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[DOD's Profit '76 Study and New Profit Policy]. B-159896; PSAD-77-75. February 17, 1977. 8 pp.

Report to Secretary, Department of Defense; by Elmer B. Staats, Comptroller General.

Issue Area: Federal Procurement of Goods and Services: Reasonableness of Prices Under Negotiated Contracts and Subcontracts (1904).
Contact: Procurement and Systems Acquisition Div.
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Congressional Relevance: House Committee on Armed Services; Senate Committee on Armed Services.

Data generated by the DOD Profit '76 Study were reviewed in terms of its impact on the development of the Department's new profit policy. The profit policy is designed to motivate defense contractors to make investments which will increase productivity and reduce contract costs.
Findings/Conclusions: The study was generally approached in a competent and professional manner. GAO agreed with the new profit policy concerning: holding average negotiated profits to prior levels, attempting to encourage contractor investments in cost-reducing facilities, and offsetting the aggregate effect of imputed interest in facilities capital. The basis for profit comparison could be improved, however, and it was felt that there is too little incentive to encourage increased contractor capital investments. Imputed interest may not be completely eliminated from the profit element. The potential exists for an overall profit increase in the negotiated contracts.
Recommendations: The Secretary of Defense should monitor the implementation of the new profit policy to prevent its intent from being circumvented by unjustified variations in the profit factor ranges or negotiation of rates higher than indicated by application of weighted guidelines. The Secretary should: reduce the impact of cost input in establishing profit objectives; issue additional guidance to promote reasonably consistent and uniform application of the productivity reward factor; and focus future profit studies on a comparison of profits earned by defense contractors to specific industry profit rates. (RRS)

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

FEB 17 1977

B-159896

The Honorable
The Secretary of Defense

Dear Mr. Secretary:

We have completed a limited review of the Profit '76 Study conducted by your office during 1976. Our primary objective was to review the data generated by the study and its impact on the development of the Defense Department's new profit policy which became effective October 1, 1976. The new profit policy is designed to motivate defense contractors to make investments which will increase productivity and reduce contract costs.

We received a number of briefings from the Department of Defense regarding the profit study and the new profit policy, and we visited the Department's offices many times to obtain clarifications concerning both. We examined pertinent summary financial data submitted by Coopers and Lybrand, under contract with the Department, and other data and documents prepared by your staff. We also reviewed the report of the Special Advisory Committee that evaluated the Department's efforts concerning these subjects. We were not able to review the source data obtained from the contractors since it was returned to them by Coopers and Lybrand and only summarized data was available.

The overall goal of the profit study was to develop policy revisions that would reduce production costs by encouraging contractors to make more investments in capital assets. The profit element is important to the Government since each 1 percent of profit will amount to $220 million for fiscal year 1977, based on estimated applicable costs of $22 billion. If projected increases occur in the values of procurements subject to the weighted-guidelines method of negotiating profit objectives, the effect in subsequent years will be proportionately higher.

PSAD-77-75

PROFIT STUDY SELECTION PROCEDURES

The Department originally selected 133 companies to participate in the study. These were from the top 300 prime contractors which did business with the Department in fiscal year 1974. We were told that the Department intended to cover a high percentage of its total procurement, and at the same time tried to include the important categories of missiles, aircraft, electronics, and ship procurements in approximately the same relationship that these categories had within total departmental procurement. Of the 133 contractors, 56 refused to participate or were considered inappropriate for this particular effort. Twelve companies submitted unusable data or data that was disclaimed by their certified public accountant firms. Data from three firms was excluded because it was qualified by the firms' certified public accountants. This left a total of 62 contractors whose data was considered acceptable by the Department.

Financial data was requested from Government profit centers and commercial profit centers with similar activities. Although the Department was instrumental in selecting the representative Government profit centers, the companies selected what they believed were similar commercial centers. Thus, the companies' selections could have been biased.

PROFIT STUDY RESULTS

Coopers and Lybrand included the following summary information in its report to the Department for the 62 contractors with acceptable data. The annual profit, before taxes, for the 5-year period 1970 through 1974 for U.S. Government profit centers was 4.7 percent on sales of $12.9 billion. This was considerably lower than the 17.1-percent profit on sales of $8.5 billion for the reported commercial sector. In comparison, however, the Department computed an average annual profit of 6.7 percent on sales of about $450 billion for approximately 5,000 durable goods companies, based on data provided by the Federal Trade Commission.

The reported profits, before taxes, on total assets were 17.6 percent for commercial profit centers and 13.5 percent for Government profit centers, in comparison to 10.7 percent for the 5,000 durable goods companies. Since the rate of profit on total assets was lower for these durable goods companies than for the Government centers, the Department told us it concluded that an increased overall profit on total contractor investment could not be justified at this time. This judgment apparently resulted from the Department's belief that the Commission's data represented a competitive commercial environment more than the commercial center data submitted by the contractors.

In terms of production facilities per dollar of sales, commercial firms invested more than twice the amount that defense contractors did. While there may have been many reasons for the low rate of investment by the defense sector, the profit study staff concluded that the failure to relate profit to investment in a satisfactory way was an important factor. The new profit policy is an effort to correct this situation.

Summary data relating to facilities capital and allowable costs on defense contracts was also included in the Coopers and Lybrand report. The profit study staff computed a composite rate of 11.6 percent which represented the relationship of tangible capital assets to allowable costs for U.S. Government profit centers. The staff used this rate to determine an adjustment factor for contracting officers. It is planned that use of the factor will approximately offset the effect of imputed interest from profit objectives developed for contract pricing negotiations.

SUMMARY OBSERVATIONS

We found that the study was generally approached in a competent and professional manner. Since we were unable to review the basic contractor financial data, as a result of the Department's efforts to protect the confidentiality of the data, we can express no opinion on its accuracy. We have, however, a number of observations regarding other aspects of the study results and the new profit policy.

We agree with the Department's new profit policy relative to

--holding average negotiated profits to prior levels,

--attempting to encourage contractor investments in cost-reducing facilities, and

--offsetting the aggregate effect of imputed interest on facilities capital (provided for by Cost Accounting Standard 414) from the profit computation.

Although we agree with these basic positions, we believe there are some potentially troublesome aspects which could impede the effectiveness of the Department's new policy.

BASIS FOR PROFIT COMPARISON COULD BE IMPROVED

The Department concluded that an increase in the average profit rate on total contractor assets employed on Government contracts was not justified, based on industry's rate of return on assets computed from Federal Trade Commission reports. Although the Commission's data, which was based on averaging the profits of about 5,000 durable goods companies, may be considered sufficiently broad-based for comparison with the average Government center profit rate, a number of questionable aspects should be considered.

The Commission classifies the listed companies according to a single dominant activity. Thus, although a conglomerate corporation may be classified in the electrical and communication equipment category, for example, it may have subsidiaries or affiliates which are involved in other activities, such as toy manufacturing, food industry, cigarette manufacturing, paper products, and services and repairs. Since there is not a single defense industry, and the Department is dealing with a number of industries, specific industry profit rates may be a better basis for comparison and more meaningful in determining the reasonableness of the negotiated profit rates for particular contractors.

TOO LITTLE INCENTIVE TO ENCOURAGE INCREASED CONTRACTOR CAPITAL INVESTMENTS

The Department is trying to motivate contractors to make larger investments in cost effective facilities by deemphasizing contractor costs in establishing prenegotiation profit rates and giving some consideration to capital investment. However, approximately 90 percent of the prenegotiation profit objective is still based on costs. Since a higher dollar profit results from a higher cost estimate, it is questionable whether contractors will be sufficiently motivated to reduce their costs in view of this high relative weight given to the elements of cost input to total performance and to risk.

We are pleased to note that the Department has stated that the 10-percent relative weight assigned to "Investment" in establishing prenegotiation profit objectives will be reevaluated in the future with a view toward increasing the relative weight. A Department official told us that the Department expects to develop specific detailed criteria for reevaluating this profit element. Department officials have also stated that no study has been underway to determine the optimum level of facilities investment from a cost-effectiveness viewpoint.

IMPUTED INTEREST MAY NOT BE FULLY ELIMINATED FROM THE PROFIT ELEMENT

We agree with the Department's plan to reduce contract profit objectives by the amounts of the economic cost of facilities' capital included as elements of contract cost. This type of cost has been implicitly included as a part of the overall profit objective since interest expense is considered an unallowable cost for reimbursement purposes on Government contracts.

To prevent the double counting of facilities' capital in computing the interest cost element and the profit element, the Department's instructions provide for reducing the profit objectives used in contract negotiations by a factor representative of the imputed interest allowed as a cost. This factor resulted from several computations.

One computation involved determining average tangible capital asset investments (land, building, and equipment) of the 62 major defense contractors that submitted usable profit data, but these contractors do not represent all defense contractors. If the average capital asset investments of all defense contractors doing business with the Department are larger than those of the 62, the reduction factor computed by the Department may be insufficient to fully offset the imputed interest on contractors' investments. Insufficient offsets will result in increased profits to contractors and increased costs to the Government.

Although the base on which imputed interest on facilities capital is computed includes both tangible and intangible capital assets, the Department's profit study staff only used tangible capital assets in computing the estimated amount of offset. A Department official stated that these intangible assets were considered relatively insignificant. However, some increase in costs to the Government will occur since consideration of intangible capital assets, such as computer software, will result in increased interest costs which are not offset by the reduction factor provided by the Department.

POTENTIAL EXISTS FOR AN OVERALL PROFIT INCREASE

Certain conditions or circumstances relating to the negotiation and establishment of prenegotiation profit objectives could seriously affect the Department's ability to prevent an overall increase in profit rate on defense contracts. For example, some contractors with less than average invested capital may refuse to negotiate profit rates lower than those negotiated on prior contracts for similar work. Should this situation result in negotiated profit rates above those contemplated by the new profit policy, costs to the Government would be increased.

REWARD FOR IMPROVED PRODUCTIVITY

In addition to the profit determinants of cost input to performance, risk, and investment, a "productivity" factor was added to the computation of the prenegotiation profit objective within the new profit policy. No relative percent relationship to the total average prenegotiation profit rate was assigned to this factor. The Department's objective for adding this provision is to reduce costs by motivating defense contractors to be more efficient. To the extent that costs serve as the basis for pricing, it is generally acknowledged that there is no real incentive for contractors to reduce their costs since this would reduce profits on follow-on contracts. To reduce the loss of profit dollars when costs are reduced, a special "Productivity Reward" may be included in the prenegotiation profit objective under certain circumstances.

Although we see no problem at this time with the "Applicability Criteria" developed by the Department, we have some questions concerning the Armed Services Procurement Regulation implementation instructions. The instructions are not clear or comprehensive enough to expect reasonably consistent application by hundreds of contracting officers. For example, the development of a technique to determine the portion of the cost decrease which is attributable to productivity gains as opposed to the effects of quantity differences between prior production and the pending procurement, is left to the individual contracting officer. We believe the instructions should at least define what constitutes productivity gains. It should be made clear that a productivity award should be for something more than a productivity increase from improved worker learning and skill resulting from normal job performance.

Without consistent application of the productivity factor, the same contractor under the same set of circumstances would most likely be treated differently by different contracting officers. This could lead to considerable contractor dissatisfaction.

RECOMMENDATIONS

We recommend that the Secretary of Defense:

--Closely monitor the implementation of the new profit policy to prevent its overall intent from being circumvented by unjustified variations in the profit factor ranges or negotiation of rates higher than indicated by application of the weighted guidelines.

--Perform a study after a test period, to determine whether the effect of imputed interest on facilities capital is being offset in the prenegotiation profit objective computed under the weighted guidelines.

--Further reduce the impact of cost input in establishing profit objectives. One possible consideration is to compute the risk factor based on contractor's invested capital.

--Issue additional guidance necessary to promote reasonably consistent and uniform application of the productivity reward factor by the Department's contracting officers.

--Focus future profit studies on a comparison of profits earned by defense contractors to specific industry profit rates.

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We invite your attention to section 236 of the Legislative Reorganization Act of 1970 which requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House and Senate Committees on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We would appreciate your comments on these matters and would be pleased to discuss any questions that you may have.

We are sending copies of this letter to the Director, Office of Management and Budget; to the Chairmen of the Senate and House Committees on Government Operations, Appropriations, and Armed Services; and to other interested parties.

Sincerely yours,

Comptroller General
of the United States