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

RELEASED

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Dear Mr. Chairman:

Your letter of November 17, 1972, requested that the General Accounting Office inquire into the new Department of Defense (DOD) policy on contract profits and assist you in proposing improvements in this policy. Under this policy, the amount of private capital a contractor intends to use in work under a DOD contract will be considered by DOD in negotiating profits on the contract. One-half the Government's prenegotiation profit objective will be based on the amount of private capital expected to be employed. The other half will continue to be based on estimated contract costs.

This policy will be implemented in two phases. The first phase is termed a "service test" and was scheduled to begin January 1, 1973. DOD considers this phase to be a continuation of policy development that began approximately 5 years ago. During this test period, use of the return on capital policy will be optional by mutual agreement of the contractor and the Government.

The objectives of the service test are to allow a transition period for adjustment to the return on invested capital procedure and to develop a greater understanding of the procedure's impact on negotiated profits. If the results of the service test are favorable, it is intended that the second and final phase of the return on invested capital policy will be implemented. At that time the policy will become mandatory for all contracts meeting the applicability criteria. A date for mandatory use has not been established.

As noted in your letter, we have gone on record as favoring the consideration of invested capital in negotiating profits on Government contracts. A conclusion to this effect was contained in our report on defense industry profits, issued March 17, 1971. During our profit study, and for the last several months, we have followed DOD's efforts to develop its new contract profit policy and its methodology for implementation. This monitorship has included several discussions with

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and briefings by cognizant DOD officials and reviews of the proposed methodology for implementing the new policy.

The policy of using return on invested capital as one element in computing profit objectives is not intended to increase or decrease overall defense industry profits. Rather it is designed to allow more equitable profit-on-capital opportunities and to remove the financial penalties currently associated with capital investment. Meeting these goals should increase some companies' profits and decrease other companies' profits.

Your letter and your press release dated November 3, 1972, indicated that you were concerned that the new policy would result in substantial increases in defense industry profits. You noted that the study of defense industry profits performed by the Logistics Management Institute (LMI) showed that profits as a percent of capital averaged 15 percent. You also noted that DOD's new profit policy will be based on rates of return ranging from 28 to 32 percent for fixed-price-type contracts.

The LMI rate of 15 percent should be compared with the 20.2-percent average rate established by DOD as a target objective, or benchmark, for its contractors. The rates DOD used for various types of contracts range from 20 percent to 32 percent.

AVERAGE RATE OF 20.2 PERCENT

The differences between LMI's 15 percent and DOD's 20.2 percent are due to the differences (1) in the profit and capital data analyzed and (2) in the methodology used in determining return on invested capital.

The defense industry profit rate of 15 percent LMI computed was based on analyses of information provided confidentially to LMI by 40 medium and large companies concerning sales to DOD for the 10-year period 1958-67. LMI did not intend this rate as a benchmark for the new policy.

The profit rate of 20.2 contemplated in the new policy was based on the average rate of return on investment experienced by six durable goods industrial groupings over the 8-year period 1963-70, as reported in Quarterly Financial Reports for Manufacturing Corporations, published jointly by the Federal Trade Commission (FTC) and the Securities and Exchange Commission (SEC). DOD believed that profit information on these groups provided the best broadly based indications available as to the commercial profit rates being realized by industrial groups most resembling defense industry. Commercial profit rates were used as a benchmark in the return on invested capital policy to provide contractors the same incentive to do business with DOD as they had to invest their resources in commercial work. Using DOD's definitions of capital and profit, the average rate of return on capital experienced by the six industrial groups was 20.2 percent.

The DOD and LMI methodologies for calculating return on invested capital are shown below.

DOD	(Profit)	Before taxes and before deduction of interest expense
	(Capital)	Accounts receivable + inventories + net fixed assets - accounts payable, progress payments, and cost reimbursements
LMI	(Profit)	Before taxes but after deduction of interest expense
	(Capital)	Equity + long-term debt

In an effort to account for the differences between LMI's 15 percent and DOD's 20.2 percent, DOD applied the method of computing return on capital LMI used to the same FTC-SEC reports DOD used in computing the standard profit rate of 20.2 percent. The rate derived was 19.2 percent. Therefore, it appears that the primary reason for the difference between the LMI and DOD rates is the differing data bases used. The remaining 1 percent could be attributable to differences in the formulas above.

RANGE OF RATES

DOD made various adjustments to the 20.2-percent rate derived from the FTC-SEC reports in arriving at the standard profit rates to be used in determining the profit negotiation objective. These adjustments were intended to provide defense contractors with profit rates comparable to those being realized by industrial groups most resembling defense industry.

DOD does not consider certain business expenses, such as those for product advertising, entertainment, and bad debts, as reimbursable costs in negotiating contract prices. Contractors have borne these costs from profits. The profit rate experienced by the six durable goods industrial groupings was calculated net of all business expenses except interest expense. Therefore, for the return on invested capital for DOD contractors to be comparable with that of the durable goods industry, the profit rate experienced by the durable goods industry is increased by a factor to cover expenses that are not allowable as costs under DOD contracts.

An adjustment was made to recognize that contractors are exposed to differing degrees of financial risks under DOD contracts, depending on the type of contract, and that different degrees of risk justify different profit rates.

A final adjustment was made to reflect differences between "going in," or negotiated profit rates, and "coming out," or realized profits on DOD contracts. Historically, according to DOD, DOD contractors, on the average, have realized smaller profit rates than those negotiated.

These adjustments resulted in four standard profit rates, as follows:

Contract type	Standard profit rate (percent of capital)
Cost plus fixed fee	20
Cost plus incentive fee	24
Fixed price incentive	28
Firm fixed price	32

The Government's profit objective under the new methodology is, in effect, calculated as follows. The amount of non-Government capital estimated to be used in performing the contract is multiplied by one of the four profit rates shown above. Half the product is added to half the profit computed on costs in accordance with the existing weighted guidelines method. The sum of the two constitutes the DOD profit objective.

RESULTS TO DATE

On the basis of results of two tests performed to date, it does not appear that the return on invested capital policy will have a significant impact on overall profits for DOD contractors when fully implemented.

In the first of these tests, capital-employed data was obtained relative to 82[1] contracts that had been negotiated in fiscal year 1970. DOD retrospectively applied its return on invested capital methodology to these contracts and found that its overall profit objective would have decreased from 9.2 to 8.7 percent of the total cost objective.

In the second test, nine contracts were negotiated using the proposed new policy. The nine contractors that participated in this test volunteered to do so. Test results showed

[1]Actually 165 contracts were initially studied but only 82 met the current applicability criteria for using the return on invested capital policy (contracts over $3 million, etc.).

that negotiated profits on three[1] contracts were lower than they would have been had invested capital not been considered (from 0.7 to 2.4 percent lower, computed as a percentage of cost). The other six contracts were negotiated at higher profit rates than they would have been had invested capital not been considered (from 0.2 to 1.6 percent higher, computed as a percentage of cost). Nevertheless, we believe it is significant that three of the nine contracts resulted in lower profits since it might be expected that only contractors that stood to gain would agree to participate in the test.

We believe the effectiveness of the new policy in encouraging contractors to invest their own resources in performing Government contracts and its impact on profits can best be determined through use in negotiating additional contracts. We believe that, rather than proposing changes in the policy at this time, DOD should implement its announced plan to perform additional testing. We intend to continue monitoring DOD efforts in this area.

We trust the foregoing information is responsive to your request.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

The Honorable William Proxmire
Chairman, Subcommittee on Priorities
and Economy in Government
Joint Economic Committee
Congress of the United States

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[1]On two of three contracts the decreases referred to were decreases in prenegotiation profit objectives. The impact on the contractors' expected profits was not determined.