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United States General Accounting Office  
Washington, DC 20548

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November 20, 2001

Defense Acquisition Regulations Council  
Department of Defense

Re: Comments on Proposed Changes to Profit Policy (DFARS Case 2000-D018)

On July 24, 2000, the Department of Defense (DOD) published a proposed revision of its guidelines for developing profit objectives used in contract negotiations. After reviewing comments on the proposed rule, DOD published, on September 21, 2001, a revised proposal. This letter provides our comments on the September 21 proposal.

The existing profit policy guidelines consist of three factors: (1) investment in facilities and equipment (called “facilities capital employed”), (2) performance risk, and (3) contract type risk. For each profit factor, the contracting officer determines an appropriate value and applies this value against a specified base to develop the profit objectives for a contract. For example, the normal value for contract type risk on a firm, fixed-priced contract (with progress payments) is 3 percent, while the normal value for facilities (buildings) is 15 percent. The base for facilities capital employed is the investment that the contractor has made in buildings and equipment. For performance risk and contract type risk, the base is the estimated costs of performing the contract, excluding general and administrative expenses.

The proposed revision to profit policy would make the following changes in the profit guidelines:

- A fourth element—cost efficiency—would be added. The cost efficiency factor would allow the contracting officer to add up to 4 percent in profit to reward cost reduction efforts.
- Profit on investment in buildings would be eliminated and the amount of profit derived from investment in equipment reduced.
- The amount of profit based on performance risk would be increased.
- General and administrative expenses would be included in the cost base. This base is used in computing profit for performance risk, contract type risk, and cost efficiency.

The decrease in profit for investment in facilities would be offset by the increased profit derived from performance risk and the inclusion of general and administrative expenses. According to the *Federal Register* notice, these changes are not intended to increase or decrease average profit objectives. The cost efficiency factor represents an additional amount of profit than is available under the existing profit guidelines.

These changes represent a significant restructuring of DOD profit policy. The importance of contractor investment in facilities and equipment would decline significantly and a new profit factor—cost efficiency—would be added. According to DOD, the current profit structure rewards contractors for investment in facilities at a time when the defense industry has excess capacity and under-utilized facilities, acting as a disincentive to the further rationalization of the defense industry.

In implementing the cost efficiency factor, we believe that DOD should consider developing metrics to aid in assessing cost efficiency gains. For example, examining loaded labor hours (i.e., cost per labor hour, including all direct and indirect costs) along with productivity measures could provide a basis for assessing contractor cost efficiencies over time. Such metrics could also be used to compare relative costs from one contractor to another for similar types of work. Measures of the cost efficiencies of contractors would help the Department determine whether the purpose of the proposed regulatory change is being achieved.

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We appreciate your consideration of our comments. If you have questions or would like to discuss our comments further, please call me at (202) 512-4841.

Sincerely yours,

A handwritten signature in black ink that reads "William T. Woods". The signature is written in a cursive, flowing style.

William T. Woods  
Acting Director  
Acquisition and Sourcing Management

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