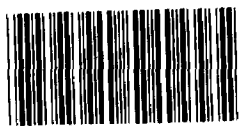
COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-198098

The Honorable Carl M. Levin
Ranking Minority Member
Preparedness Subcommittee
Committee on Armed Services
United States Senate

April 20, 1981



116068

Dear Senator Levin:

Subject: GAO Views and Position on Profit Limitations and the Vinson-Trammell Act (PLRD-81-26)

This is in reference to your April 13, 1981, letter concerning various questions on the Vinson-Trammel Act profit limitations. The following information is provided for your use

1. Has the GAO performed any recent studies of Defense contractor profits? How do those profits generally compare with those on commercial ventures in terms of return on equity and return on assets?

We have not made any recent studies on Defense profits. Our last report, "Defense Industry Profit Study" was issued on March 17, 1971. At that time, we reported that profits before Federal income taxes, measured as a percentage of sales, were significantly lower on Defense work than on comparable commercia work (4.3 percent versus 9.9 percent).

However, when profits were considered as a percentage of th total capital investment (total liabilities and equity but exclu ing Government capital) used in generating the sales, the differ ence narrowed (11.2 percent for Defense sales versus 14 percent for commercial sales).

Further, when profit was considered as a percentage of equi capital investment, there was little difference in the rate of return between Defense work and commercial work. The contractor in our study realized average returns before Federal income taxe of 21.1 percent on equity capital allocated to Defense sales and 22.9 percent on equity capital allocated to commercial sales.

Data developed on an individual contract basis showed a wid range in the rates of return on total capital investment (0.1 percent to 240 percent).

More recently, in 1975-76, Defense conducted a 1-year study (Profit '76, dated Dec. 7, 1976) on Defense contractor earnings. This study showed that Defense contractor profits, when measured on the basis of sales, were on the average lower than those generated in commercial endeavors. However, when measured on a

return on investment basis, Defense returns are somewhat higher than commercial returns. This relationship was traceable to a comparatively low level of investment by Defense contractors. In terms of production facilities, for example, Defense found that commercial firms, on the average, invest more than twice the amount that Defense contractors do on the basis of sales dollars.

2. What is the GAO's view of the adequacy of each of the various supposed surrogates for a direct profit limitation system (e.g. the Truth in Negotiation Act, the Cost Accounting Standards Act) to protect fully against excess profits?

The Truth in Negotiations Act was designed to place both parties to certain noncompetitive Government contracts in a position of equality at the bargaining table with regard to data available to the contractor. The act functions as a limitation on profits only to the extent that it provides the Government with recourse if a contract price is increased due to a contractor's failure to provide accurate, current, and complete cost or pricing data as required by the act.

Cost Accounting standards and regulations promulgated by the Cost Accounting Standards Board are designed to achieve uniformity and consistency in cost accounting under certain negotiated defense contracts. Although the Board is no longer in existence, Defense contractors and subcontractors are still required to disclose their cost accounting practices and to follow Cost Accounting standards in estimating, accumulating, or reporting costs on covered contracts. Both of these provisions represent major improvements in the contracting process unavailable at the time of enactment of either the Renegotiation Act or the Vinson-Trammell Act. We support these efforts and their continuing improvement. However, they do not provide any means of controlling profits when the vendor is not in a price competitive environment and seeks to exploit its position.

In our previous work, we found that excessive profits were usually not caused by inadequate procurement procedures or poor implementation of procedures by Government procurement officials. More often, they resulted from a seller's market aggravated by sharp increases in Government demand on an industry operating at or near capacity. With lessened competition, price increases were often unrelated to production costs. We found instances where a contractor's volume rose, and unit production costs diminished, resulting in greatly increased profits because prices were not reduced.

It is interesting to note that in one of our studies, half of the high-profit contracts we looked at were awarded on the basis of price competition, indicating that neither formal advertising nor competitive negotiation were totally effective in preventing excessive profits. In addition, price or cost analyses were made

for most of the negotiated awards and the cost data were audited by the Defense Contract Audit Agency for the sole-source prime contract awards, and nevertheless, high profits were made.

3. Does the GAO position on replacing the Vinson-Trammell Act remain the same as it was last year?

We still believe that the Vinson-Trammel Act should be replaced. In its present form, it is outdated, inequitable, and unworkable, and its continued use would present numerous administrative problems. However, we do not advocate eliminating the concept of profit limitations. As we previously maintained, as a minimum, a profit limitation statute should be in place that would become operative during periods of national emergency, when contract activities increase significantly and the prospects for excess profits are substantially increased.

In addition, we remain concerned about those cases where sole-source contractors may attempt to take unconscionable advantage of a "sellers market." As we have stated in the past, even during periods when no national emergency exists, a profit limiting statute provides a means of moderating unreasonable demands where Defense has to deal with sole-source contractors who maintain a "take-it-or-leave-it" attitude.

In this regard, Defense currently procures over 70 percent of its needs under sole-source or other contracts without price competition. In these noncompetitive situations, contractors could fully comply with cost accounting standards; submit accurate, current, and complete cost data that is verified; and still demand and obtain unreasonable profits.

Significant increases are being proposed in Defense spending over the next few years, and new Defense policies call for increased production and procurement of weapon systems. The effect of these policies on a Defense industry with pockets of fully utilized industrial capacity could, in some cases, be sizeable. Defense sales for some contractors are expected to double over the next 2-year period.

The Government has the means available to require production for national defense needs, but presently there is no provision to assure reasonable prices for this mandated production. Title 1 of the Defense Production Act provides for mandatory contractor acceptance of Defense contracts and for giving them priority over other work, but there is no provision in that law for assuring reasonable prices for such contracts. Contractors can and do insist on very high prices in certain circumstances. A profit limiting statute would provide a means of moderating unreasonable demands and would be the only way the Government could recover excessive profits that may result.

For these reasons, we believe that some profit limitation measure is in the public interest and should be maintained.

4. If the GAO still believes that the Vinson-Trammell Act should be replaced, what form should the replacement statute take?

In its present form, the Vinson-Trammel Act is outdated, unworkable, an administrative burden, and inequitable. We believe, however, that the act and its regulations provide an existing framework that could be updated and modified to correct its objectionable defects. Specific changes can substantially reduce the administrative burden in complying with the act, especially on small businesses.

If the statute is to be updated, we suggest that the following general guidelines be considered:

--Expand coverage to include all Defense items, not just ships and aircraft.

--Limit its application to completed noncompetitive negotiated contracts and first-tier subcontracts.

--Increase the dollar threshold from $10,000 to at least $5 million.

--Compute profit on the basis of a predetermined return on investment rather than on a percentage of contract prices.

--Adopt Section XV, Defense Acquisition Regulation cost rules.

--Provide specific criteria for offsetting losses against profits.

--Simplify reporting.

--Permit audit sampling of profit reports to monitor compliance.

--Provide stiff administrative penalties for contractors who do not comply with reporting requirements.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of the report. At that time we will send copies to interested parties and make copies available to others upon request.

Sincerely yours,

Milton J. Socolar

Acting Comptroller General
of the United States