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ACCOUNTING PROBLEMS UNDER THE RENEGOTIATION ACT

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Miss Priester has spent ten years of her working career in public accounting, and eleven years in private industry in executive positions. She has been an officer and director of several corporations, and her background well qualifies her to write with authority on the subject of renegotiation.

Since the enactment of the original Renegotiation Act of 1942, accountants have been faced with ever-mounting problems in the preparation of the reports required and in the determination of whether income and expense items should be considered as renegotiable, non-renegotiable, allocable or non-allocable.

It has been stated that, because substantially the same conditions affecting the procurement of supplies for defense which necessitated the renegotiation statutes of World War II now prevail, the general pattern of the Renegotiation Act of 1951 is more like the Renegotiation Act of 1942, as amended, than the Renegotiation Act of 1948, as amended.

In spite of the fact that Renegotiation has been with us in one form or another since 1942, and the Regulations of the Renegotiation Board pursuant to the Renegotiation Act of 1951 were officially adopted on March 25, 1952, it has already become necessary to issue seven Staff Bulletins (to September 12, 1952). These Staff Bulletins are in the nature of information to all personnel working on renegotiation and for the guidance of Contractors in preparing their information. This service formerly was not given to the Contractor and he was often faced with inter-office rulings which did not appear in the Regulations to which he had access. It is of the utmost importance that the accountant review all Staff Bulletins before submitting accounting data.

The Staff Bulletins that have been issued cover such items as advertising expenses, stock item exemptions, gifts as unallowable costs, traveling and entertainment expenses, commissions to brokers, and listings of Controlled Materials Plan (CMP) symbols and Defense Order (DO) ratings indicating whether a sale is renegotiable, non-renegotiable or possibly renegotiable. The staff Bulletin relating to sales classifications by use of the symbols of CMP and DO have already had two supplements issued—known as Staff Bulletins 3A and 3B.

Section 102(a) of the Renegotiation Act of 1951 provides as follows:

> "In general. The provisions of this title shall be applicable (1) to all contracts with the Departments specifically named in section 103 (a), and related subcontracts, to the extent of the amounts received or accrued by a contractor or subcontractor on or after the first day of January 1951, whether such contracts or subcontracts were made on, before, or after such first day, and (2) to all contracts with the Departments designated by the President under section 103 (a), and related subcontracts, to the extent of the amounts received or accrued by a contractor or subcontractor on or after the first day of the first month beginning after the date of such designation, whether such contracts or subcontracts were made on, before, or after such first day; but the provisions of this title shall not be applicable to receipts or accruals attributable to performance under contracts or subcontracts, after December 31, 1953."

The 1951 Act makes renegotiable the contracts and subcontracts let by the following agencies beginning January 1, 1951:

Department of Defense
Department of the Army
Department of the Navy
Department of the Air Force
Department of Commerce
General Services Administration
Atomic Energy Commission
Reconstruction Finance Corporation
Canal Zone Government
Panama Canal Company
Housing and Home Finance Agency

In addition, the President has designated as renegotiable the contracts and subcontracts of the following additional agencies, and the dates indicated are the dates from which its contracts are renegotiable:

July 1, 1951:
- Federal Civil Defense Administration
- National Advisory Committee for Aeronautics
- Tennessee Valley Authority
- United States Coast Guard

October 1, 1951:
- Defense Materials Procurement Agency
- Bureau of Mines
- (United States) Geological Survey

November 1, 1951:
- Bonneville Power Administration

By itself, the naming of the renegotiable contract agencies designated in the 1951 Act or in the President's Executive Orders does not answer fully all questions as to whether or not a particular contract or subcontract may be renegotiable. This is because many of these named agencies have within them sub-agencies which let contracts in their own names—contracts which are, of course, renegotiable.

ACCOUNTING PROBLEMS IN SEGREGATING SALES

The Standard Form of Contractor's Report, known as R. B. Form 1, requires the segregation of direct sales under renegotiable prime contracts and purchase orders into the following groups:

(a) Fixed price contracts
(b) Cost-plus-a-fixed-fee
(c) Other

and the inclusion of indirect sales under purchase orders or renegotiable subcontracts of any tier.

In order to make this segregation the accountant must frequently review all the contract provisions because the various Government Departments do not use the same contract forms. The contractor may have a fixed price contract with an upward or downward provision, or he may have a fixed price contract with a downward price revision clause only. Some contracts for research and development have a limited overhead rate. Cost-plus-a-fixed-fee contracts usually have an individual renegotiation provision and the amounts received under such contracts are subject to audit and final determination of actual costs. Certain service contracts also have a price redetermination clause, even though monthly billings are made on the basis of a stated price per day per man.

Thus, the above are just a few of the problems in ascertaining renegotiable sales of a prime contractor.

The work of the accountant in determining the renegotiable sales in subcontracting work is even more difficult, because many subcontractors may deliver items to a prime contractor which are used in the prime contractor's commercial business as well as for his government contracts.

The Board will not disapprove any method that may be used in allocating lower tier subcontracts between renegotiable and non-renegotiable sales, provided the Board is satisfied that such method, under all the circumstances, affords the best basis for reasonable, precise determination. It is for this reason, however, that the Board requests the contractor or subcontractor to submit detailed information as to the method used in making an allocation between renegotiable and non-renegotiable sales.

In many instances a subcontractor may have thousands of small orders that are processed during a month. The subcontractor may attempt to correspond with all his customers in an effort to determine the percentage of renegotiable sales to the total sales. However, in actual practice, unless a contractor is practically 100 percent on government work, he cannot notify the subcontractor of the percentage until all of his own calculations have been made. As an indication of the problem involved Renegotiation Staff Bulletin No. 5 was issued to cover the so-called "stock item exemptions"—which in effect means that if items are purchased for stock by a contractor—then the sale by the subcontractor is definitely non-renegotiable.

Another method of making the determination or allocation to renegotiable sales, where subcontractors are delivering similar items for commercial business and government business, in the same industry for a single product, permits the contractor or subcontractor to use a percentage that conforms roughly to the factors pertaining to that industry.

To indicate the care that must be exercised by the accountant in arriving at the allocation of renegotiable and non-renegotiable sales, the following incident stresses the importance of looking at every provision of a contract.

Under the 1942 Act, a contract was considered closed and not subject to renegotiation provided all deliveries had been made and payment therefor received prior to April 28, 1942. One contractor had made

deliveries of approximately $11,000,000 during the months of January and February of 1942, and payment therefor had been received during the month of March 1942. The contract, however, had a provision that the contractor pay the freight charges. The freight charges were paid by the contractor on receipt of invoices from the Government. The contractor had no way of knowing where the shipments went until such invoices were received. During the month of December 1941, the contractor had been notified that a charge of $45.00 was due on a certain shipment. The contractor had paid this charge, as well as all other charges submitted for freight, prior to April 28, 1942. In July of 1942 the contractor was notified that the $45.00 freight invoice issued in December 1941 should only have been for $30.00, and it was suggested that the contractor submit an invoice for reimbursement of the $15.00 freight charge since it would involve a substantial amount of red tape to have the government issue a credit memo for the $15.00. An employee of the contractor prepared the $15.00 invoice. Because the $15.00 freight invoice was dated subsequent to April 28, 1942, the matter of whether or not the $11,000,000 sales should be considered renegotiable or non-renegotiable has not yet been decided. It is a matter of stipulation in a Tax Court case. Of course, it remains an open question as to whether the contract would have been considered a "closed contract" if the contractor had refused to issue the $15.00 freight invoice.

ACCOUNTING PROBLEMS IN SEGREGATING COST OF SALES

The statutory provisions are contained in Section 1459.1(a), Determination of costs. Section 103(f) of the act provides:

> ". . . All items estimated to be allowed as deductions and exclusions under Chapter 1 of the Internal Revenue Code (excluding taxes measured by income) shall, to the extent allocable to such contracts and subcontracts, be allowed as items of cost, except that no amount shall be allowed as an item of cost by reason of the application of a carry-over or carry-back."

However, for the first time, the Renegotiation Act permits a carry-over loss provided it falls within the purview of the following:

> "Notwithstanding any other provision of this section, there shall be allowed as an item of cost in any fiscal year, subject to regulations of the Board, an amount equal to the excess, if any, of costs (computed without the application of this sentence) paid or incurred in the preceding fiscal year with respect to receipts or accruals subject to the provisions of this title over the amount of receipts or accruals subject to the provisions of this title which were received or accrued in such preceding fiscal year, but only to the extent that such excess did not result from gross inefficiency of the contractor or subcontractor. For the purpose of the preceding sentence, the term "preceding fiscal year" does not include any fiscal year ending prior to January 1, 1951."

The direct costs of sales must be analyzed so that they will be applicable to the respective sales categories mentioned previously. However, in examining the factory burden, there may be several expense items that require elimination or that fall in the category of non-renegotiable expenses, and as such you cannot apply your normal or standard burden rate in determining total costs. It again becomes necessary to first determine the burden items that are entirely in the renegotiable class, the items that are entirely in the non-renegotiable class, and the so-called allocable items which are applicable to both renegotiable and non-renegotiable business. When this has been determined, how are the allocable items divided between renegotiable and non-renegotiable business? Several methods have been used and are acceptable to the Board provided the Board is satisfied that such methods afford the best basis for reasonable, precise determination, in so far as they relate to the contractor under review. One method is to spread the allocable burden on the basis of direct labor costs. Another method is to spread the allocable burden on the basis of "total direct costs."

It is, again, up to the accountant to carefully analyze all burden expense items. For example, one contractor, because of his government business, and to meet the rigid requirements of tolerances in the units he was manufacturing, had substantial expense in his Inspection Department and in his Testing Department. In addition he maintained a Salvage Department. All three were special departments that were not ordinarily required in the contractor's commercial business. These items were included in the Factory Burden account—but were properly allocable to only renegotiable business, in so far as this one contractor was concerned.

ACCOUNTING PROBLEMS IN SEGREGATING SELLING AND GENERAL AND ADMINISTRATIVE EXPENSES

The Regulations have very specific provisions as to the costs allocable to and allowable against renegotiable business. They cover such items as salaries, wages and other compensation; amortization and depreciation; conversion to renegotiable production; losses; interest; selling and adver-

tising expenses; entertainment and other improper expenses; other costs, expenses and reserves (patent royalties, charitable contributions, etc.); and taxes measured by income ("state income taxes").

Much has been written as to the determination and allocation of the foregoing expenses. Since a review indicates that it requires a detailed analysis of each and every expense item, the accountant should insist that these analyses be submitted to him monthly, otherwise the volume of work at the end of the year will result in a hurried submission of figures and subsequent hours of work and conferences to make adjustments.

The problems of allocation mentioned are multiplied when there are multiple plant operations because usually, in addition to the individual plants, there is the question of allocation of the general and administrative expenses of the head office. Any allocation used must be set forth in a statement to the Board.

An accountant who studies the monthly analyses of costs and expenses, should, in addition, be familiar with the operations of the entire plant, or all plants in multiple plant operations. In this way he will know when the Engineering Department has improved design and methods, and may be able to trace substantial savings in costs as a result thereof. For example, one contractor, on an item which was almost impossible to obtain, set up his own facilities to manufacture the part. This resulted in a saving of almost $2.00 per unit on 40,000 units. It is important to bring this type of information before the Board while it is making its determination of profits. This type of information together with other factors, such as letters of outstanding achievement from a government agency in the manufacture of a highly technical unit, may permit an increased profit allowance on that part of the contractor's business.

FILING OF REPORTS

The Standard Form of Contractor's Report for Renegotiation of Contracts and Subcontracts subject to the Renegotiation Act of 1951 is entitled R. B. Form 1, and must be filed within ninety days after the close of the contractor's or subcontractor's fiscal year, by every contractor or subcontractor regardless of the amount of direct or indirect defense business handled during the fiscal year. The form consists of ten items which must be completed by contractors and subcontractors whose renegotiable receipts or accruals exceed $250,000, and by brokers and manufacturers' agents whose receipts and accruals, derived from renegotiable contracts or subcontracts, exceed $25,000, and must be accompanied by a copy of the contractor's or subcontractor's published annual report and a copy of the audit report by independent public accountants.

Contractors and subcontractors whose renegotiable receipts and accruals for the fiscal year do not exceed $250,000, or brokers' and manufacturers' agents who derive $25,000 or less from renegotiable contracts or subcontracts, are not subject to renegotiation; however, they are required to complete some of the items on R. B. Form 1.

Sixty days after the filling of R. B. Form 1, it is necessary to file R. B. Form 1B. This is a statement of income showing sales, cost of sales and expenses as applied to renegotiable and non-renegotiable business, which is a segregation down through the expenses to develop the renegotiable profit. It is only to be filed by contractors and subcontractors whose renegotiable receipts or accruals exceed the $250,000 minimum, and by brokers and manufacturers' agents whose receipts or accruals, derived from renegotiable business exceed $25,000. Together with the filing of this report a statement must be made as to the method or methods used in the allocation of costs and expenses between renegotiable and non-renegotiable business.

A brief summary of the work of the accountant necessary to resolve accounting problems involved under the Renegotiation Act of 1951 is as follows:

1. The Accountant must read and familiarize himself with the Renegotiation Act of 1951, and the Regulations, and Staff Bulletins relating thereto.
2. The Accountant must examine and be familiar with the various types of government contracts and the special provisions relating to price revisions in the individual contracts.
3. The Accountant must review and study the costing methods used by the contractor, and eliminate from Factory Burden accounts items of expense which are not allowable for renegotiable business or allocable.
4. The Accountant must carefully analyze all expense accounts.
5. The Accountant must, in multiple plant operations, be familiar with all work done by Engineering, Production, Research and other Divisions, and attempt to point out, with accounting analyses, savings to the Government as a result of increases and improvement in the efficiency of the contractor.
6. The Accountant should review and analyze monthly the basic information required to file the necessary forms with the Renegotiation Board at the end of the year.