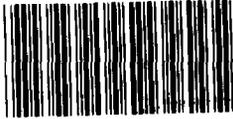


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United States General Accounting Office  
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Statement of

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PROCUREMENT AND SYSTEMS ACQUISITION DIVISION

BEFORE THE

SUBCOMMITTEE ON PROCUREMENT POLICY AND REPROGRAMMING  
SENATE COMMITTEE ON ARMED SERVICES

SEN 00329

ON

[ PROFIT LIMITATION STATUTES ]

Mr. Chairman and Members of the Committee:

At your request, we are here today to present our views with respect to the Vinson-Trammell Act and the need for profit limitation legislation. This Act, as you know, has been dormant for many years because of the Renegotiation Act which was passed in 1951. With the abolition of the Renegotiation Board last year, it again became operative. The Internal Revenue Service, which has enforcement responsibility, has been delaying implementation because it recognized the inherent limitations of Vinson-Trammell and the difficulties of enforcement.

There is almost unanimous agreement, both inside and outside of Government, that the Vinson-Trammell Act is not

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workable. The defense procurement picture has changed so radically since its passage that it is no longer relevant. The dollar threshold is far too low - many thousands of small contracts with relatively miniscule profits would be covered - creating a paper avalanche that would serve no useful purpose. The classification of items covered (only ships and aircraft) is so restrictive that it will exclude many major procurements, while at the same time being so imprecise as to be impossible to enforce. We, therefore, join with all of the other government and industry witnesses who have urged prompt repeal.

As we all recognize, the subject of profit limitation is both exceedingly complex and controversial. Contractors, naturally, would prefer to see no profit limitations imposed after a contract is negotiated and performed. On the other hand, there are many in Government and Congress who feel that such a profit limitation, either on a contract-by-contract basis, or based on a contractor's total work for the Government, is both necessary and desirable. 2

The principal arguments in favor of the first approach are as follows:

1. The primary emphasis in Government contracting should be on the negotiation of a price to the Government

based on maximum competition and on full disclosure of contractors' costs.

2. Profit limitations tend to reduce the contractors' incentive to increase efficiencies which are translated into lower costs on subsequent or follow-on contracts.

3. The Truth in Negotiations Act, the Cost Accounting Standards Act, and profit guidelines such as those utilized by the Defense Department, together provide a fair element of protection to the Government and represent major improvements in the contracting process unavailable at the time of enactment of either the Renegotiation Act or the Vinson-Trammell Act.

Arguments in favor of some form of profit limitation are as follows:

--even though there have been significant improvements in the Government's ability to negotiate and monitor contracts, the possibility still exists that excessive profits can be a problem on a limited number of contracts,

--as a matter of public policy, it is generally agreed that contractors should not earn excessive profits at the expense of the Government,

--from the standpoint of public trust and confidence in the Government procurement process, there should be some assurance that contractors will not get "fat" on public monies.

It must be recognized that no statute will satisfactorily address all of the concerns of interested parties. There are a number of issues that should be addressed in developing a statute that is both equitable and workable--such as:

1. How to limit profits and still motivate contractors to invest capital, increase productivity, and deliver quality products.
2. What dollar threshold should apply.
3. Should both competitive and non-competitive contracts be covered.
4. Should the limitations apply on a contract-by-contract basis or on some aggregate business base.
5. What levels of contracting should be covered--prime, first tier subcontracts, lower tiers.
6. How can excessive profits be defined.
7. How can the profit limitation activity be administered at a relatively low cost.

The Renegotiation Act died because industry claimed, and the Congress agreed, that (1) excess profits were not consistently and equitably defined and (2) the costs of administration probably exceeded the benefits to the Government. With respect to this latter point, I don't believe it will ever be possible to measure costs vs. benefits of any profit limiting statute because the benefits being sought are largely intangible. This

does not mean, however, that every effort should not be made to keep any new statute as simple as possible.

There are several suggestions I would like to offer for your consideration with respect to the several bills already introduced, or to others that may be introduced at a later date.

--A profit limitation based on a fixed percentage of contract costs can result in inequities and could be counterproductive. There could be many instances where the circumstances warrant higher profits than those that would be specified in a statute.

--A profit limit based on an aggregate business basis is difficult to administer. A better solution is somewhat of a compromise--limits on individual contracts with provision to offset losses on specific contracts against profits. Something similar to the carry-forward and carry-back income tax treatment for capital losses.

--While any dollar threshold is arbitrary, anything lower than a \$5 to \$10 million range will today result in coverage of too many small contracts. A continued high rate of inflation would soon make even that figure unrealistic, and the legislation should probably include some indexing procedure

to keep up with rising prices. Failure to keep the threshold realistic will soon have a severe adverse impact on small business.

If the Congress decides to enact new legislation, we would therefore like to suggest that it include provisions along the following lines:

1. Limit its application to negotiated prime contracts and subcontracts exceeding \$10 million.
2. Permit retention of profits equal to a percentage of the negotiated dollar amount (i.e. 125 percent or 150 percent). (See chart attached.)
3. Permit carry-forward of losses, to offset excessive profits, for a 3-year period.
4. Provide for filing of certified statements with the contracting officers on conclusion of individual contracts, subject to audit by GAO and executive agency internal auditors.

There is one other point that I would like to bring to your attention. When profit limitation statutes were first proposed, there were no really major nondefense contracts. The pattern

of Government spending has changed over the years and agencies like NASA, DOT, GSA, DOE, make major contract awards. At this point in time, there is no reason to single out defense contracts for profit limitation - and the Congress should consider making any new statute applicable to all Government contracts and expenditures with grant funds.

In conclusion, while the General Accounting Office agrees that the Vinson-Trammell Act is outdated and should be replaced, we believe that the question of whether or not this Act should be replaced with a new statute is a matter of policy which the Congress should determine after considering all of the advantages and disadvantages. As a minimum, we would suggest that a profit limitation statute, that would become operative during a period of national emergency when contract activities increase significantly, should be in place. We would also suggest, as a minimum, that the secretaries of the various agencies have the right to promulgate regulations that would limit profits in those cases where sole-source contractors are attempting to take unconscionable advantage of the situation.

This concludes my prepared statement, I will be happy to answer any questions you may have at this time.

Attachment

Attachment

EXAMPLE OF EXCESS PROFIT COMPUTATION

NEGOTIATED CONTRACT COST	\$10,000,000	
NEGOTIATED PROFIT	<u>1,500,000</u>	(15%)
CONTRACT PRICE	\$11,500,000 =====	
ACTUAL COST	\$ 8,500,000	
ACTUAL PROFIT	<u>3,000,000</u>	(35%)
CONTRACT PRICE	\$11,500,000 =====	
NEGOTIATED PROFIT	\$ 1,500,000 =====	
MAXIMUM ALLOWABLE - 150%	\$ 2,250,000 =====	
REFUND DUE GOVERNMENT	\$ 750,000 =====	
NET PROFIT PERCENTAGE EARNED BY CONTRACTOR		
	$\frac{\$2,250,000}{8,500,000}$	=26%