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UNITED STATES GENERAL ACCOUNTING OFFICE

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STATEMENT OF
ELMER B. STAATS
COMPTROLLER GENERAL OF THE UNITED STATES
BEFORE THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ON
THE [DEFENSE DEPARTMENT'S NEW PROFIT POLICY]



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Text

Mr. Chairman and members of the Subcommittee:

We appreciate the opportunity to appear today to present our views on the Department of Defense's (DOD) new policy for determining profit objectives for most negotiated contracts.

We know your interest in defense industry profits goes back many years. In 1969 when you were Chairman of the Joint Economic Committee, we testified before you and pointed out that there was a need to revise the weighted guidelines used by the Defense Department for establishing profit objectives for negotiated contracts. We were concerned with the inadequacy of the factor relating to recognition of contractors' investments in facilities and operating capital used in the performance of Government contracts. The need for a study of Defense industry profits was also developed during those hearings; and, as a result of your amendment to the Armed Forces Appropriation Authorization Act of 1970, we were directed to make such a study. In our report on Defense Industry Profits in March 1971, we stated:

"We believe that it is essential to change the present system in order to motivate contractors to reduce costs under Government noncompetitive negotiated contracts. Where the acquisition of more efficient facilities by contractors will result in savings to the Government in the form of lower contract costs, contractors should be encouraged to make such investments. Proper consideration of contractor provided capital can cause a greater reliance on private capital to support defense production. To accomplish this, it is essential that capital investment be substituted for estimated costs as a basis for negotiating profit rates."

On October 1, 1976, the Department revised its profit policy in an attempt to deal with this problem and give

recognition to contractor capital investment in determining contract prenegotiation profit objectives. The weight given to investment, however, was relatively small, a maximum of 10 percent. Ninety percent of the profit was still based on estimated costs. Unfortunately, the effort has not been successful in promoting capital investments that would result in future cost reductions.

In its new procedures, the Department also provided for treating the imputed interest cost of contractors' facility investments as a cost of performance under most negotiated contracts in accordance with Cost Accounting Standard 414. We have some reservations, however, about the way this change was applied. I will now address these two points in some detail.

In the first year after the new profit policies went into effect, DOD negotiated an undetermined number of noncompetitive contract pricing actions totaling about \$22 billion. To determine the effect the new policy was having, we selected and analyzed 142 negotiated contracts of the Army, Navy, and Air Force. Seventy-one of these contracts were negotiated before and 71 were negotiated after the effective date of the new profit policy, with each pair of contracts involving the acquisition of the same or similar items. Total negotiated contract amounts were about \$1.7 billion under the former policy and about \$1.8 billion under the new policy. We also sent questionnaires to 66 contractors to identify the impact of DOD's profit policy on decisions the companies made relative

to investments in new plant and equipment and received 47 written responses (71 percent). Most of the contractors we sent questionnaires to performed one or more of the contracts that we reviewed.

On March 8, 1979, we issued our report entitled, "Recent Changes in the Defense Department's Profit Policy--Intended Results Not Achieved," PSAD-79-38. As the title indicates, we concluded that higher aggregate profits were negotiated without any demonstrable reduction in costs to the Government. We found little indication that contractors responded positively to DOD's attempts to encourage greater investment in new or upgraded plant and equipment which would lower production costs. Although some added investments were identified, the reasons for making them were unrelated to DOD's profit policy. Replies to the 66 questionnaires we sent to contractors confirmed that the chief motivating factor influencing decisions to make capital investments was the desire to expand production capabilities rather than to reduce production costs.

While we recognize that it may take a longer time period for the new policy to become effective, contractors said that the new profit policy, as presently structured, was not a significant factor in their investment decisions nor would it be in the future. We believe the lack of success in meeting DOD's objective is attributable primarily to the limited emphasis given to facility investments in establishing the Government's prenegotiation profit objectives. When the

new policy was published, DOD recognized that the 10 percent relationship to total profit objective was a modest beginning and that the weight might have to be increased. We believe that the lack of progress confirms that the emphasis given to investments must be substantially increased if the desired results are to be achieved.

Although the new profit policy has not encouraged contractors to increase their investments in cost-reducing facilities, it has resulted in the negotiation of higher profit rates on an overall basis. For the 71 contracts we reviewed that were negotiated after the new policy went into effect, the average negotiated profit rate increased about nine-tenths of 1 percent over an 11.5 percent average for the comparable group of contracts that had been awarded prior to the new profit policy. This represented a 7.8 percent increase. The higher profit rates negotiated on these contracts increased the Government's price by about \$14.5 million.

If the increase we found in our sample were projected to all noncompetitive contracts negotiated in fiscal year 1977, the additional profit to contractors would approximate \$200 million. DOD, in its monitoring of a larger sample of 811 contract negotiations in fiscal year 1977, found an aggregate profit increase of a little more than half the increase we found, which would result in about \$100 million if its sample were more representative of the entire universe. In any event, both samples reveal significant profit increases.

We also identified several other problem areas which we believe contributed to the profit increases. Imputed interest on contractors' facilities capital, allowed as a cost, was not fully offset from profit. Formerly, this cost was implicitly included as a part of the profit objective because interest was not an allowable cost under Government contracts. To conform to Cost Accounting Standard 414 and to prevent double counting of facilities capital in computing contract cost and profit, DOD constructed a reduction factor believed to represent the average imputed interest allowed as a cost. The Department believed that the use of an average offset would be preferable to having a dollar for dollar offset on each contract. While we do not take issue with the averaging method used, we believe that the DOD offset factor probably needs to be increased.

We found that a contributing factor to the profit increase was a lack of definitive criteria for contracting officers' use in determining the profit dollars to be allowed for facilities investment and other profit determinants. In many cases, we found that contracting officers allowed more than the minimum weight for different factors without adequate explanation.

Profits on some contracts were also higher than DOD objectives because contractors in relatively strong negotiating positions would not accept the lower profit objectives developed in accordance with DOD's new profit policy.

DOD is aware of problems associated with implementing its profit policy. By July 1978 the Office of the Secretary of Defense's (OSD) monitoring efforts had identified needed

improvements to correct numerous errors in the weighted guidelines computations, to avoid continued use of the former policy, and to document and review negotiated profits which substantially exceed the prenegotiation objectives. Preliminary results also indicated unexpected profit increases.

OSD has taken or proposed limited action to correct some of the problems it identified. A July 1978 memorandum sent to the Army, Navy, and Air Force identified the problems noted and suggested corrective action be achieved by improving some contract review procedures. In September 1978, OSD circulated its proposal for two policy changes, based on an analysis of the first year's experience, to industry and Government agencies for comment. The first change was not relevant to the problems we identified, since it involves an exception to the weighted guidelines method. However, the second proposed change alters profit weights for the risk element. OSD believes that this change will result in lowering profit objectives to a level that approximates those that would have been established under the former profit policy. OSD stated that the average profit increase for cost-plus-fixed-fee contracts was not attributable to the level of facilities investment. Thus, it is considering reducing the maximum allowable cost risk for these contracts. OSD also proposed reductions in maximum profit allowances for the risk element for cost-plus-incentive-fee and fixed-price-incentive contracts with cost incentives only.

The OSD proposed action may not be adequate to correct all of the problems and to offset many of the profit increases we identified. We, therefore, recommended in our report that the Secretary of Defense:

- Substantially increase the emphasis on facilities capital investment and further reduce the portion of the prenegotiation profit objectives that is based on estimated costs.
- Perform additional analyses to determine more precisely the impact of the new profit policy on overall negotiated profit rates and the need to increase the offset factor to more closely approximate the amount of imputed interest on facilities capital.
- Establish more definitive criteria and procedures to enable contracting officers to determine the appropriate profit allowances for contractors' facilities capital investments, cost risk, and productivity improvements subject to special profit rewards.
- Develop safeguards to prevent negotiating profits significantly greater than Government objectives without a complete explanation and review of the rationale and consideration of possible alternatives, such as the development of another source of supply.
- Even though a portion of the profit rate might still be based on cost, for each contract compute the rate of return on facilities investment considering the total negotiated profit amount. This should be of assistance in identifying any potentially excessive profits.
- Monitor more extensively the implementation of the new profit policy and revisions made thereto to provide greater assurance that the desired results are achieved.

While we did not obtain written comments on our report, through discussions with DOD representatives, we were pleased to learn that they basically agreed with all of our recommendations. We look forward to a number of actions by Defense

personnel to improve the implementation of the new profit policy and help attain the intended objectives. Also, in regard to our recommendation to substantially increase the portion of the profit factor that is based on return on capital, the Logistics Management Institute recently completed a study for the Office of Federal Procurement Policy and recommended that this portion of the factor be increased from 10 percent to about 70 percent of the total profit objective.

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In conclusion, Mr. Chairman, we believe the Defense Department is going in the right direction, but a great deal remains to be done. This completes our statement, and we will be glad to respond to any questions.