹ 125 percent of labor allowed: 150 percent actual.

² 10 percent of total manufacturing costs allowed: 12 percent actual.

When a contract contains incentive provisions the independent auditor's procedures should include consideration of whether the contractor has adjusted his determination of revenue to recognize appropriate incentive amounts based upon the latest estimate of allowable cost at completion.

The following illustration demonstrates the impact of a cost incentive provision on income recognition taking into consideration the differences between actual and allowable costs.

	<i>Target Cost</i>	<i>Actual Cost</i>	
		<i>Allowed</i>	<i>Incurred</i>
Material	\$1,100	\$1,000	\$1,000
Labor	200	200	200
Overhead	300	250	300
General and Administrative	200	150	180
	<u>1,800</u>	<u>1,600</u>	<u>1,680</u>
Profit	180	220 ¹	140 ²
Contract Price	<u>\$1,980</u>	<u>\$1,820</u>	<u>\$1,820</u>

Incentive—Government and contractor share underruns and overruns 80 percent and 20 percent respectively.

¹ $\$180 + 20 \text{ percent } (\$1,800 - \$1,600) = \$220.$

² Difference between cost incurred and contract sales price as determined in the second column. Amount can be proven by deducting unallowable cost, \$80 ($\$1,680 - \$1,600$), from allowed profit of \$220.

Some contracts contain provisions for awards or penalties for achieving or failing to achieve performance criteria other than cost. (See Contract Incentives, chapter 2.) The independent auditor's review of contract documents may indicate whether such provisions exist. Management's determination of whether or not the goals have been achieved may be tested by examination of correspondence to or from the contracting officer, engineering reports, or evidence of collection of an award or payment of a penalty.

If the independent auditor's review discloses any contract with an indicated loss or a deterioration of the rate of profit, he may decide to undertake additional procedures, including a review of the reasons therefor with the contractor's management. Provision should be made for losses in the period when information indicating a loss becomes available, regardless of the contractor's method of accounting for contracts.

The independent auditor may also want to obtain written representation from the company's financial and other responsible management personnel regarding the status of contracts at the audit date.

Change Orders

The major change orders involved in government contracting that directly affect the independent auditor's review are (1) change orders directed by the customer and acknowledged to be changes to the contract and which result not only in additional work (or decreases in work) but also, in many cases, adjustments of the contract price; (2) customer requests and directives not acknowledged as changes to the contract; and (3) contractor-initiated change orders.

For those change orders for which a contract price adjustment has yet to be negotiated, the independent auditor may perform procedures to determine that the contractor's estimate of the increase or decrease in contract price is reasonable based on the task involved, the contractor's cost estimate, and the contractor's prior experience in estimating and negotiating contract changes.

Contingent Liabilities

The independent auditor should determine that consideration has been given to potential liabilities which may result from the many special clauses contained in government contracts and from applicable laws and regulations. In addition to the normal correspondence with legal counsel, the independent auditor may decide to review contract files and related correspondence and any other documents which might disclose potential liabilities. Receivables or payables which have been outstanding for an unusually long period of time may also give indication of dispute or a potential liability. The independent auditor may also inquire of contractor personnel about the possibility of contingent liabilities.

Other Contract Audit Considerations

When appropriate and necessary, the independent auditor should observe a contractor's physical inventory to establish its existence and to assist in the evaluation of the contractor's estimate of the stage of completion. Similar observation procedures may be applied to research and development-type effort (even

though of an intangible nature) to establish that work is being performed.

Research and development costs that will be directly reimbursed on the basis of a contract or other arrangement may be recorded as inventory or accounts receivable, as appropriate, when incurred. In such a situation the independent auditor may decide to review provisions of the contract and data approving the expenditure of such costs.

In some instances a contractor may produce quantities in excess of current contract requirements in anticipation of follow-on orders or for spare parts. This frequently occurs when the contractor has taken advantage of a long production run to produce quantities at an economical cost. Evaluation of related costs is more difficult when a need for additional quantities is anticipated in future years. The independent auditor's review of the inventory generally encompasses use of the same valuation rules that are applied to other inventory items. However, the marketability of this inventory may depend solely on the government's need, which may be affected by technological advances, availability of funding, or changes in government procurement priorities. The independent auditor's review might include evaluation of supporting data indicating that the inventory is for contracts on hand or that future procurements are reasonably expected and that adequate consideration has been given to warehousing and carrying costs. Many contractors will have made marketing studies before proceeding with this type of program and such studies may also be consulted as part of the auditor's review.

The accuracy of unliquidated progress payments shown in the financial statements as a reduction of inventory or unbilled receivables may be verified by confirmation.

Contract Termination

When auditing a contract termination, the independent auditor may examine termination notice(s), notices of assessment of excess procurement costs (where applicable), contract terms and related regulations, and settlement proposals of claims to satisfy himself whether the termination is that of convenience or default. The independent auditor should inquire whether (1) the contract work has stopped in accordance with the termination

notice; (2) the contractor has taken all actions required pursuant to the termination clause of the contract; and (3) the contractor has established appropriate accounting to cover full accumulation of cost data to support a termination claim.

An overall objective of the independent auditor's work on termination claims is to determine that claims are recorded in amounts which are estimated to be realizable. The independent auditor should consider whether the contractor has prepared his claim in accordance with applicable termination regulations, including those relating to documentation. The independent auditor's procedures may also include, but not necessarily be limited to, the following:

1. Determine the existence of termination inventory (properly tagged and segregated).
2. Determine that the termination inventory is included in the claim at actual material and direct labor costs, plus allowable overhead cost.
3. Determine that the overhead rates have been developed in accordance with applicable cost principles as expressed in procurement regulations.
4. Determine that post-termination settlement expenses are properly included (and documented).
5. Determine that billings to date, plus the amount claimed exclusive of settlement expenses, do not exceed the contract price as adjusted.
6. Determine that the profit rate used in the termination claim is reasonable, considering the profit rate contemplated at the time the contract was negotiated and the profit rate the contractor would have earned had the contract been completed.
7. Determine whether claims of subcontractors or vendors are properly included (and whether notification was given to them and whether their claims that are included have been audited or reviewed).
8. Determine that the claim has been properly adjusted for termination inventory diverted to the contractor's other work or for inventory disposed of through sale, including sale as scrap.

9. Determine whether the contractor termination claim has been audited by the government and, if so, have disallowances been recommended.

In connection with termination for default, the independent auditor should consider not only whether all costs applicable to the contract performance have been properly recorded but also whether provision is required for any liabilities for excess reprocurement costs. Documents and correspondence between the termination contracting officer and the contractor may be evidence of existing actual or potential liabilities. If potential material liabilities exist, but amounts are not reasonably determinable, the independent auditor should consider whether disclosure in the notes to financial statements is appropriate. The independent auditor may also consider what effects these matters might have on his report.

In the independent auditor's review of significant termination matters he may, in his judgment, deem it advisable to obtain the opinion of company or outside counsel on the contractor's rights and obligations in the related contract terminations. If the independent auditor has substantial doubt about the outcome of these uncertainties and the amounts involved are material in relation to the contractor's financial statements, he should appropriately modify his opinion.

Renegotiation

In most instances, the independent auditor's examination will be completed before the contractor's renegotiation report is prepared. Nevertheless, he should review the renegotiation status for the current year, based on the best information available, and determine whether a potential liability exists. It may be advisable for the contractor to prepare preliminary renegotiation data for the independent auditor's review. The independent auditor might consider the reasonableness of the method used in segregating renegotiable sales and allocating costs and expenses thereto, and the reasonableness of presenting the resultant renegotiable profit. He may also compare the data with the prior years' reports to see if material differences (such as a change in mix of contract types, allocation methods, and profit margin) exist. Renegotiation is conducted on an annual fiscal year basis, and each

year is judged on its own merits; however, prior years' proceedings and accepted profit levels may be a guide to the existence of potential liability for excessive profits.

The independent auditor should also review the status of the prior year's renegotiation filings. If a contractor has filed reports, substantial evidence may exist, in the form of the filings, correspondence with the Renegotiation Board, orders, agreements, clearance notices, and so forth on the current status of these proceedings.

When a contractor has not had previous renegotiation experience, the independent auditor may decide to review the propriety of the filings and evaluate the reasonableness of the renegotiable profits by reference to renegotiation data showing experience of other contractors. These are published in the Renegotiation Board's annual report and other sources.

Defective Pricing

Public Law 87-653, known as the Truth in Negotiations Act, permits the government to reduce contract prices for "defective pricing" under certain conditions.

Before entering a negotiated contract, a contractor must certify to the government that cost data he has submitted (on Form DD 633) is accurate, complete, and current. If such costs are subsequently found to be inaccurate, incomplete, or noncurrent, the government may be entitled to an adjustment of the negotiated contract price.

The independent auditor should consider the effects of a potential determination of defective pricing. The contract documents will usually indicate which contracts are subject to defective pricing. The independent auditor's review typically might include the comparison of cost data in support of a proposal, with cost performance to date to determine the existence of potential defective pricing. Major differences should be investigated. The contractor's procedures for compliance, which provide a basis for his signing the Certificate of Current Cost or Pricing Data, should be reviewed by the independent auditor. The independent auditor may also inquire as to any government audit agency reviews regarding claims for defective pricing.

If defective pricing exists and the amount is determinable, provision for such amounts should be made in the accounts. If

potential defective pricing exists but the potential amounts involved are undeterminable, consideration should be given to disclosure in the financial statements.

Reporting

As is true in every audit, the independent auditor should consider the effects on his report of questions that arise in matters discussed in this audit guide. In particular, he may need to consider such things as estimated costs to complete a contract, the collectibility of claims and retained amounts, the realization of deferred costs and potential liabilities resulting from contract terminations, renegotiation, redetermination, or defective pricing. In preparing financial statements, a contractor's management is expected to use its estimate of the outcome of such matters. In many cases, the independent auditor will be able to satisfy himself regarding the propriety of management's estimates by considering various types of evidence such as those discussed in this audit guide. If the independent auditor disagrees with management's estimates, he should consider expressing a qualified or an adverse opinion. In some instances, the independent auditor may conclude that the outcome of uncertainties affecting the financial statements is not susceptible to reasonable estimation. When there are such uncertainties, it cannot be determined whether the financial statements should be adjusted and in what amount. In these instances, the independent auditor is unable to evaluate the effects of the uncertainty on the financial statements. This may suggest that he will conclude that he cannot express an unqualified opinion, even though there is extensive disclosure regarding the uncertainty.

APPENDIX A

Securities and Exchange Commission, Accounting Series Release No. 138 of January 12, 1973

Notice of Adoption of Amendments to Forms 8-K, 10-K, 12-K, S-1, S-7, S-8, S-9, S-11, 10 and 12 Requiring Increased Disclosure of Unusual Charges and Credits to Income.

The Securities and Exchange Commission today adopted amendments to its registration and reporting forms to require more detailed and timely reporting, and timely review by independent accountants of extraordinary or material unusual charges and credits to income or material provisions for losses effected by registrants. Proposals to amend these forms, as well as Forms 7-Q and 10-Q, for these purposes were published for comment in Securities Act Release No. 5313 (Securities Exchange Act Release No. 9801) on October 2, 1972. Form 8-K is the form for reporting certain specified material events and transactions pursuant to Sections 13 and 15(d) of the Securities Exchange Act of 1934 (Exchange Act); Forms 10-K and 12-K are the forms for annual reports pursuant to those sections of the Exchange Act; Forms S-1, S-7, S-8, S-9, and S-11 are forms for registration of securities pursuant to the Securities Act of 1933; and Forms 10 and 12 are forms for registration of securities pursuant to the Exchange Act.

The Commission noted when it proposed amendments to these forms that it had observed an increasing number of large charges to income which often appeared without warning and were not generally understood by investors. The Commission is concerned that this trend seems to have accelerated in recent months. While many of such charges result from an identifiable event, many also appear to be made on the basis of a discretionary decision to dispose of marginal facilities or operations or to write off deferred development or excess production costs. In the latter situations, where facilities or operations gradually deteriorate or the outlook for a contract or program gradually worsens to the point where a write-off is deemed necessary, registrants have an obligation to forewarn public investors of the deteriorating conditions which unless reversed may result in a subsequent write-off. This includes an obligation to provide information regarding the magnitude of exposure to loss.

The Commission, therefore, reiterates its view that registrants should make special efforts to recognize incipient problems that might lead to such charges and to identify them clearly at the earliest possible time in financial statements and other forms of public disclosure, including public reports filed with the Commission, so that public investors may recognize the risks involved. In this connection, registrants should consider disclosure of the investment involved in divisions operating at a loss; the undepreciated cost of plant and equipment currently considered to be obsolete or of marginal utility; the extent of deferred research and development costs incurred in connection with products whose success is not reasonably assured; and other similar items where significant uncertainties exist as to realization.

The Commission has previously urged more comprehensive disclosure of progress and problems encountered in defense and other long-term contracts which may also give rise to major charges against income (Securities Act Release No. 5263 dated June 22, 1972) and has urged greater diligence in the release of quarterly and other interim reports of operations (Securities Exchange Act Release No. 9559 dated April 5, 1972).

In addition to disclosure of incipient problems, the Commission believes that substantial additional disclosure in regard to extraordinary items and material unusual charges and credits to income or major provisions for loss is necessary to enable public investors to assess the impact of such items. This would include transactions that are classified as extraordinary items under generally accepted accounting principles and other unusual or nonrecurring material transactions or provisions for loss, such as (but not restricted to) material write-downs of inventories, receivables, or deferred research and development costs, provisions for loss on major long-term contracts or purchase commitments, and losses on disposition of assets or business segments. The release of October 2 (33-5313 and 34-9801) contained proposals for such disclosure. The comments received on these proposals have been given careful consideration in determining the amendments to adopt.

The Commission has determined not to adopt the proposed amendment calling for pro forma statements to reflect allocation of charges and credits to prior years since, on the basis of comments received, it concluded that the proposed pro forma disclosure might leave the improper implication that past historical statements were in error as well as imposing substantial clerical burdens on registrants. The amendments adopted herein call for disclosure of the years in which the costs being included in the charge were or are expected to be incurred and the amount of cost in each year by major category of cost.

The Commission has further determined not to adopt the proposed amendments to Forms 7-Q and 10-Q and other related amendments which would have required an estimate of losses by quarters and a subsequent quarterly reconciliation of reserves provided. Comments indicated that quarterly estimates and reconciliations would be diffi-

cult to make within acceptable limits of accuracy, would not supply significant data for investors, and would impose a clerical burden on registrants. The amendments adopted herein require an estimate of losses by year and a subsequent annual explanation of differences between estimated and actual amounts and a reconciliation of any reserve provided.

In addition, the Commission has determined to omit the definition of "material" contained in the proposed note to Item 10(a) of Form 8-K. Comments indicated that a definition which relates materiality to a criterion based on separate reporting of an item to stockholders might have the effect of discouraging such disclosure rather than improving the quality thereof. Materiality, therefore, must be considered within the context of the definition contained in Rule 1-02 of Regulation S-X.

The text of the amendments follows:

A. *Form 8-K*

I. The caption of Item 10 and paragraph (a) have been amended as follows:

Item 10. Extraordinary Item Charges and Credits, Other Material Charges and Credits to Income of an Unusual Nature, Material Provisions for Loss, and Restatements of Capital Share Account.

(a) If there have been any extraordinary item charges or credits, any other material charges or credits to income of an unusual nature, or any material provisions for loss, the following shall be furnished for each such charge, credit, or provision:

(1) The date of the registrant's determination to make the charge, credit, or provision;

(2) A statement of the reasons for making the charge, credit, or provision;

(3) An analysis of the components (in dollar amounts) of the charge, credit, or provision, which includes

(i) A description of the various types of items written down or off;

(ii) A description of any provision for losses on liquidation of assets or for other losses including a detailed schedule showing the components of any losses provided for, which schedule shows the amount of administrative and fixed costs, if any, allocated to the loss;

(iii) A description of any estimated recoveries or costs netted against the charge or credit;

(4) A statement setting forth the years in which costs being reflected in the charge (or net credit) being described were or are expected to be incurred and the amount of cost for each year by major category (e.g., fixed assets, research and development costs, operating losses);

(5) A statement setting forth the estimated amount of net cash outlays (or in-flows) associated with the charge (or credit) in the year the charge (or credit) is made and in each subsequent year in which such estimate of the cash amount differs from the amount of total costs stated in part (4) for that year;

(6) A description of the accounting principles or practices followed and any changes therein or in the methods of applying such principles or practices which was made in connection with the transaction; and

(7) A report from the registrant's independent accountants in which they state that they have read the description in the Form 8-K of the facts set forth therein and of the accounting principles applied and whether they believe that on the basis of the facts so set forth that such accounting principles are fairly applied in conformity with generally accepted accounting principles or, if not, the respects in which they believe the principles do not conform to generally accepted accounting principles.

II. The following new instruction 8 has been added under EXHIBITS of Form 8-K.

8. Reports from the independent accountants furnished pursuant to Item 10.

B. *Form 10-K*

A new instruction (6) has been added to the instructions to Item 2, Summary of Operations, as follows:

(6) For any event subsequent to January 31, 1973, which was required to be reported pursuant to Item 10(a) of Form 8-K in which an amount of cost was estimated to be incurred in the fiscal year being reported on or the prior fiscal year, summarize such transaction and state the amounts of such estimated cost and the amounts of the actual cost incurred in such periods, the reasons for differences between estimated and actual amounts, if any, and provide a detailed reconciliation showing all charges and credits to any reserve provided.

C. *Form 12-K*

A new instruction 6 has been added to the INSTRUCTIONS AS TO EXHIBITS, as follows:

6. For any event subsequent to January 31, 1973, which was required to be reported pursuant to Item 10(a) of Form 8-K in which an amount of cost was estimated to be incurred in the fiscal year being reported on or the prior fiscal year, summarize such transaction and state the amounts of such estimated cost and the amounts of the actual cost incurred in such periods, the reasons for differences between estimated and actual amounts, if any, and provide a detailed reconciliation showing all charges and credits to any reserve provided.

D. Form S-1

A new instruction 7 has been added to Item 6, Summary of Earnings, as follows:

7. For any event subsequent to January 31, 1973, which was required to be reported pursuant to Item 10(a) of Form 8-K in which an amount of cost was estimated to be applicable to any of the fiscal years being reported on, summarize such transaction and state the amounts of such estimated cost and the amounts of the actual cost incurred in such periods, the reasons for differences between estimated and actual amounts, if any, and provide a detailed reconciliation showing all charges and credits to any reserve provided. If the issuer was not a registrant prior to the filing of this registration statement, this instruction shall apply to any transaction subsequent to January 31, 1973 which would have been required to be reported pursuant to Item 10(a) of Form 8-K had the issuer been a registrant and in which an amount of cost was estimated to be applicable to the fiscal years being reported on.

E. Form S-7

Instruction 8 of Item 6, Statement of Income, has been changed to number 9 and a new instruction 8 has been added, as follows:

8. For any event subsequent to January 31, 1973, which was required to be reported pursuant to Item 10(a) of Form 8-K in which an amount of cost was estimated to be applicable to any of the fiscal years being reported on, summarize such transaction and state the amounts of such estimated cost and the amounts of the actual cost incurred in such periods, the reasons for differences between estimated and actual amounts, if any, and provide a detailed reconciliation showing all charges and credits to any reserve provided.

F. Form S-8

Instruction 4 of Item 19, Summary of Earnings, has been changed to number 5 and a new instruction 4 has been added, as follows:

4. For any event subsequent to January 31, 1973, which was required to be reported pursuant to Item 10(a) of Form 8-K in which an amount of cost was estimated to be applicable to any of the fiscal years being reported on, summarize such transaction and state the amounts of such estimated cost and the amounts of the actual cost incurred in such periods, the reasons for differences between estimated and actual amounts, if any, and provide a detailed reconciliation showing all charges and credits to any reserve provided.

G. Form S-9

Instruction 6 to part (a) of Item 3, Statements of Income, has been changed to number 7 and a new instruction 6 has been added, as follows:

6. For any event subsequent to January 31, 1973, which was required to be reported pursuant to Item 10(a) of Form 8-K in which an amount of cost was estimated to be applicable to any of the fiscal years being reported on, summarize such transaction and state the amounts of such estimated cost and the amounts of the actual cost incurred in such periods, the reasons for differences between estimated and actual amounts, if any, and provide a detailed reconciliation showing all charges and credits to any reserve provided.

H. *Form S-11*

A new instruction 7 has been added to part (a) of Item 6, Summary Financial Data, as follows:

7. For any event subsequent to January 31, 1973, which was required to be reported pursuant to Item 10(a) of Form 8-K in which an amount of cost was estimated to be applicable to any of the fiscal years being reported on, summarize such transaction and state the amounts of such estimated cost and the amounts of the actual cost incurred in such periods, the reasons for differences between estimated and actual amounts, if any, and provide a detailed reconciliation showing all charges and credits to any reserve provided. If the issuer was not a registrant prior to the filing of this registration statement, this instruction shall apply to any transaction subsequent to January 31, 1973 which would have been required to be reported pursuant to Item 10(a) of Form 8-K had the issuer been a registrant and in which an amount of cost was estimated to be applicable to the fiscal years being reported on.

I. *Form 10*

A new instruction 5 has been added to Item 2, Summary of Operations, as follows:

5. For any event subsequent to January 31, 1973, which was required to be reported pursuant to Item 10(a) of Form 8-K in which an amount of cost was estimated to be applicable to any of the fiscal years being reported on, summarize such transaction and state the amounts of such estimated cost and the amounts of the actual cost incurred in such periods, the reasons for differences between estimated and actual amounts, if any, and provide a detailed reconciliation showing all charges and credits to any reserve provided. If the issuer was not a registrant prior to the filing of this registration statement, this instruction shall apply to any transaction subsequent to January 31, 1973 which would have been required to be reported pursuant to Item 10(a) of Form 8-K had the issuer been a registrant and in which an amount of cost was estimated to be applicable to the fiscal years being reported on.

J. *Form 12*

A new instruction 9 has been added to the INSTRUCTIONS AS TO EXHIBITS, as follows:

9. For any event subsequent to January 31, 1973, which was required to be reported pursuant to Item 10(a) of Form 8-K in which an amount of cost was estimated to be applicable to any of the fiscal years being reported on, summarize such transaction and state the amounts of such estimated cost and the amounts of the actual cost incurred in such periods, the reasons for differences between estimated and actual amounts, if any, and provide a detailed reconciliation showing all charges and credits to any reserve provided. If the issuer was not a registrant prior to the filing of this registration statement, this instruction shall apply to any transaction subsequent to January 31, 1973 which would have been required to be reported pursuant to Item 10(a) of Form 8-K had the issuer been a registrant and in which an amount of cost was estimated to be applicable to the fiscal years being reported on.

* * * * *

The foregoing amendments are adopted pursuant to Sections 6, 7, 8, 10 and 19(a) of the Securities Act of 1933 and Sections 13, 15(d) and 23(a) of the Securities Exchange Act of 1934. The amendments shall be effective with respect to reports on Form 8-K and registration statements on Forms S-1, S-7, S-8, S-9, S-11, 10 and 12, and with respect to annual reports on Forms 10-K and 12-K filed on or after February 28, 1973.

By the Commission.

Ronald F. Hunt
Secretary

APPENDIX B

Securities and Exchange Commission, Accounting Series Release No. 164 of November 21, 1974

Notice of adoption of amendments to Regulation S-X to provide for improved disclosures related to defense and other long-term contract activities.

A. INTRODUCTION

The Securities and Exchange Commission has long been concerned about the quality of disclosures made by registrants engaged in defense and other long-term contract activities because these activities involve inventories and receivables with unique risk and liquidity characteristics. After initially urging corporate managers to review their disclosure policies with respect to such contracting activities,¹ the Commission published for comment proposed amendments to Rules 5-02.3 and 5-02.6 of Regulation S-X.²

As noted in its release proposing these amendments, the Commission believes that it is necessary and appropriate to expand these Rules to require disclosure of greater detail in certain critical areas of long-term contract activity, particularly with respect to the nature of costs accumulated in inventories, the effect of cost accumulation policies on cost of sales, and the effect of revenue recognition practices on receivables and inventories.

The proposed amendments elicited numerous letters of comment which have been duly considered by the Commission in the formulation of the amendments specifically adopted in this release. The following discussion outlines the Commission's responses to certain of these comments as reflected in the adopted rules on receivables and inventories.

Comments on Disclosure of Receivables—Rule 5-02.3

Paragraph (b). Several commentators pointed out that the proposed amendment could be broadly construed to require additional disclosure

¹ Securities Act Release No. 5263, Securities Exchange Act Release No. 9650, June 22, 1972.

² Securities Act Release No. 5492, Securities Exchange Act Release No. 10775, May 6, 1974.

for receivables other than those arising from long-term contract activities. At the present time the Commission intends only to improve disclosures related to long-term contract activities. Consequently, the amendment to this paragraph has been deleted and the proposed disclosure of collection expectations has been incorporated in the amendments addressed specifically to receivables arising from such activities.

Paragraph (e). Some commentators suggested that the retainage disclosure should be limited to amounts not expected to be collected within one year. Due to the unique liquidity characteristics of retainage, the Commission believes that any material amount of retainage should be disclosed no matter when such amount is expected to be collected. However, the Commission also believes that the significant uncertainties which often affect the determination of a mutually satisfactory contract completion may cause the estimates of amounts to be collected within specific years to become progressively less reliable. Consequently, the amendment as adopted requires the isolation of only the aggregate amount of retainage expected to be collected after one year. However, registrants are encouraged to provide estimated collections by year if their experience or other factors enable them to do so with reasonable accuracy.

Several commentators suggested that the amendment should be modified to provide for amounts retained by contractors pursuant to the provisions of subcontracts. The Commission believes that this is unnecessary because Rule 5-02.25 can be interpreted to require separate disclosure of significant amounts of retentions payable to sub-contractors.

Paragraph (f). Numerous commentators pointed out that a literal interpretation of the proposed amendment would call for disclosures regarding all accrued receivables rather than just those related to long-term contracts and might also result in a duplication of disclosures made under paragraph (g). The Commission recognizes the validity of these comments and the amendment has been modified accordingly.

The amendment as adopted also calls for disclosure of the amounts of receivables not billed or billable that are expected to be collected after one year. The Commission believes that disclosure of the timing of expected collections provides investors with meaningful liquidity and risk information.

It should be noted that the amendment is not directed at items which are "unbilled" at the balance sheet date merely because the necessary paperwork has not been processed in accordance with the normal operation of a billing system. Such items would generally be considered "billable" for purposes of this Rule.

Paragraph (g). Many commentators argued that the proposed amendment was too broad since it would require the disclosure of amounts which could be determined with reasonable certainty under express contractual escalation or change order clauses and which

would be virtually assured of realization. The Commission has concluded that amounts due under routine change orders and escalation features commonly found in the terms of contracts are typically not subject to such uncertainty that separate disclosure is required. On the other hand, it believes that disclosure is necessary when amounts are recorded which are not reasonably determinable under the specific terms of existing contracts. Accordingly, the text of this rule has been amended to require disclosure where the amounts included in receivables whether billed or unbilled, are either claims or other similar items subject to uncertainty concerning their determination or ultimate realization.

Several commentators questioned the meaning of the term "components" as used in the requirement for footnote disclosure of the principal items comprising the aggregate of claims and other similar items subject to uncertainties. In response, the Commission has used the term "nature and status" to more accurately reflect its intentions and has expanded the attached Exhibit to provide examples of disclosure envisioned by these terms.

Comments on Disclosure of Inventories—Rule 5-02.6

Paragraph (b). In response to numerous comments, this amendment has been modified in several significant ways. First, in recognition of the recently adopted Statement of Financial Accounting Standards No. 2, the Commission has deleted the requirements for disclosure of the amounts of research and development costs incurred during the period or remaining in inventory. Compliance with that Statement will obviate the need for the disclosure of these amounts. However, the amendment still contemplates a description of such costs being carried in inventory in compliance with the new Statement.

Second, the Commission recognizes that some registrants may find it impracticable to determine the actual amount of general and administrative costs remaining in inventory at the balance sheet dates. However, the Commission believes that registrants can provide reasonable estimates of such remaining costs determined, for example, on the assumption that costs related to a particular contract or program have been removed from inventory on a basis proportional to the totals of the various cost elements expected to be charged to cost of sales for that contract or program. The assumptions used to develop these estimates should be described in a note to the financial statements.

Third, the Commission expects that the description of the cost elements included in inventory will appropriately disclose the existence of items not typically included in inventoried costs in a usual manufacturing operation. Described items may include, for example, retained costs representing the excess of manufacturing or production costs over the amounts charged to costs of sales for delivered or in-process units, initial tooling and other deferred start-up costs, general and administrative costs, or research and development under contractual arrangements. In general, the Commission believes that the

accounting treatment of such costs is sufficiently unique to warrant the disclosure of their existence and, to the extent noted below, their magnitude.

Paragraph (c). This paragraph contains the last sentence of Rule 5-02.6(b) as it existed prior to the amendments adopted in this release. However, the requirements of this paragraph may be amended by the proposal published in Securities Act Release No. 5427. Comments on that proposal are still being considered.

Paragraph (d). Numerous commentators pointed out that the proposed definition would include supply or service contracts expected to be in process for more than one year even though such contracts may not involve the unique risk and liquidity characteristics associated with long-term manufacturing and construction contracts or programs. The Commission believes that the proposed definition was susceptible to an overly broad interpretation. Consequently, the Commission has modified the definition to deal explicitly with all contracts or programs accounted for on either a percentage of completion or a completed contract basis provided that any such contract or program has associated with it material amounts of inventories or unbilled receivables and has been or is expected to be performed over a period of more than twelve months.

Paragraph (d)(i). Many commentators argued that the amounts reported under this proposed amendment would not be mutually exclusive from the amounts reported under subparagraph (iii). To eliminate this problem, the Commission has modified proposed subparagraphs (i) and (iii) and now deals with these matters in one subparagraph which requires disclosure of (1) the aggregate amount of (a) manufacturing or production costs which have been carried forward under a "learning curve" concept and (b) any related costs which have been deferred for allocation to future production, and (2) the portion of such aggregate amount which would not be absorbed in cost of sales based on existing firm orders. The amendment also calls for the isolation of the cost elements included in the costs carried forward if it is practicable for the registrant to provide this detail. The Commission believes that these disclosures will provide investors with meaningful information concerning the nature of costs accumulated in inventories.

Paragraph (d)(ii). Many of the comments noted above under proposed Rule 5-02.3(g) were also directed to this amendment. The Commission has modified this subparagraph to reflect those comments. This amendment recognizes that certain registrants classify amounts representing claims or other similar items subject to uncertainties as inventories rather than as receivables reportable under Rule 5-02.3(g). Regardless of where such amounts are classified, the Commission believes that material amounts must be disclosed together with an appropriate description of the nature and status of the principal items

comprising such amounts. In this connection, the Commission has expanded the accompanying Exhibit to provide helpful examples of the type of disclosure envisioned by this Rule.

Paragraph (d)(v). Numerous commentators expressed the view that the concept of "title" is fraught with substantial difficulties of legal interpretation and that in any event it would be unduly burdensome to attempt such an analysis of the items included in inventory. The Commission accepts these comments and accordingly has deleted this proposal.

The subject rules, as amended herein, apply to disclosure in financial statements filed with the Commission. Registrants and their independent public accountants must make the determination as to what information regarding such matters is required to constitute satisfactory financial statement disclosure under generally accepted accounting principles.

B. AMENDMENTS

Rules 5-02.3 and 5-02.6 of Regulation S-X are amended as follows (amendments underlined):

Rule 5-02.3. Accounts and notes receivable.—

(a) through (d) (No change)

(e) If receivables include amounts representing balances billed but not paid by customers under retainage provisions in contracts, state the amount thereof either in the balance sheet or in a note to the financial statements. In addition, state the amounts, if any expected to be collected after one year. If practicable, state by years when the amounts are expected to be collected.

(f) If receivables include amounts (other than amounts reportable under paragraph (g) below) representing the recognized sales value of performance under long-term contracts (see Rule 5-02.6(d)) and such amounts had not been billed and were not billable to customers at the date of the balance sheet, state separately in the balance sheet or in a note to the financial statements, the amount thereof and include a general description of the prerequisites for billing. In addition, state the amount, if any, expected to be collected after one year.

(g) If receivables include amounts under long-term contracts (see Rule 5-02.6(d)), whether billed or unbilled, representing claims or other similar items subject to uncertainty concerning their determination or ultimate realization, state separately in the balance sheet or in a note to the financial statements, the amount thereof and include

a description of the nature and status of the principal items comprising such amount. In addition, state the amount, if any, expected to be collected after one year.

Rule 5-02.6. Inventories.—(a) State separately here, or in a note referred to herein, if practicable, the major classes of inventory such as (1) finished goods; (2) inventoried costs relating to long-term contracts or programs (see (d) below and Rule 3-11); (3) work in process (see Rule 3-11); (4) raw materials; and (5) supplies.

(b) The basis of determining the amounts shall be stated.

If “cost” is used to determine any portion of the inventory amounts, describe the method of determining cost. This description shall include the nature of the cost elements included in inventory.

If “market” is used to determine any portion of the inventory amounts, describe the method of determining “market” if other than current replacement cost.

The method by which amounts are removed from inventory (e.g., “average cost,” “first-in, first-out,” “last-in, first-out,” “estimated average cost per unit”) shall be described. If the estimated average cost per unit is used as a basis to determine amounts removed from inventory under a total program or similar basis of accounting, the principal assumptions (including, where meaningful, the aggregate number of units expected to be delivered under the program, the number of units delivered to date and the number of units on order) shall be disclosed.

If any general and administrative costs are charged to inventory, state in a note to the financial statements the aggregate amount of the general and administrative costs incurred in each period and the actual or estimated amount remaining in inventory at the date of each balance sheet.

(c) If the LIFO inventory method is used, the excess of replacement or current cost over stated LIFO value shall, if material, be stated parenthetically or in a note to the financial statements. (Note: Paragraph (c) as proposed in Securities Act Release 5427 would modify this requirement. Comments on that proposal continue under consideration.)

(d) For purposes of Rules 5-02.3 and 5-02.6, long-term contracts or programs include (1) all contracts or programs for which gross profits are recognized on a percentage-of-completion method of accounting or any variant thereof (e.g., delivered unit, cost to cost, physical com-

pletion) and (2) any contracts or programs accounted for on a completed contract basis of accounting where, in either case, the contracts or programs have associated with them material amounts of inventories or unbilled receivables and where such contracts or programs have been or are expected to be performed over a period of more than twelve months. Contracts or programs of shorter duration may also be included, if deemed appropriate.

For all long-term contracts or programs, the following information, if applicable, shall be stated in a note to the financial statements:

(i) The aggregate amount of manufacturing or production costs and any related deferred costs (e.g., initial tooling costs) which exceeds the aggregate estimated cost of all in-process and delivered units on the basis of the estimated average cost of all units expected to be produced under long-term contracts and programs not yet complete, as well as that portion of such amount which would not be absorbed in cost of sales based on existing firm orders at the latest balance sheet date. In addition, if practicable, disclose the amount of deferred costs by type of cost (e.g., initial tooling, deferred production, etc.).

(ii) The aggregate amount representing claims or other similar items subject to uncertainty concerning their determination or ultimate realization, and include a description of the nature and status of the principal items comprising such aggregate amount.

(iii) The amount of progress payments netted against inventory at the date of the balance sheet.

* * * * *

The amendments to Regulation S-X have been adopted pursuant to authority conferred on the Commission by the Securities Act of 1933, particularly Sections 6, 7, 8, 10 and 19(a) thereof and the Securities Exchange Act of 1934, particularly Sections 12, 13, 15(d) and 23(a) thereof.

The above amendments to Regulation S-X shall be applicable to financial statements for periods ending on or after December 20, 1974. Such disclosure is recommended but not required for financial statements for fiscal periods ending prior to December 20, 1974.

By the Commission.

George A. Fitzsimmons
Secretary

C. EXHIBIT

The following hypothetical example is furnished to illustrate the character and detail of the disclosures which might be furnished in response to Rules 5-02.3 and 5-02.6 of Regulation S-X as amended by the accompanying release. The illustration is provided to assist in understanding and evaluating the amendments.

* * * * *

XYZ Company and Subsidiaries
Consolidated Balance Sheets
At December 31,

	1974	1973
	(000 omitted)	
ASSETS		
CURRENT ASSETS:		
Cash	\$ 438	\$ 627
Accounts receivable:		
Trade and other receivables, net of allowance for uncollectible accounts of \$38,000 in 1974 and \$36,000 in 1973	2,846	2,396
Long-term contracts and programs (notes 1 and 2)	18,985	19,036
Total accounts receivable	21,831	21,432
Inventories and costs relating to long-term contracts and programs in process, net of progress payments (notes 1 and 3)	6,278	6,257
Prepaid expenses	46	27
Total current assets	\$28,593	\$28,343

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Revenue Recognition. Sales of commercial products under long-term contracts and programs are recognized in the accounts as deliveries are made. The estimated sales value of performance under Government fixed-price and fixed-price incentive contracts in process is recognized under the percentage of completion method of accounting whereunder the estimated sales value is determined on the basis of physical completion to date (the total contract amount multiplied by percent of performance to date less sales value recognized in previous periods) and costs (including general and administrative, except as described below) are expensed as incurred. Sales under cost-reimbursement contracts are recorded as costs are incurred and include estimated earned fees in the proportion that costs incurred to date bear to total estimated costs. The fees under certain Government contracts may be increased or decreased in accordance with cost or performance incentive provisions which measure actual performance against established targets or other criteria. Such incentive fee awards or penalties are included in sales at the time the amounts can be determined reasonably.

Inventories. Inventories, other than inventoried costs relating to long-term contracts and programs, are stated at the lower of cost (principally first-in, first-out) or market. Inventoried costs relating to long-term contracts and programs are stated at the actual production cost, including factory overhead, initial tooling and other related non-recurring costs, incurred to date reduced by amounts identified with revenue recognized on units delivered or progress completed. General and administrative costs applicable to cost-plus Government contracts are also included in inventories. Inventoried costs relating to long-term contracts and programs are reduced by charging any amounts in excess of estimated realizable value to cost of sales. The costs attributed to units delivered under long-term commercial contracts and programs are based on the estimated average cost of all units expected to be produced and are determined under the learning curve concept which anticipates a predictable decrease in unit costs as tasks and production techniques become more efficient through repetition.

In accordance with industry practice, inventories include amounts relating to contracts and programs having production cycles longer than one year and a portion thereof will not be realized within one year.

* * * * *

NOTE 2—ACCOUNTS RECEIVABLE

The following tabulation shows the component elements of accounts receivable from long-term contracts and programs:

	1974	1973
	(000 omitted)	
U.S. Government:		
Amounts billed	\$ 7,136	\$ 6,532
Recoverable costs and accrued profit on progress completed—not billed	4,173	3,791
Unrecovered costs and estimated profits subject to future negotiation—not billed	1,468	1,735
	<u>12,777</u>	<u>12,058</u>
Commercial Customers:		
Amounts billed	1,937	3,442
Recoverable costs and accrued profit on units delivered—not billed	1,293	364
Retainage, due upon completion of contracts	2,441	2,279
Unrecovered costs and estimated profits subject to future negotiation—not billed	537	893
	<u>\$18,985</u>	<u>\$19,036</u>

The balances billed but not paid by customers pursuant to retainage provisions in construction contracts will be due upon completion of the contracts and acceptance by the owner. Based on the Company's experience with similar contracts in recent years, the retention balances at December 31, 1974 are expected to be collected as follows: \$270,000 in 1975, \$845,000 in 1976 and the balance in 1977.

Recoverable costs and accrued profit not billed comprise principally amounts of revenue recognized on contracts for which billings had not been presented to the contract owners because the amounts were not billable at balance sheet date. It is anticipated such unbilled amounts receivable from the U.S. Government at December 31, 1974 will be

billed over the next 60 days as units are delivered. The unbilled accounts receivable applicable to commercial customers are billable upon completion of performance tests which are expected to be completed in September 1975.

Unrecovered costs and estimated profits subject to future negotiation, the principal amount of which is expected to be billed and collected within one year, consist of the following elements:

	1974	1973
	(000 omitted)	
U.S. Government Contracts:		
Excess of estimated or proposed over provisional price	\$ 190	\$ 157
Amounts claimed for incremental costs arising from customer occasioned contract delays	1,278	1,578
	<u>1,468</u>	<u>1,735</u>
Commercial Contracts:		
Unrecovered costs and estimated profit relating to work not specified in ex- press contract provisions	537	893
	<u>\$2,005</u>	<u>\$2,628</u>

NOTE 3—INVENTORIES

Inventories and inventoried costs relating to long-term contracts and programs are classified as follows:

	December 31,	
	1974	1973
	(000 omitted)	
Finished goods	\$3,562	\$3,435
Inventoried costs relating to long-term contracts and programs, net of amounts attributed to revenues recognized to date	2,552	2,638
Work in process	738	947
Raw materials	453	383
Supplies	112	71
	<u>7,417</u>	<u>7,474</u>
Deduct progress payments related to long-term contracts and programs	1,139	1,217
	<u>\$6,278</u>	<u>\$6,257</u>

The following tabulation shows the cost elements included in inventoried costs related to long-term contracts:

	December 31,	
	1974	1973
	(000 omitted)	
Production costs of goods currently in process	\$1,184	\$ 960
Excess of production cost of delivered units over the estimated average cost of all units expected to be produced	647	893
Unrecovered costs subject to future negotiation	280	310
General and administrative costs	260	270
Initial tooling and other non-recurring costs	181	205
	<u>\$2,552</u>	<u>\$2,638</u>

The inventoried costs relating to long-term contracts and programs includes unrecovered costs of \$280,000 and \$310,000 at December 31, 1974 and 1973, respectively, which are subject to future determination through negotiation or other procedures not complete at balance sheet dates. Of such amounts, \$260,000 and \$280,000 are in respect to contracts under which all goods have been delivered at December 31, 1974 and 1973, respectively. The unrecovered amount at December 31, 1973 consisted of three items, one of which was settled during 1974. The amount remaining at December 31, 1974 is represented principally by a claim asserted against a customer for amounts incurred as a result of faulty materials furnished by the customer which in turn caused delays in performance under the contract. In the opinion of management these costs will be recovered by contract modification or litigation. It is expected that the negotiations which are being conducted currently with the customer, will be successfully concluded during the next twelve months. If this expectation is not realized, the matter will be referred to the Armed Services Board of Contract Appeals, with the consequence that settlement could be delayed for an indeterminate period.

The actual per unit production cost of the NX-4C aircraft produced during the most recent fiscal year was less than the estimated average per unit cost of all units expected to be produced under the program. Prior to 1974, the Company's NX-4C commercial aircraft program was in the early high cost period. During the initial years of the program, the cost of units produced exceeded the sales price of the delivered units and the estimated average unit cost of all units to be produced under the program. At December 31, 1974, inventories in-

cluded costs of \$647,000 representing the excess of costs incurred over estimated average costs per aircraft for the 117 aircraft delivered through the year end. The estimated average unit cost is predicated on the assumption that 250 planes will be produced and that production costs (principally labor and materials) will decrease as the project matures and efficiencies associated with increased volume, improved production techniques and the performance of repetitive tasks (the learning curve concept) are realized. (Note: The amount by which the production costs of the equivalent finished units in process at the date of the latest balance sheet exceeds the cost of such units on the basis of the estimated average unit cost of all units expected to be produced under the program should be stated. Since, as stated above, the actual per unit production cost is currently less than the estimated average per unit cost of all units expected to be produced under the program, no such excess is assumed in this example.)

Recovery of the deferred production, initial tooling and related non-recurring costs is dependent on the number of aircraft ultimately sold and actual selling prices and production costs associated with future transactions. Sales significantly under estimates or costs significantly over estimates could result in the realization of substantial losses on the program in future years. Realization of approximately \$421,000 of the gross commercial aircraft inventories at December 31, 1974 is dependent on receipt of future firm orders.

Based on studies made by and on behalf of the Company, management believes there exists for this aircraft a market for over 250 units, including deliveries to date, with production and deliveries continuing at a normal rate to at least 1980. At December 31, 1974, 117 aircraft had been delivered under the program, and the backlog included 64 firm unfilled orders and options for 43 units.

The aggregate amounts of general and administrative costs incurred during 1974 and 1973 were \$2,251,000 and \$2,238,000, respectively. As stated in Note 1, the Company allocates general and administrative costs to certain types of Government contracts. The amounts of general and administrative costs remaining in inventories at December 31, 1974 and 1973 are estimated at \$260,000 and \$270,000, respectively. Such estimates assume that costs have been removed from inventories on a basis proportional to the amounts of each cost element expected to be charged to cost of sales.

* * * * *