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STATEMENT OF

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BEFORE THE

LEGISLATION AND NATIONAL SECURITY SUBCOMMITTEE

OF THE

COMMITTEE ON GOVERNMENT OPERATIONS

UNITED STATES HOUSE OF REPRESENTATIVES

ON

DOD's DEFENSE FINANCIAL AND INVESTMENT REVIEW

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss DOD's Defense Financial and Investment Review (DFAIR) report which recommended changes in DOD's policy concerning contractors' profits. I will give a brief background of DOD's profit policy, explain our concerns about the DFAIR report, and describe what we think could be done to improve DOD's profit policy.

BACKGROUND

DOD's profit policy provides contracting officers a structured approach to calculating prenegotiation profit objectives through weighted guidelines. The profit objectives determined through weighted guidelines, coupled with the government's estimate of contract cost, produces the government "target" price used by the contracting officer in negotiating with a potential contractor.

The profit policy has been studied several times over the years and changes have been made to it. DFAIR is the most recent such study.

On May 13, 1975, the Deputy Secretary of Defense initiated Profit '76--a major DOD study of profit and its relationship to capital investment and increased productivity. The Profit '76 study group concluded that government contractors were able to maintain a high return on investment by keeping investment low.

As a result of the Profit 76 study, DOD promulgated Defense Procurement Circular (DPC) 76-3 on September 1, 1976, which made a number of changes to DOD's profit policy. These changes were designed to encourage investment, increase productivity, compensate contractors for higher risk, and decrease emphasis on cost and past peformance.

On March 8, 1979, we issued a report entitled Recent Changes in the Defense Departments' Profit Policy--Intended Results Not Achieved (PSAD-79-83). The report concluded that negotiated profit rates increased on a substantial number of DOD contracts because of the Department's new profit policy. However, the increased profits and other policy incentives had not been sufficient to motivate many defense contractors to invest in additional cost reducing facilities. As a result, DOD had not accomplished its objective to reduce production costs through additional contractor investments in more efficient facilities.

Our report recommended that the Secretary of Defense substantially increase emphasis on facilities capital investment and further reduce emphasis on cost through the offset factor. The offset factor is a reduction of profit objectives based on estimated cost. The factor, which has been fixed at 30 percent since its development in 1976, was designed to place less emphasis on estimated cost as a basis for profit.

DOD determined that based on its experience with DPC 76-3, the profit policy needed two major changes. On February 26, 1980, DOD issued Defense Acquisition Circular (DAC) 76-23 which revised DPC 76-3.

--DOD increased the profit for facilities capital investment from 6 to 10 percent to 16 to 20 percent.

--The weighted guidelines were modified to provide separate profit weight ranges for manufacturing, R&D and service contracts.

In our 1979 report we recommended that DOD increase the offset factor. DOD did not increase it. The DFAIR report confirms that profit objectives increased as a result of DAC 76-23. The DFAIR report says DAC 76-23 caused an unintended increase in profit objectives of 0.5 to 1 percent annually over the fiscal years 1981 through 1983.

On March 14, 1986, we issued our report, Cost Accounting Standard 414--It's Relationship to DOD Profit Policy (NSIAD-86-55). The report showed that the offset factor was too small to compensate for increases in profit objectives. We found that profit objectives increased slowly after the implementation of DPC 76-3 in 1976. However, after the implementation of DAC 76-23 in 1980, profit objectives increased dramatically. For

example, for a sample of 1,448 contract actions from DOD's Form 1499 data base from October 1982 to September 1983, covering 25.7 billion dollars, profit objectives experienced a net increase of $481 million dollars over what they would have been prior to the implementation of DPC 76-3. This represents an increase of 1.9 percent.

DOD has recently, in several instances, stated that it had already taken action to eliminate the excess profits by reducing progress payments to defense contractors from 90 percent to 80 percent. It stated that the DFAIR analysis demonstrated that this policy change would have the same effect on reducing contractor profits as rescinding DAC 76-23. We disagree with this position.

The mere act of reducing the progress payment rate by itself will not necessarily decrease contractor profits. As the profit policy stands currently, there is nothing in the regulations that would prevent contractors from passing this increased financing cost on to the government by negotiating higher profits. This conclusion is supported by the 1983 report of the Office of the Under Secretary of Defense for Research and Engineering which recognizes that although some short-term savings may result from a reduction in progress payments, price increases would cause outyear outlays to be substantially higher.

In order for a reduction in progress payments to reduce profits, a mechanism would have to be established in the profit policy to control negotiated profits when progress payments percentages are changed. Only if DOD's profit policy did not allow negotiated profits to rise, would the lowering of progress payment rate reduce contractor profits.

OUR CONCERNS REGARDING THE DFAIR REPORT

There were positive aspects of the DFAIR report. For example, it:

--recognized that profit policy, contract financing and contractor investment are related;

--used return on assets to compare profitability; and

--showed that reporting and evaluating government contractor profitability can be done. (I will have more to say on this later.)

Although DFAIR had some positive aspects we have some major concerns about the report. These concerns fall into three areas:

1. DFAIR's comparison of the profitability of defense contracting and commercial manufacturing.

2. The weighted guidelines changes DFAIR proposes to reduce profit negotiation objectives by 0.5 to 1 percent.

3. DFAIR's evaluation of defense contractors' contract financing needs.

Comparative Profitability

In calculating return on assets (ROA)--the ratio of income to assets--DOD increased the asset base by adding government progress payments to contractor inventories. In an additional computation, DOD adjusted income by using a unique methodology to calculate "economic profit." These two actions reduced the apparent return on assets for defense business and led to an understatement of its profitability.

DFAIR's calculations showed that from 1970 to 1979 DOD contracting provided a 6.52 percent return on assets while durable goods manufacturers had a 5.76 percent return. The calculations showed that from 1980 to 1983, DOD contracting provided a 4.73 percent return on assets while durable goods manufacturers had a negative 3.65 percent return.

DFAIR used a major certified public accounting firm, to gather and aggregate the data from the 76 contractors who participated in the study. An analysis done by the CPA firm

shows that defense contracting was, except for 1978, consistently more profitable than commercial manufacturing from 1975 to 1983. The analysis shows that defense contracting provided an average return on assets of 19.4 percent from 1975 to 1979 while durable goods manufacturers had a 15.8 percent average return. From 1980 to 1983 defense contracting provided an average 23.8 percent return on assets while durable goods manufacturers had a 10.6 percent average return.

GAO's independent analysis of publically available data also indicates that defense business was substantially more profitable than durable goods manufacturing during the period 1975 to 1983.

GAO's and the CPA firm's analysis follows, in essence, the methodology of DOD's earlier "Profit '76" study. This methodology conforms more closely to conventional analysis than does DFAIR's methodology.

There are three reasons why the ROA calculations based on the aggregated data are different from the DFAIR ROA calculations.

1. DFAIR adds 5 years of earlier data from the Profit '76 study which obscure the rapid growth of defense profits since 1975.

2. DFAIR adds government progress payments to the contractor's asset base which doubles the denominator of the ROA equation. DFAIR also adds an interest factor to profits to try to take into account the value of the government's progress payments, but this factor is not large enough to offset the increase in the denominator.

3. DFAIR created its own unique definition of profit, which made both DOD business and commercial manufacturers' profits appear lower.

The effect of DFAIR's adjustments to the ROA calculation is to dramatically raise the denominator (assets), slightly raise the numerator (operating profits) and significantly lower the return on assets ratio.

DFAIR Changes to the Weighted Guidelines Policy

DFAIR claims its recommended changes to DOD's weighted guidelines will reduce the average profit negotiation objective from 12.3 percent to 11.5 percent of total cost. We do not agree with DFAIR's conclusion. We do not believe DFAIR's proposed revisions to the weighted guidelines will lower the average profit objective--in some cases it may increase.

There are three reasons for our conclusion:

1. DFAIR assumed contracting officers would change their historical pattern and negotiate profits at the lower end of the individual weighted guidelines profit element ranges which would not be consistent with prior experience. GAO used an average, weighted by contract type, to determine the historic pattern of profit objectives. Applying that pattern to the proposed policy leads us to conclude that the average profit objective for non-shipbuilding contracts will be 11.9 percent rather than the 11.5 percent DFAIR predicts.

2. DFAIR did not take into account its recommendation to include shipbuilding in its proposed policy. Shipbuilding contracts have a significant effect on the outcome of the proposed policy. Including shipbuilding contracts in our weighted guidelines analysis increases the expected average profit objective to 12.3 percent.

3. DFAIR's proposed policy is sensitive to changes in the mix of contract type. DFAIR assumed substantially fewer firm-fixed price contracts in its total contract mix than past experience would indicate was reasonable. Using the contract mix of the total prime contract awards for fiscal year 1984 that shows fixed price contracts were 65.7 percent of the total, GAO concludes that DFAIR's proposed policy could result in a profit objective as high as 12.8 percent.

Defense Contractors' Contract Financing

DFAIR uses a model of a "typical" contract to determine the cost contractors must pay to finance their working capital requirements over and above progress payments received from DOD. DFAIR concludes that contractors' financing costs are roughly 2 percent of total cost and recommends an additional weighted guidelines factor to compensate contractors for those costs.

We do not believe that DFAIR has made a convincing argument to support the conclusion that contractors incur a 2 percent financing cost. DFAIR's model is based on only 12 contracts from 5 contractors. The historic data collected by the CPA firm shows for the 76 contractors that the interest cost incurred in defense contracting to finance all assets--not just working capital--is less than 1 percent of total contract cost.

An additional concern we have involves a related DFAIR recommendation to establish interim acceptance payments. These payments would pay contractors for costs incurred that were not covered by progress payments plus some profit. The payments could start 6 months after contract initiation and would be paid monthly or quarterly. The effect of interim acceptance payments is to drop contract financing cost dramatically--to as little as 0.2 percent compared to the 2 percent claimed by DFAIR.

DOD should not implement either of the two recommendations until it has a better analysis of contract financing costs.

DOD should take steps immediately to reduce the unintended flow of profits. One alternative is to rescind DAC 76-23. As an interim measure--because it is a known position--reinstating DPC 76-3 should be considered. An advantage to this approach is that it would be a straightforward solution. A disadvantage is that it may reduce contractor investment incentives.

DOD should initiate new analyses of the data developed by the CPA firm using conventional methods to compare the profitability of defense contracting and durable goods manufacturers. DOD should not implement the DFAIR recommendations based on the current, flawed, profitability analyses.

NEED FOR LEGISLATION TO ASSURE CONSISTENT CREDITABLE STUDIES OF THE PROFITABILITY OF GOVERNMENT CONTRACTING

The Comptroller General, in an October 1983 address to the National Security Industrial Association, stated the need for periodic studies of profit to consider those factors that will ensure a fair return to contractors and will encourage investment in government programs, while assuring taxpayers that their interests are being served. The DFAIR study falls short of this charge. As discussed above, the use of methodology not

consistent with generally accepted accounting principles and profitability evaluation techniques not consistent with prior studies of defense profits has produced results that are not credible. Moreover, for both Profit '76 and DFAIR defense contractors participated voluntarily, and for various reasons some declined to participate. The financial data provided for the studies was not verified by any government agency.

Major revisions to profit policy have occurred over the last 9 years between ad hoc studies. In that same period the Renegotiation Board and the Cost Accounting Standards Board have been eliminated. Further, in 1981, the peace time application of the Vinson-Trammell Act was abolished and its application to defense profits in war time was significantly weakened. These actions have reduced the government's visibility over the effectiveness and equity of profit policies.

We believe legislation is necessary to establish a profitability reporting system to annually collect consistent and verifiable data from contractors. Reporting would be mandatory. The repository of this data should be an executive branch entity and steps would need to be taken to protect proprietary data.

The data would need to be accessible for use in auditing the implementation of the studies and the substantive results of

these studies. We are working on the framework for such a system now. The data collected through such a reporting system could be used for periodic studies to evaluate the results of the DOD's profit policy and provide the basis for formulating future policy.

Mr. Chairman that concludes my statement.