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STATEMENT OF

CHARLES A. BOWSHER, COMPTROLLER GENERAL

BEFORE THE

SUBCOMMITTEE ON GENERAL OVERSIGHT AND RENEGOTIATION

OF THE

COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS

UNITED STATES HOUSE OF REPRESENTATIVES

ON

PROFITS ON DEFENSE CONTRACTS

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before the Subcommittee to discuss the issue of profits on defense contracts and methods by which the government can assure itself that profits are not excessive.

I have for some time expressed some concern about the rapid growth in defense spending. According to a 1983 DOD report, the net value of DOD prime contracts has risen from $32.5 billion in 1974 to $120 billion in 1983. At a time when the defense procurement outlays have risen so rapidly, I believe that all concerned, industry as well as government, need to pay particular attention to all aspects of the procurement process to be sure that abuses do not occur.

The appropriate level of profits on government contracts has long been a subject of debate. In the debates on profit, there is a clear understanding that adequate profit is a prerequisite to contractors investing shareholder resources in performing government contracts. And it is generally agreed that profits earned by contractors under defense contracts have a significant impact on our defense industrial base.

In the mid-1970s, DOD was concerned with what was believed to be unacceptably low levels of investment by defense contractors. In May 1975, the Deputy Secretary of Defense directed a major study of capital investment, profit, and productivity. This study, known as Profit '76, set out to develop policy revisions that would encourage contractors to invest in capital assets which would reduce production costs. The study resulted in adjustments to the weighted guidelines used by contracting officers to establish government negotiating positions. These adjustments reduced the percent of profit based on cost and created a profit factor on the capital facilities devoted to the contract. By making these changes, DOD believed it was creating appropriate incentives for contractors to invest in productivity enhancing capital facilities.

At about the same time, the Cost Accounting Standards Board issued Cost Accounting Standard 414 which calls for measurement and allocation of the imputed cost of facilities capital employed. These costs which had previously been covered as a part of profit were made specifically allowable through another revision to DOD's profit policy.

Since these fundamental changes to DOD's profit policy have been made, various reports by GAO and others have raised questions regarding the results of DOD's action. We are currently reviewing Cost Accounting Standard 414 and its effects on DOD profit policy. However, we do not think that this limited review will be comprehensive enough to assess whether current Defense profit policy is equitable.

Because of the significant increase in defense spending and concern that this buildup not result in excessive profits, I along with others recommended that DOD conduct a comprehensive review of its profit policy. A study was announced by the Deputy Secretary of Defense in December, 1983. While DOD's intent is to conduct a study along the lines of Profit '76, the effort will be somewhat broader in scope in that it will examine

DOD financing and pricing policies as well as their appropriate integration with the profit policy.

Specific areas of interest in that study will include analysis of:

(1) The impact of cost allowability on pricing and profits.

(2) The relationship of contract pricing to capital investment.

(3) The use of pricing to motivate contractors to find cost efficiencies in areas other than capital investment.

(4) The relationship between payment policy and contract pricing.

It is important that the DOD study consider all factors that will ensure a fair return to contractors and encourage investment in government programs, while at the same time assuring taxpayers that their interests are being served properly. The framework of the proposed study appears to be broad enough to include the appropriate factors. However, we believe that, as a priority step in this study, DOD should obtain data on the impact that its current profit policy has had on defense contract profits. I have offered our advice and assistance to DOD in identifying the factors and criteria which should be considered in making the study. Our staff has had several conversations with the DOD study group and we will continue to exchange views and information on this very important issue. I cannot emphasize strongly enough that, to be useful, the study has to be done properly.

I believe that the current DOD profit study, if done correctly, could be the foundation for a long term approach to deal with the issue of excessive profits. Once the study is completed and appropriate revisions to DOD profit policy are made, periodic studies should be made to evaluate overall defense contract profits.

The fundamental areas to be addressed in these studies would include (1) the actual profits experienced under defense contracts; (2) how the profitability of defense contracts compares with other industries and the private sector as a whole; and (3) whether variations between the profitability of defense contracts and other industries are justified given the circumstances. Reports resulting from the studies should provide both the DOD and the Congress a good basis to evaluate defense profits and decide whether any adjustments are required to DOD's profit policy.

My thinking is that such studies should be made every 4 to 5 years, but a shorter interval may be feasible. The key is that the studies be periodic and scheduled so that everyone knows that they are going to be done.

If the overall profit policy that develops out of the current DOD review is structured correctly, and if periodic reviews are made to validate implementation and results of the policy, DOD will be able to monitor profits on a continuing and timely basis, and make whatever policy adjustments are necessary to assure that profits remain at reasonable levels.

I recognize, despite good controls and well defined profit policies, that there will doubtlessly be instances where contractors will make unusually high profits. I well understand your desire, Mr. Chairman, that a mechanism be devised to provide for recoupment of excessive profits from contractors who earn them at the expense of our defense efforts. Nevertheless, as you are well aware, our past approach to this problem has not been particularly successful. I think it is a subject that requires careful consideration and I hope to be able to put forward some specific suggestions after we have had an opportunity at GAO to study the matter thoroughly.

This concludes my prepared statement. I will be pleased to answer any questions the Committee may have.

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