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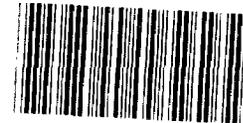
Testimony

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GAO's Comments on the Defense Contract Profit  
Policy Act of 1988

Statement of  
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Before the  
Acquisition Policy Panel  
Committee on Armed Services  
House of Representatives



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Mr. Chairman and Members of the Acquisition Policy Panel:

I am pleased to be here today to discuss the proposed Defense Contract Profit Policy Act of 1988 which would require defense contractors to report financial data and the Department of Defense (DOD) to analyze the results of realized profits on government business. As you know, we have been advocating a Profitability Reporting Program (PRP) for several years and made very specific recommendations for establishing a PRP in our September 1987 report.<sup>1</sup> We believe that the Defense Contract Profit Policy Act encompasses the most important aspects of our proposal and therefore support it.

Several recent reports by industry, dealing with perceived profitability reductions, dramatically underscore the need to systematically analyze the impact of government policies on contractor financial results. One of these reports, an industry sponsored MAC Group study was based on an analysis of volunteered data of one program for each of nine defense firms. It made no attempt to establish the level of overall defense contractor profitability. In the absence of overall industry profitability data, it is not possible to determine the results which are being obtained under existing policies. The Defense Contract Profit Policy Act contains the necessary provisions that would, in the

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<sup>1</sup>Government Contracting: A Proposal for a Program to Study the Profitability of Government Contractors (GAO/NSIAD-87-175, Sept. 1987).

future, correct the current situation and would provide on an aggregated basis, levels of profitability being obtained under existing policies.

There is a long history of concern about profits earned on government contracts. Contract prices should allow contractors to recover their costs and provide a reasonable profit to compensate for investment, risk, and effort. However, concern with excessive profits has periodically prompted the Congress to legislate price ceilings, excess profit taxes, and renegotiation of contract prices.

DOD's profit policy, among other things, seeks 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 profit policies have been evaluated several times over the years to determine the profitability of defense contractors. And, DOD has changed its profit policy based on study findings. However, due to time lags inherent in the process DOD has not learned of the effect of changes until long after the changes were made. For example, it did not learn that policy changes made in 1976 and 1980 were providing more profit than it had intended, until it completed its most recent profit study -- the Defense Financial and Investment Review -- in August 1985.

We believe that DOD needs better and more timely assurance that its policies are producing intended results. Policies as important and pervasive as those which affect the profitability of defense contractors should be supported with a means of determining how well the policies are working.

We believe that a Profitability Reporting Program is required. We believe it should require mandatory reporting on a recurring basis. Periodic evaluations should be based on consistent use of acceptable methodology. The Program should result in the timely development of meaningful trends on which profitability outcomes can be determined on a more representative basis. Since DOD is not required to develop such a program and because of its importance in light of the historical concern, we believe that legislation is needed that would create a systematic Profit Reporting Program that builds on and improves what has been done in the past.

Several bills have been introduced that would require defense contractors to report data on realized profits. Some of these bills mirror our proposal closer than others.

Our proposal for a Profitability Reporting Program describes a framework that provides for a consistent and appropriate analytical methodology to evaluate profitability, as well as a

plan for conducting a detailed analysis of the aggregated profitability data. The framework of our proposed Profit Reporting Program was based in part on the methodology used in previous DOD studies of defense contractor profitability.

Our proposal is what we consider to be a model program, and as stated in previous testimonies we are willing to work with the Congress, DOD, and the defense industry in formulating an agreed upon approach for achieving the desired results.

Although the Defense Contract Profit Policy Act differs from some aspects of our model, it encompasses the most important aspects and therefore we support it.

Industry has vigorously opposed establishing a PRP and a main reason cited is the fear that confidentiality of this vital information would be compromised. Confidentiality of company data is a major concern, and it should be.

It is important to note that under the system set forth in the Defense Contract Profit Policy Act any data that is disclosed in these studies will be aggregate data, not individual contractor data. This is the way the data was handled in previous DOD studies on defense contractor profitability.

We believe that the Defense Contract Profit Policy Act addresses industry's concern regarding the confidentiality of data because it eliminates all government's access to contractors' raw data. Since checks by independent certified public accountants to ensure that reliability of the financial data provided by defense contractors are contained in the amendment, we support it as a viable alternative.

Another instance where the Defense Contract Profit Policy Act differs from the details of our proposal is in determining the methodology to be used for data analysis. The Defense Contract Profit Policy Act provides for an Advisory Council on Profit Study Methodology that was not in our proposal. Since the Advisory Council should provide a suitable forum for addressing the methodology issues and is required to consider the findings in our report entitled Government Contracting: Assessment of the Study of Defense Contractor Profitability (GAO/NSIAD-87-50), we support this provision.

In summary, the Defense Contract Profit Policy Act is designed to produce reliable statistics based on timely, accurate, and verifiable data. Aggregated profitability information will be summarized and reported to appropriate DOD officials. Those statistics and 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 Defense Contract Profit Policy Act provides a diagnostic capability that is preferable to alternatives such as renegotiation.