

32658
128277

UNITED STATES GENERAL ACCOUNTING OFFICE

WASHINGTON, D.C. 20548

FOR RELEASE ON DELIVERY
EXPECTED AT 10:00 A.M.
OCTOBER 30, 1985

STATEMENT OF

PAUL F. MATH, ASSOCIATE DIRECTOR

NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION

UNITED STATES GENERAL ACCOUNTING OFFICE

BEFORE THE

SUBCOMMITTEE ON GENERAL OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS

UNITED STATES OF REPRESENTATIVES

ON

H. R. 3020



128277

033634 / 128277

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before the Subcommittee to discuss H.R. 3020, the "War Profiteering Prohibition Act of 1985", a bill to revise and reinstate the Renegotiation Act of 1951.

As Mr. Bowsher indicated in his testimony before this Subcommittee on March 21, 1984, we are concerned about the increase in defense spending and the ability of the Department of Defense (DOD) to ensure that contractor profit levels are fair and equitable. At that time, we reported that the net value of DOD prime contracts had risen from \$32.5 billion in 1974 to \$120 billion in 1983. In 1984 the figure had risen to \$125 billion. This procurement figure has continued to rise. DOD's authorization for procurement in 1985 was \$131 billion and the proposed procurement authorization for 1986 is \$132.7 billion.

I am sure we would all agree that defense contractors should be allowed to make an appropriate level of profit on these procurements. However, the appropriate level of profits on government contracts has long been a subject of debate. In these debates, there is a clear understanding that contractors must anticipate earning an adequate profit before they will invest shareholder resources to perform government contracts. It is generally agreed that profits earned by contractors under defense contracts have a significant effect on our defense industrial base.

In the mid-1970s, DOD was concerned with what was believed to be unacceptably low levels of investment by defense contractors. Some believed that the low profits awarded on government contracts caused this lack of investment. In May 1975, the Deputy Secretary of Defense directed a major study of capital investment, profit, and productivity. This study, known as Profit '76, set out to develop policy revisions that would encourage contractors to invest in capital assets which would reduce production costs. The study resulted in adjustments to the weighted guidelines used by contracting officers to establish government negotiating positions. These adjustments reduced the percent of profit based on cost and created a profit factor on the capital facilities devoted to the contract. By making these changes, DOD believed it was creating appropriate incentives for contractors to invest in productivity enhancing capital facilities.

Because of the significant increase in defense spending and our concern that this buildup not result in excessive profits, we, along with others, recommended that DOD conduct another comprehensive review of its profit policy. This study, entitled Defense Financial and Investment Review (DFAIR), was announced by the Deputy Secretary of Defense in December 1983. While DOD's intent was to conduct a study along the lines of

Profit '76, the effort was somewhat broader in scope in that it examined DOD financing and pricing policies as well as their appropriate integration with the profit policy.

That study has now been completed, and we, at the request of several congressional committees, recently initiated our review of the adequacy of the study, the validity of its findings, and the appropriateness of its recommendations. We expect to issue our report next year.

The legislation we are addressing today would reauthorize the Renegotiation Act of 1951 with a termination date of September 30, 1988. It would also amend the act to require the Contract Renegotiation Board to renegotiate all contracts and subcontracts by division, and by major product line within a division, of the contractor or subcontractor.

We share the concern implicit in this bill regarding the level of contractor profits. However, we believe that rather than reinstating the Renegotiation Act of 1951, legislation requiring periodic studies of contractor profit should be enacted. The legislation should provide that the studies be based on data provided through a mandatory defense contractor profitability reporting system. The periodic studies should be designed to provide the information necessary to guide overall

DOD profit policy. We believe this is preferable to reestablishing a renegotiation board, even one designed to renegotiate by contractor division and product line, because:

- (1) A renegotiation board takes back profits already negotiated and earned by contractors--changes to profit policy based on regular and mandatory reporting should be designed to provide contractors with an appropriate level of profits in the first place.
- (2) A renegotiation board would require contractors to file financial data which may be very similar to the data provisions we envision under a periodic profit reporting system. However, our suggested solution would use this data for a prospective, forward-looking approach to adjusting contractor profit.

As I mentioned earlier, DOD's comprehensive review of its pricing, financing, and profit policy (DFAIR) is now complete. One of our concerns about the validity of this study is that it is based on unaudited data voluntarily submitted by defense contractors. On November 9, 1984, we sent a letter to the Secretary of Defense expressing our concerns regarding the accuracy and reliability of data voluntarily provided by contractors. We cautioned that such unaudited data may not be a

satisfactory basis for a reliable profitability analysis.

Decisions regarding long-term DOD profit policy which are based on voluntary, and possibly incomplete, data, will suffer from inherent weaknesses.

In our November 9, 1984, letter we recommended that a requirement for periodic profit studies, based on regularly reported data on defense contract profitability, be established. The fundamental areas to be addressed in these periodic studies would include (1) the actual profits earned and level of investment under defense contracts, (2) how the profitability and investment behavior of defense contractors compares with firms in other industries and with the private sector as a whole, and (3) whether variations between the profitability of defense contracts and other industries are justified given the circumstances. The periodic studies would allow DOD to make continuing adjustments to its profit policy on a regular basis rather than make major changes every 10 years.

The studies would be based on data developed from a mandatory profitability reporting program. This would require annual reporting of profitability by contractor segments engaged in defense work. The reports would be reconcilable to the corporate financial statements and would be reviewed by the company's certified public accounting firm. Once operational, this reporting system would yield reliable information on the profitability of defense work which would make meaningful periodic studies possible.

If the overall profit policy that develops out of the DFAIR profit study is structured correctly, if a requirement for mandatory annual reporting is established, and if periodic reviews are made to validate the results being obtained by the policy, DOD will be able to monitor profits on a continuing and timely basis, and make the policy adjustments that are necessary to ensure that profits remain at reasonable levels.

In conclusion let me say again that we share your concerns that defense contractor profits should be at an appropriate level. However, we believe the way to address this issue is to establish a systematic procedure to periodically review and, if necessary, alter DOD's overall profit policy, rather than reestablishing the Contract Renegotiation Board.

This concludes my prepared statement. I will be pleased to answer any questions the Subcommittee may have.

32633