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STATEMENT OF
ELMER B. STAATS, COMPTROLLER GENERAL OF THE UNITED STATES
BEFORE THE
SUBCOMMITTEE ON LEGISLATION AND MILITARY OPERATIONS
HOUSE GOVERNMENT OPERATIONS COMMITTEE

Mr. Chairman and Members of the Subcommittee:

We appear this morning in response to your request to discuss our report of March 17, 1971, entitled "Defense Industry Profit Study." It is my understanding that your request originated at the suggestion of several members of the House of Representatives to obtain our views with respect to critical comments made by the press, in particular, the allegation that GAO had been subjected to pressures from defense contractors and the defense agencies, and had altered the facts and conclusions in its report as a result of such pressures.

While I welcome this hearing, I should like to express my regret that a few, but widely circulated, premature, inaccurate, and misleading press stories have made this hearing necessary. In my opinion, such reports are a disservice to the Office which I head and to the Congress of which the General Accounting Office is a part. I am pleased that most press accounts, issued following the release of the GAO report, have been generally accurate and objective.

In summary, I would like to emphasize these points:

1. It has been the policy of the GAO for many years to refer draft reports of this Office to the agencies, organizations, and others specifically affected to obtain their views. This is done to enable us to

report to the Congress and the public any disagreements as to the factual completeness of the report as well as differences with respect to our findings and conclusions.

2. Not a single figure has been altered at any stage in the drafting of the report on defense industry profit and none has been added or deleted as a result of agency or contractor views.

3. Our conclusion in the report has been unchanged since the original draft was sent to agencies and industry groups for review. The final report is critical of the way in which profit objectives have been established on defense contracts in that profit objectives have been primarily on the basis of cost of sales without adequate consideration of return on capital investment. Some contractors agree with our position but many do not. It was primarily to obtain their views on this subject that we asked the agencies and the contractors, through their associations, to react to our report. We believe that the Congress and the public should know that some disagree with our conclusion.

4. Contrary to certain press reports, there was no "pressure" of any type. Neither I nor any member of our staff received any follow-up communications, oral or written, from these associations beyond the formal responses to our request for their views.

At this point, I would like to discuss our policy of submitting draft reports to agencies and other affected parties for comments prior to issuance as an official report of the Comptroller General to the Congress. In discussing this point, we shall, as you requested, relate

in some detail the evolution from the initial draft through to the final draft of the report dated March 17, 1971, on the Defense Industry Profit Study.

GENERAL POLICY TO SEEK PRE-RELEASE COMMENTS FROM AFFECTED PARTIES

The practice of obtaining comments from affected parties on proposed audit reports is one of long standing within the GAO and it goes even further back in the public accounting profession, just how far I do not know. It is interesting to note that as early as 1935 the Congress, in an amendment to the Tennessee Valley Authority Act, specifically prohibited issuance of reports on GAO audits required in the Act until TVA "shall have had reasonable opportunity to examine the exceptions and criticisms ***, to point out errors therein, explain or answer the same, and to file a statement which shall be submitted by the Comptroller General with his report." The practice became written policy of the Office when it was incorporated into internal instructions to the Accounting and Auditing staff in 1954. This policy became applicable to contract audit reports in 1955. Prior to that time it was fairly common practice to obtain oral and sometimes written comments from agency officials and contractors on specific matters as the individual audit manager may have felt it was desirable.

Although I can claim no responsibility for instituting such a policy, I examined this policy carefully when I became Comptroller General in 1966. I endorsed the policy and have retained it.

A review of the auditors' findings and conclusions by the person or organization on whose records and operations we are reporting is desirable for a number of reasons. Since our reports deal with highly important

matters, frequently of national significance, it is essential that all the relevant facts be ascertained and that they be properly evaluated. In our opinion, it is premature to report to the Congress our findings, conclusions, and recommendations on the basis of information gathered at various agency or contractor operating levels without considering any additional pertinent information which may only be secured from top agency or contractor officials.

The practice of obtaining advance comments on drafts of our reports before issuance as final reports and giving objective consideration to those comments provides additional assurance that our reports are fair, complete and objective.

Another very important consideration, it seems to me, is the fact that obtaining comments and reactions in advance enables us to present to the Congress in one document the whole package--the facts as we found them, our conclusions from those facts, our recommendations for corrective action and the head of the agency's position on the matter. If a disagreement exists between the Comptroller General and the agency head, the report reflects it, and the Committee or Member is then in position to evaluate the issues from a study of the document in hand.

From time to time we will have exceptional situations in which we find it appropriate to proceed without awaiting formal agency comment when formal comments are unreasonably delayed. However, the substance of a proposed report would in all cases be discussed with top agency officials. In the unusual cases, when we proceed without formal comment, we attempt to give the agency advance notice and indicate in the report why comments have not be received.

With that background in mind, it should not seem unusual or suspect in any way for our proposed findings and conclusions in the Defense Industry Profit Study to have been reviewed by the defense contracting agencies and the associations of contractors whose records provided the basis for those findings and conclusions. In fact, it would seem especially important to do so inasmuch as the study was of such importance that it was directed by an Act of Congress. Therefore, the highest degree of objectivity, in my view, was absolutely essential.

Let me now discuss that study and report specifically. First, the study and its results:

THE DEFENSE INDUSTRY PROFIT STUDY

During the hearings in November 1968 and in January 1969 the Subcommittee on Economy in Government of the Joint Economic Committee developed in considerable detail the need for a comprehensive study of profits realized by defense contractors. Subsequently, the Armed Forces Appropriation Authorization Act for fiscal year 1970, Public Law 91-121, approved November 19, 1969, directed GAO to study profits earned on negotiated contracts and subcontracts entered into by the Department of Defense, National Aeronautics and Space Administration, and the Coast Guard. Contracts of the Atomic Energy Commission awarded to meet requirements of the Department of Defense were also included.

In responding to the mandate of the Congress in that Act, we requested annual overall profit data from 154 contractors through the use of questionnaires.

In our questionnaire we requested information for the years 1966 through 1969 on sales, profits, total capital investment, and contractor equity investment for defense business and comparable commercial sales. The 154 contractors included 81 large DOD contractors, 63 smaller defense contractors, and 10 contractors who received a major portion of their defense business in the form of subcontract awards. We worked closely with the contractors in explaining the questionnaire and in assisting any contractor needing help. As a result, we obtained data from all of the contractors except 2 that had gone out of business. The contractors that furnished data accounted for (1) about 60 percent of recent DOD prime contract awards of $10,000 or more, (2) about 80 percent of similar NASA contract awards, and (3) a significant part of AEC and Coast Guard contract awards.

Upon receiving information through the use of questionnaires we devoted considerable effort to testing and evaluating the data. We selected 40 of the 152 completed questionnaires for site verification, and carefully reviewed the remaining 112 questionnaires. As a result of this review we made visits to additional contractors as we deemed necessary for checking any apparently questionable data. We did not, of course, completely verify all the data because it was not practicable to do so. We did the work we considered reasonable in the circumstances. In this connection we made use of the contractors' financial statements which had been audited by their certified public accountants.

As a result of our 40 site reviews and careful checking of the remaining 112 questionnaires the profit data was revised to some extent. As an

indication of the extent of change, the return on total capital investment (TCI) changed as follows:

40 Questionnaires reviewed at the sites

Return on TCI for DOD work increased 1.2 percent from 9.7 to 10.9 percent, a 12.4 percent increase. Return on TCI for commercial work decreased 0.4 percent from 13.6 to 13.2 percent, a decrease of 2.9 percent.

112 Questionnaires reviewed largely in Washington

Return on TCI for DOD work increased 0.5 percent from 10.3 to 10.8 percent, an increase of 4.9 percent.

Return on TCI for commercial work decreased 0.1 percent from 13.4 to 13.3 percent, a decrease of 0.7 percent.

Review of Individual Defense Contracts

In reviewing hearings of the Joint Economic Committee which led to this study, we noted some concern that contractor capital requirements were not considered in negotiating defense contract prices. Although not called for specifically in the legislation, we decided to attempt to determine whether it was practical to develop investment data by contract and to see if there was a wide range in profits as a percent of invested capital.

By our examination we found that it was feasible to develop invested capital data by contract and we believe that it is feasible to forecast similar data for use in negotiating defense contracts. Further, as stated in our report, we believe that the wide range in rates of return on capital used for defense contracts is due in some degree to the fact that, under present policies, Government procurement personnel give little consideration to contractors' capital requirements in developing profit rate objectives for negotiated contracts. Instead, profit objectives are developed as a percentage of the

anticipated cost of material, labor and overhead. As a result, inequities can and do arise among contractors providing differing proportions of the capital required for contract performance. Also, by relating profits to costs, contractors have little incentive to make investments in equipment which would increase efficiency and reduce costs. Such investments tend to lower rather than increase profits in the long run. Of course, other factors, such as whether or not the program will be continued, could be an overriding consideration in bringing about contractor investments to reduce costs.

We believe that of the various ratios available for evaluating profits earned by contractors, the percentage of profit earned on total capital investment--the total investment in all assets used in the business, exclusive of any Government-owned items or leased items--is the most meaningful for evaluating defense profits. The rate of return on total capital investment relates earnings to total capital employed, regardless of whether it was provided by the owners of a business, its creditors, or its suppliers. Since interest is not an allowable cost under Government contracts and must be paid out of profits, it seems only equitable to consider total capital in determining profits.

With respect to the individual contract data, as in the case of the questionnaire data, the information was taken from the contractors' books and records. We did the verification work we thought necessary in the circumstances and we believe that the data is reasonably accurate. None of the data has been subject to detailed audit in the sense of tracing cost from individual source documents, such as invoices and payroll records, to the contractors' records. In each case we presented our data to the contractors involved for review and comment. We carefully considered the comments received and there were relatively few cases involving disagreements.

In selecting contracts for review we found that it would be impracticable to attempt to obtain a sample that would support a projection of the results to all defense contracts. Some examples of the variables that make such a projection impracticable are as follows:

1. Identification of the universe of completed contracts was not available. This would have had to be developed by querying all of the companies involved.
2. There were several types of negotiated contracts represented, including cost plus fixed fee, cost plus incentive fee, fixed price incentive, and firm fixed price.
3. Numerous product classes were involved, including aircraft, missile-space, ships, tank-automotive, weapons, ammunition, electronics, communications, and many others.
4. Four agencies had to be covered - DOD, NASA, AEC and Coast Guard.

Considering the above variables plus (1) the need for information as to the status of production involved, and (2) the fact that there are about 180,000 annual DOD contract actions of $10,000 or more, the sample size required for making a reasonably accurate projection as to the entire universe was prohibitive. Nevertheless, we thought that it was desirable to review some contracts and since a representative sample was prohibitive, we selected some contracts for review based on availability of manpower in our regions.

In summary of our discussion on this point, it would be misleading to generalize on overall defense contracts from the individual contract

data. The questionnaire data covered $125 billion in defense sales while our individual contract data accounted for only $4.3 billion over approximately the same period. The questionnaire data, therefore, provides a better and more reliable basis for reflecting defense industry profits.

Preparation of the Final Report

I would now like to discuss briefly some of the changes made in our report on Defense profits after it was issued in draft form for comment by those concerned. In our consideration here of these changes, I believe we should primarily concern outselves with whether the changes improved the report in terms of balance, objectivity, fairness, and completeness.

Much has been said about the placement in the report of the section dealing with our review of individual contracts. The facts are these. It was decided at the very outset of our work that the only practical way of meeting the requirements of the law was by the use of the questionnaire in developing data on the overall profitability of defense work. Our work on individual contracts was completed and the results were written up in draft form first. This section appeared in our draft first since it was the most complete at that time, not because we considered it the most significant portion of our work.

When the report draft was released for comments, our analysis and verification work on the questionnaire data had not yet been completed and the results were tentative only. In the final report, we believed it only logical that the portion of our report which we concluded to

be responsive to the statutory directive be discussed first. We then bring in the individual contract data in developing our point that contractors' invested capital should be given greater emphasis in negotiating defense contracts. Further, we do not believe there is a problem of subordination of points in this report involving only 55 pages and containing a summary of four and one-half pages.

In developing the final report we decided to have a single conclusions section. We also deleted from the conclusions section information concerning benefits to contractos attributable to defense work since benefits also flow to defense work from commercial work of defense contractors. We had not developed specifically in our review the extent of such benefits and whether there was a preponderance of benefits to commercial or defense work. Further, we had not been asked to evaluate defense profits in terms of whether they were too high or too low. Our purpose was simply to find out what the profits were.

There are numerous changes in wording between the draft and final report. This occurs in almost every report we issue. Our review processes require consideration of our reports by our Office of Policy and Special Studies and by our Office of General Counsel, as well as by report reviewers in our operating Divisions responsible for the assignment. Sometimes changes are made at meetings of two or more of these review groups.

I believe it is reasonable to think that many of editorial changes involved in the report would have taken place even if we hadn't received agency or contractor comments. For example, one change we made in wording was made regarding consideration of return on investment in developing

profit objectives in price negotiations. In our final report we added that risk complexity and other factors should also continue to receive consideration. Some may consider this a softening of our position; we do not agree. It is simply reflective of our conclusion that the return on investment cannot be the only criterion. I would like to emphasize that there was no softening of the report as a result of obtaining comments on the rough draft.

One columnist reported that we had weakened the report by eliminating a phrase in our recommendation that profit guidelines "stress" return on capital in determining profits. Actually in the recommendation in the final report it is stated that the profit guidelines should "emphasize" consideration of the total amount of contractor capital required. We think the final wording is just as strong if not stronger than the original wording.

RELEASE OF SPECIAL GAO REPORTS

Now, Mr. Chairman, you have asked that we discuss the point concerning our policy with regard to the release by GAO--or non-release--of reports made to Committees or individual Members at their request.

It has been the policy in the General Accounting Office as far back as anyone in our Office knows to accord to the requesting Member or Committee Chairman complete control over the report he receives. Without his approval or unless he himself makes public the contents, we do not consider it proper to release copies to any one else. I think courtesy demands this kind of treatment.

That is not to say, however, that a Member could effectively "lock up" information on any certain matter by simply requesting GAO to review it and report to him. We would most certainly honor the same request from other members and we would, if necessary, make a similar report to other requesting members at the same time, regardless of the relative timing of the requests. Normally, an accomodation can be arranged so that one report, with copies available to other interested members, will suffice, eliminating the time and expense of separately addressed reports. However, if necessary, making similar reports simultaneously to more than one member is a small price to pay for harmony. In practice, problems in this respect arise only infrequently.

One may question--the more basic policy of honoring requests at all from individual Members of Congress for reviews, audits, or investigations of specific subjects. The law does not expressly require it but, to the extent that available resources permit, the Office has always, so far as I can learn, followed the policy of complying with all reasonable requests for such assistance by Members. Many times, in so doing, we find situations which need correcting and some which indicate a more general problem needing attention. Instances of bad management or poor controls are sometimes brought to light which we might not have discovered but for the request.

We are told frequently by Members that they consider the General Accounting Office as the only independent and objective source available

to them for information regarding program operations in the Executive Branch.

Of course, we do not as a matter of policy automatically accede to every request we receive. The customary practice is to discuss with the requesting Member or Committee at the very outset just what we may be able to do in a given situation and, if necessary, insist on confining the job to manageable and reasonable boundaries. Also, we would not undertake reviews outside our normal jurisdication such as one designed to reflect upon a potential political opponent, for example. We would not undertake purely criminal type investigations since these should be handled by appropriate law enforcement agencies.

When a review or investigation requested specially by an individual results in significant findings which we know should be of broad interest, we take the initiative in attempting to arrange for wider distribution of the information. We may arrange with the requester for us to address the report to Congress or, failing that, we would urge the Member to either make the wider distribution himself or permit us to do it. I know of no significant case in which we have been unable to obtain wider distribution when we considered it important to do so.

Mr. Chairman, with regard to special requests and special reports, I think it is pertinent to note the comments of the House Committee on Rules in its report on H.R. 17654, which was enacted as the Legislative Reorganization Act of 1970. In discussing the provisions of the bill

encouraging wider distribution of our reports to Members and Committees, the report states at page 13:

> "The Comptroller General must exercise some discretion in deciding what constitutes a 'report.' There are times when the Comptroller General and a Member or committee of Congress have a confidential relationship such as might exist between an attorney or an accountant and his client. Committee frequently ask the Comptroller General for information to be used during committee hearings in the examination of witnesses. It would clearly be unwise to require the Comptroller General to make the contents of these reports available on request in advance of their intended use."

Mr. Chairman, this completes my prepared statement. My associates and I will be happy to respond to any questions you may have.