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DOD's Profit Policy and GAO's Proposal For A Program to Study the Profitability of Government Contractors

Statement of
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Before the
Legislation and National Security Subcommittee
of the
Committee on Government Operations
United States House of Representatives

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss DOD's profit policy and our proposal for a program to study the profitability of government contracting. I will give a brief overview on how DOD's profit policy has evolved, discuss some of our observations on the latest policy change, and describe how we believe the effectiveness of government profit policies should be evaluated.

OVERVIEW

Profit policies set the direction and provide the wherewithal in our economic system to create a healthy and productive industry to support governmental goals. In this regard the defense industrial base is particularly important. More than $160 billion worth of prime contracts were awarded in fiscal year 1985 to ensure our Nation's defense. In addition to providing assurances to the public that prices paid by the government are reasonable, the profit policies should provide fair and reasonable returns to the contractors for the risks they are taking and the efforts they are directing toward government business. Our proposal for a program to study contractor profitability is aimed at making government agencies accountable to the public and the Congress for the policies they formulate. I do not envision the proposal as just another set of procurement regulations placed on our industry in reaction to problems discovered one at a time after-the-fact. I would be opposed to such an approach.

President Harry Truman observed that to prevent waste we need a before the fact rather than our usual after the fact approach. In 1941 Senator Truman established a Senate committee to investigate war production and procurement for World War II. Truman explained in his memoirs:

> "The idea of the committee was to conduct the investigation of the defense effort simultaneously with the war program in order that mistakes could be remedied before irretrievable damage was done. We were interested in doing a surgeon's job to cure, not in performing an autopsy to find out why the patient died."

Likewise, diagnosis through a profit reporting program should alert us to problems with the federal profit policy before they become unmanageable. The procurement agencies would be able to revise profit policy so as to ensure fair treatment for both the contractor and the taxpayer. Having assured this equity through proper disclosure the long term result should be less regulation of the procurement process.

Where practical, the preferred situation for government contracting would be full and open competition for most goods or services the government purchases; however, experience shows us, that this is not usually the case. Most of the dollar volume of government contracts is awarded without the benefit of price competition. To compensate for the lack of competition, federal regulations require that defense and civil agencies making noncompetitive contract awards over $100,000, where such awards total to $50 million or more a year, should develop and use a structured approach for determining negotiation profit objectives. DOD's structured approach is referred to as the Weighted Guidelines Method.

Weighted guidelines emphasize certain aspects of a contractor's performance. DOD's profit policy, among other things, seeks to encourage investment in facilities and equipment to increase efficiency and ensure a strong defense industrial base. Profit policies are also designed to encourage companies to enter and remain active in the government market and to increase or decrease profits for contracts in line with the risks the contractor is assuming.

DOD has investigated the effects of its profit policies twice since 1975, using different methodologies with each study to determine the profitability of defense contractors. Both times DOD has changed its profit policy based on the study findings. However, due to time lags inherent in the process DOD did not learn that policy changes made in 1976 and 1980 in Defense Procurement Circular 76-3 and Defense Acquisition Circular 76-23, respectively, were providing more profit than it had intended, until it completed its most recent profit study -- the Defense Financial and Investment Review (DFAIR) -- in August 1985. We believe that the government needs better and more timely assurance that profit policies are producing intended results. We agree with DFAIR's recommendation that access to actual contractor results and more frequent profitability studies are needed. We believe that such studies should be based on consistent and generally accepted methodology to analyze verifiable data provided by contractors performing government contracts.

In June 1986, we testified before this Subcommittee on our analysis of the DFAIR methodology. DFAIR used return on assets as a measure of profitability, and we agree. In calculating return on assets--the ratio of income to assets--DOD increased the asset base by adding government progress payments to contractor inventories. In an additional computation, DOD adjusted income by using a unique methodology to calculate "economic profit." These two actions reduced the apparent return on assets for defense business and led, in our opinion, to an understatement of defense industry profitability. We recommended that DOD initiate new analyses using conventional methods as it used in the 1976 study to compute return on assets and to compare the profitability of defense contracting and durable goods manufacturers. Your Committee report on the same subject contained a similar recommendation. To our knowledge, DOD has not responded positively to these recommendations and the new policy now in effect and under discussion, while correcting some of the problems we had observed in the DFAIR recommendations, is still based on the flawed analysis.

At your October 1986 request, and requirements levied on our office in the Fiscal Year 1987 Conference Report on the Continuing Appropriations, we are reviewing DOD's new profit policy. All the DOD data needed to finalize our evaluation is not yet available; thus we will discuss our observations to date. In general, we see DOD's policy changes as a step in the right direction, but we believe that more changes are needed and we will discuss these additional changes. We will also outline our proposal for a continuous program to study the profitability of government contractors which is designed to systematically, objectively, and consistently determine if the goals of government agencies profit policies are being achieved.

THE NEW PROFIT POLICY GIVES MORE EMPHASIS TO INVESTMENT IN FACILITIES AND EQUIPMENT AND LESS EMPHASIS ON COST

DOD's new profit policy maintains the basic weighted guidelines structure but places less emphasis on cost in determining profit and more emphasis on investment in facilities and equipment as a profit determinant. We agree with this basic thrust.

We agree that profit objectives should be increased for contractors willing to invest their capital in productivity enhancing equipment because of the potential for increased efficiency and lower overall costs. In the previous profit policy, land, buildings, and equipment were all included as profit factors with equal weights. Under DOD's new policy, apparently in an attempt to encourage investment in productivity enhancing equipment, equipment is assigned a higher profit weight range than buildings and land is dropped as a profit factor. Though we do not disagree with this aspect of the policy, we are not aware of any empirical studies that have analyzed the relative contribution of equipment, buildings, and land in increasing productivity. Data is needed that would provide a means for evaluating the effectiveness of this approach over a period of time.

We also agree that prenegotiation profit objectives should be lower for contracts in which price is based primarily on the contractor's costs. Contractors have little incentive to reduce cost when profits are determined as a percentage of costs, and thereby in turn ultimately reduce profits. The new policy reduces the amount of profit objective applied to contract costs; however, cost continues to play a significant part in the calculations. Material, labor, overhead, and general administrative costs are eliminated as specific factors to which profit is assigned by category. Having eliminated those cost elements as profit factors, it might be said that this approach entirely eliminates contract cost as a profit determinant. However, the profit objective to be awarded for contract type risk and performance risk is calculated as a percentage of total estimated contract cost.

PROFIT POLICY GIVES SPECIAL CONSIDERATION FOR CONTRACTORS WITH A RELATIVELY LOW INVESTMENT IN FACILITIES AND EQUIPMENT

Although DOD's new profit policy provides more emphasis for investment in facilities and equipment and less for cost for determining profit, it provides for using different profit objectives in those cases where the nature of the contractor's business makes investments in facilities and equipment not significant. We agree that a policy that primarily assigns profit based on investment in facilities and equipment must provide a means for recognizing exceptional cases where other considerations should be given some weight. The new profit policy contains such provisions. As with the previous profit policy, the new policy provides ways to determine profit in these circumstances, such as architect-engineering contracts, management contracts, construction contracts, cost-plus-award-fee contracts, and so forth. Although we have not evaluated the reasonableness of weights assigned to these special categories, we support the flexibility provided for these contracts.

DOD'S GOAL TO REDUCE CONTRACTOR PROFIT BY 1 PERCENT MAY NOT BE SUFFICIENT TO ACHIEVE COMPARABILITY OF PROFITS

A principal objective of the new policy is to reduce overall DOD profit objectives by 1 percent. This objective was derived from DFAIR which concluded that such a reduction would bring defense contractors' profitability more into line with comparable durable goods manufacturers.

We believe it is important to point out that the goal of the policy is to reduce negotiated profit objectives. This in turn should result in a similar reduction in profits actually negotiated. As stated earlier, DOD's profit policy provides its contracting officers with a structured approach to calculate the negotiated profit objective through the weighted guidelines method. The profit objectives are used as a basis for negotiating profits on a government contract with a contractor, which can be referred to as going-in profits. As discussed later, there is no systematic, recurring process for obtaining and analyzing actual profits earned to determine if the goals have been achieved.

Our preliminary analysis of the available data indicates that the new profit policy may come close to achieving DOD's goal to reduce profit objectives by 1 percent. This goal was established based on analysis of 1981-83 data. DOD concluded that adjustments in profit policy made in 1980 resulted in an unintended excess profit of about 1 percent and that the profit objectives should therefore be reduced from the 1981-83 average of 12.3 to 11.3 percent. DOD used more current 1985 average profit objectives to make adjustments for their interim profit policy. However, even in face of an increase from 12.3 to 13.5 percent the goal of a 1-percent reduction was retained. Our analyses shows that the 1985 average profit objectives for the Air Force were about 14 percent and for the Navy were about 12.6 percent. The overall weighted average for these two services was about 13.5 percent. Therefore, a 1-percent reduction would result in profit objectives of about 12.5 percent--not 11.3 percent. This does not take into consideration the average profit objectives for the Army because this information is not as yet available.

It should be stressed that over and above the question of whether the factors in the proposal will produce a 1 percent reduction, that 1 percent may not be enough to bring defense contractors' return on assets in line with comparable durable goods manufacturers which was a goal implied in DFAIR. DOD should have rationale justifying negotiation of profit levels that produce return on assets for defense contractors that, as we reported in our review of DFAIR, more than doubled the returns earned by comparable durable goods manufacturers for 1981-83. We believe these matters should be addressed before DOD's new profit policy is finalized.

NO PERIODIC STUDY REQUIREMENT EXISTS MAKING DOD ACCOUNTABLE FOR WHETHER PROFIT POLICY IS ACHIEVING ITS OBJECTIVES

Probably the most glaring void in DOD's profit policy is absence of any requirement to systematically assess the effect of its policy on the profitability of defense contractors. We have no reason to believe that DOD will not continue to perform ad hoc profitability studies. However, DOD is not required to perform such studies. The interval between studies has been too long and previous studies have depended on the voluntary cooperation of those in industry willing to cooperate. We do not consider such studies to be adequate assessments of profitability or the effectiveness of profit policy. As an alternative to ad hoc profit studies and other profitability checks after the fact, such as renegotiation, we are proposing legislation to create a systematic profit reporting program that builds on and improves what has been done in the past.

A PROPOSAL FOR A PROGRAM TO STUDY THE PROFITABILITY OF GOVERNMENT CONTRACTORS

In November 1986, we released our exposure draft outlining a proposal for a program to study the profitability of government contractors. We are currently evaluating comments on our proposal and hope to finalize it shortly. We believe a government policy as important and pervasive as one which affects the distribution of profit on negotiated government contracts should be supported with a means of determining how well the policy is working. I think we all agree that policies should be tested periodically to determine how well they are working. Most of our better decisions are made with some understanding of the results produced by similar situations in the past.

SETTING PROCEDURES IN LAW

The procedures we are proposing for the profit reporting program are essential to study the effect of profit policies. Foremost in our thinking is that analytical consistency is needed to determine profitability over time. With consistent use of acceptable methodology, meaningful trends can be established and more representative comparisons can be made. Profit policy has been, and will continue to be, amended based on the outcome of profitability studies; for that reason the bottom line of such studies should not be subject to unconventional methodology changes each time a new profit study is performed raising questions about the objectivity of the analysis. Legislating basic profitability reporting program requirements will provide that:

--Data are collected, attested to, and analyzed consistently.

--Each study includes a consistent and high percentage of the total dollar value of all negotiated contracts. Although our draft bill calls for 60 percent, we are not necessarily committed to any specific percentage as long as representative coverage is obtained.

--Return on assets is the principal factor used to analyze profitability.

It will be the responsibility of the administrator of the program, in coordination with contracting officials throughout the executive branch, to make the profit reporting program work. The profit reporting program is designed to be a meaningful and helpful tool with but one purpose, to determine if profit policy goals and objectives are being achieved.

PROFIT STUDIES

The profit reporting program will be the basis for profit studies that will be reported to the president, members of congress, contracting officials, and the general public. The studies should provide timely, accurate, and verifiable information that is not now available. It is important to note here that any data that is disclosed in these studies will be aggregate data, not individual contractor data. This is no different from the way the data was handled in DFAIR. At least every 3 years the studies will answer several questions, including: (1) How profitable is government contracting? (2) Are profits from government contracting similar to those earned by durable goods manufacturers? (3) Are profit policy goals being achieved? For example, are higher profit objectives resulting in investment in facilities? and (4) Are contractors earning profits for their government work that will perpetuate a strong base for government contract work, especially for defense? If returns for government work are not similar to those earned for commercial work, why, and what should be done to increase or decrease margins?

Confidentiality of company data is a major concern, and it should be. We believe our proposed profit reporting program legislation contains the measures necessary to protect individual company data. The legislation provides access to individual company data only to the company providing the data, its independent certified public accountant, and employees and contractors of the profit reporting program office and our Office. Access by the profit reporting program office and the General Accounting Office is essential to data verification and in turn the credibility of any study. The profit reporting program administrator must ensure that the legislation and the implementing regulations are being properly carried out. The General Accounting Office needs access to test and verify data as part of an audit of the profit study reports.

SUMMARY

In summary, the new DOD profit policy increases the potential profit for contractors that invest in facilities and equipment and reduces the emphasis placed on cost in determining negotiated profit. We agree that the defense profit policy needs to stimulate efficient contract performance by placing increased emphasis on the use of capital investments.

Limited available data indicates that the policy will probably achieve one of its principal objectives of reducing overall negotiated profit levels by 1 percent. However, DOD needs to evaluate whether a 1-percent reduction is enough to achieve comparability with other durable goods manufacturers. We believe serious questions concerning the objectives of the policy and how well these objectives will be achieved must be answered before the policy is finalized.

Our proposed profit reporting program is a dynamic system designed to produce reliable statistics based on timely, accurate, and verifiable data. Aggregated profitability information will be summarized and reported to appropriate government officials. Those statistics and appropriate findings will be of assistance to officials responsible for making profit policy, in assessing the effect of, and where necessary, making changes to profit policy. History leaves little doubt there will always be a demand for accountability for returns earned by government contractors. We believe the profit reporting program provides a diagnostic capability that is more preferable to alternatives such as renegotiation.