

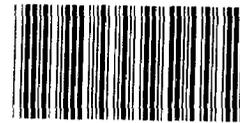
GAO

Exposure Draft

November 1986

# GOVERNMENT CONTRACTING

## A Proposal for A Program to Study the Profitability of Government Contractors



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# Preface

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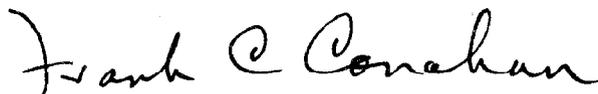
Management information, based on accurate and current data, and consistent and impartial analysis is essential for efficient and effective federal program decisions. The federal government's policy regarding the profitability of government contractors can benefit from improved management information.

The most visible evidence that such improvements are needed is the current debate over whether profit policy objectives are being achieved, and whether government contractors are earning higher returns on their defense work than contractors, many times the same contractors, producing durable goods for general consumption. There is presently no legislatively mandated requirement to make such determinations, and past administrative branch attempts to do so have been challenged because of their limited scope and differing analytical methodology. In early December, 1986 we will release our report evaluating the Department of Defense's most recent profit study, The Defense Financial and Investment Review.

The government must develop a systematic method of measuring the performance of its profit policy. This document explains why a structured and consistent profit reporting program is needed and offers draft legislation for the Congress to consider in establishing such a program.

Starting in June of this year we discussed the framework for our proposal with federal officials, industry associations and individual contractors. On the basis of the advice received we revised our proposal. We are now seeking comments on our revised proposal. We are asking the organizations identified in appendix I to the draft document to provide their comments by January 16, 1987. We are also inviting comments from any other interested parties, be they individuals, associations, companies, or government agencies within the same time frame.

Your comments should be provided to the United States General Accounting Office, National Security and International Affairs Division, attention Mr. Paul Math, Associate Director, Research, Development, Acquisition and Procurement. If you have any questions please contact Mr. Chuck Smith, telephone (202) 275-8434.



Frank C. Conahan  
Assistant Comptroller General

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# Overview

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Historically, the Congress has expressed concern about profits received by government contractors. With government procurement currently amounting to more than \$199 billion a year and most of it being done with no or limited competition, the historical concern shows no sign of abating.

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## Profit Studies Demonstrate the Need for Consistent and Recurring Profit Policy Evaluations

Over the past two decades, there have been several Department of Defense ad hoc studies to assess how the Department of Defense's profit policy is working to achieve profit levels that are equitable to industry and provide sufficient incentive to invest profits into capital facilities.

To date, these profit studies have played an important role in shaping the Department of Defense's profit policy. For example, the Department implemented recommendations of its Profit '76 study to induce contractors to invest in capital facilities. However, study results were not universally accepted and produced some controversy because they used inconsistent methodologies and relied on unverified data and voluntary contractor participation.

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## Framework for a Profit Reporting Program

To correct noted weaknesses in prior studies, we are recommending a profit program requiring:

- a consistent and appropriate analytical methodology to evaluate profitability
- a means to verify contractor-furnished data; and
- mandatory contractor participation.

Specifically, we are recommending legislation to require major government contractors to annually report financial results to an independent government unit. The proposed legislation defines who will do the studies, the criteria for determining which companies will be subject to reporting requirements, and sets forth essential program requirements. The specific legislation, entitled the Profit Reporting Program (PRP), is contained in Appendix II.

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## Major Concerns Were Considered When Designing the Profit Reporting Program

Generally, we found that contractors, industry associations, federal agencies, and private sector analysts raised questions about the need for the program, the cost to implement and support the program, and the risk of improper disclosure and use of proprietary and individual company data. We share concerns about cost and safeguarding proprietary data and have attempted to address them in structuring the legislative proposal.

Our proposal attempts to contain cost by limiting (1) the companies that must participate and (2) the amount of data they are required to report. Our proposal suggests that only those contractors with more than \$50 million in negotiated prime contracts would be required to report. With this threshold, only 131 companies would be required to report data for approximately 923 company segments. If the threshold were raised fewer companies would be required to report. Our proposal provides the PRP administrator the authority to adjust the reporting threshold as long as a fixed percentage of total federal procurements are included.

With respect to the issues of proprietary data, the proposed legislation allows the PRP administrator and the Comptroller General access to sensitive contractor data. Understandably, these provisions raise contractor concerns that such data would be improperly released. To deal with this concern, the legislation imposes criminal penalties for improper release of such data.

We see the PRP as a viable way to obtain information needed to assure the effectiveness of the government's profit policy. Equitable profits are a prerequisite for a healthy and efficient industrial base needed to support government procurements.

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Figure

Figure 1.1: Department of Defense Outlays

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**Abbreviations**

|       |   |
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| CASB  | Cost Accounting Standards Board         |
| DFAIR | Defense Financial and Investment Review |
| DOD   | Department of Defense                   |
| OFPP  | Office of Federal Procurement Policy    |
| OPSA  | Office of Profit Studies and Analysis   |
| PRP   | Profit Reporting Program                |

# Introduction

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There is a long history of concern about profits earned on government contracts, particularly during wartime. Contract prices should allow contractors to recover their costs and provide a reasonable profit to compensate for investment, risk, and effort. However, concern with excessive profits has periodically prompted the Congress to legislate price ceilings, excess profit taxes, and renegotiation of contract prices.

Postperformance renegotiation of contracts was for more than 25 years the prevailing method of profit control. The Renegotiation Act expired in 1976, but bills to reinstate various forms of renegotiation have been introduced. Today no statutory guidelines exist for comprehensively addressing government contractor profits. Rather, contractor profitability has been recently evaluated by infrequent and inconsistent studies of profit data voluntarily provided by contractors. These studies have been used to evaluate whether DOD is successfully applying its structured profit policy. However, even though basically the same large companies are annually negotiating contracts valued at billions of dollars with federal civil agencies, to date studies have not addressed the profit policy goals of agencies such as the National Aeronautics and Space Administration and the Department of Transportation.

Our evaluation of the Defense Financial and Investment Review (DFAIR)<sup>1</sup>, the latest DOD study, concluded that better information could be obtained if profit studies were regularly performed, based on data provided by specified contractors, and applying consistent analytical methodology. In our report, we recommended that the Congress consider legislation establishing a program for mandatory reporting of profitability on contracts negotiated with the federal government. This report outlines how that recommendation can be implemented and provides a framework for a mandatory profit reporting program covering both defense and civil agencies.

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## Outlay Trends Since Fiscal Year 1950

The federal government awarded prime contracts valued at about \$200 billion for fiscal year 1985. Of this amount, 82 percent, or almost \$164 billion was for defense.

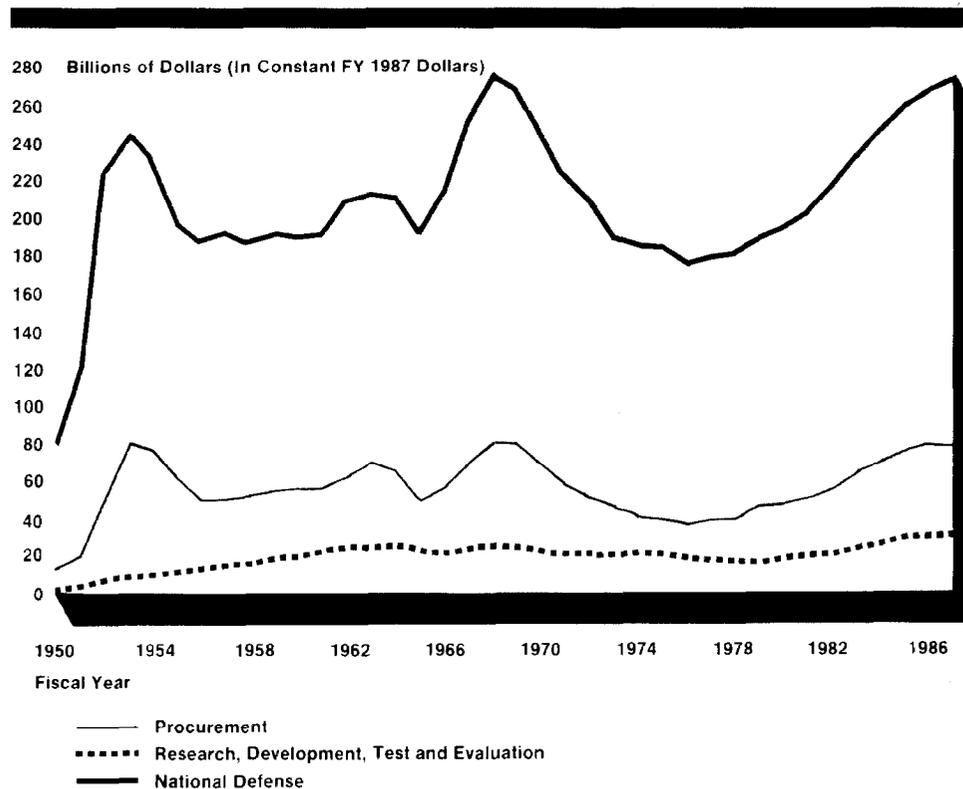
Prices for the great bulk of defense procurement are established by negotiations. Therefore, the ultimate price is not set through a competitive market. The two DOD budget categories that mainly fund negotiated contracts are "Procurement" and "Research, Development, Test and

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<sup>1</sup>GAO Assessment of DOD's Defense Financial and Investment Review (GAO/NSIAD 86- , , 1986).

Evaluation". Procurement outlays increased as a share of total defense spending dollars from 16.5 percent in fiscal year 1950 to an estimated 28 percent in fiscal year 1987. In constant 1987 dollars as estimated by DOD, procurement outlays as a percent of the total Defense budget grew by almost 70 percent and outlays for Research, Development, Test and Evaluation tripled over the past 37 years. (See figure 1.1.)

Figure 1.1: Department of Defense Outlays



## Profit Policy—A Means of Rewarding Contractors and Modernizing Industry

The preferred method of procurement for the federal government is full and open competition because the competitive forces of the market place are assumed to result in fair and reasonable prices. However, the majority of dollars the government spends, particularly for defense and space exploration, are for complex, nonstandard items which do not lend themselves to full and open competition, and must, therefore, be purchased without competition as the ultimate determinant of price. This means the government can not rely on the marketplace to produce prices that are reasonable. To assess the reasonableness of a proposed contract price in a noncompetitive environment, the government buyer

must analyze the validity of the contractor's proposed costs and reach agreement on the rate of profit. Government contracting officers employ a number of analytical techniques—such as cost and price analysis, audit, and weighted guidelines—to help them arrive at prices that they consider fair and reasonable.

It is in the government's interest to offer contractors opportunities for profit sufficient to (1) stimulate efficient contract performance, (2) not discourage companies from seeking government business, and (3) promote investment to enhance productivity, and provide for an adequate industrial base, that will allow a quick buildup of defense items in case of emergency.

DOD implements its profit policy through the use of the weighted guidelines method—a technique for computing an overall profit. Generally, government negotiators are directed to use profit objectives when negotiating a contract. Under weighted guidelines, a profit objective is determined for several profit factors. The major factors used in determining the overall profit objective for a contract are (1) profit on estimated cost (excluding cost of money), (2) profit for risk, and (3) profit for investment. The sum of the profit objectives for these factors, plus cost of money, represents the overall profit objective for a contract. Similar structured approaches are used by the Department of Energy, National Aeronautics and Space Administration and other civilian agencies. To determine how effectively negotiation and contract performance have achieved profit policy goals, various profitability measurements are necessary.

Although profitability studies have not been completed by civil agencies, studies have been performed by DOD and the services to determine the effect of profit policy. However, such studies are not required by law or regulation, have not been performed at predetermined intervals, have been based on data volunteered by contractors not verified by the government, and have not been consistent in what elements of profitability they measure and how they measure them. As a result, the same type of data has been the basis for differing conclusions. The conclusions have caused changes in profit policy, some of which have resulted in DOD paying out more profits than intended and other major profit policy changes are now being considered. The effect of profit policy is not routinely evaluated based on fixed criteria, and the result of policy changes is unknown until the next study is completed and its results analyzed and reported.

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## Objectives, Scope, and Methodology

Our objective was to develop a means of routinely providing federal contracting officials and other government offices with aggregated and analyzed contractor financial and efficiency data to help them assess the effectiveness of government profit policy.

To do this we assembled a task force of evaluators and subject area experts. The task force drafted a framework for a Profit Reporting Program and forms for reporting of contractor financial data that contained an outline of data we considered essential to implement the program, and presented our proposal to a group of consultants. The consultants, comprised of individuals with years of high level organizational experience in both the government and private sector, recommended changes to our approach which were incorporated into our framework and forms.

We reviewed the history of congressional concern with contractor profits, emphasizing legislation passed to address the issue and committee reports highlighting specific concerns.

We also reviewed prior studies of contractor profitability performed by GAO, DOD, and the services.

We selected a comprehensive grouping of interested parties to consult on our proposal which included: (1) a group of 24 of the top defense contractors, in terms of dollar value of total prime contract awards, for fiscal year 1985, (2) five industry associations, (3) 13 procurement, regulatory, and statistical agencies from throughout the federal government, (4) a federally funded research and development center, (5) the accounting firm that assisted DOD in its DFAIR, (6) a private consulting firm, and (7) the American Institute of Certified Public Accountants. We discussed our framework and reporting form with 22 of the contractors, and all of the other agencies and businesses we contacted. The comments and opinions of the people we visited were presented to and discussed with the task force and significant changes were made to both the Profit Reporting Program framework and the reporting forms. Appendix I lists the offices we visited and our consultants.

Our assignment was conducted between February and July 1986 in accordance with generally accepted government audit standards.

# A History of Government Concern With Contractor Profitability

Concerns over the level of profits government contractors earn are as old as the Nation. The Congress and the Executive Branch have responded to charges of contractors' unreasonable profits with a succession of laws, regulations, investigating committees, and studies. Except for the studies performed since 1970, past initiatives generally focused on limiting contractor profits by imposing profit ceilings or by recovering what were deemed excessive profits through taxes or renegotiation of contracts and did not address the question of whether the government's profit policy was effective or needed adjustment.

## Contractor Profits Have Been a Congressional Concern for Years

The history of efforts to deal with the issue of government contractor profits is important because it emphasizes the need for periodic studies of profitability based on a mandatory profit reporting system. Underpinning our economic system is the concept of a free market that establishes a fair price to the buyer and an equitable profit to the seller. However, because of aberrations in the marketplace, such as an escalating demand for war materials or the inability to obtain competition for many of the unique items which the government buys, the Congress, over the years, has found it necessary to address allegations of excess contractor profits. Congressional actions have included legislation which set prices, limit profits, and tax excessive profits or authorize the government to recover profits deemed excessive through renegotiation of contracts. These measures were generally taken without adequate information because it was not available.

## Early Legislation Focused on Control of Profits Through Excess Profit Taxes and Price Fixing

Before World War I the Congress made no sustained attempt to regulate the profits of arms manufacturers, perhaps because there was no permanent arms industry. Until the Navy authorized shipbuilding in the early 1880s, the Army and the Navy purchased very little in peacetime. Although legislation relating to bribery, corruption and fraud in government contracting dated to the civil war, nothing was done to comprehensively regulate profiteering.

Congress enacted legislation in 1897, to fix the price of armor plate for the Navy's ships. However, manufacturers refused to bid at that price, so when the Spanish-American War broke out in 1898 the law was first amended to increase the price and subsequently repealed in 1901.

During World War I the government attempted to control prices by instituting cost-type contracts and administrative price fixing of raw materials. More successful were two successive excess-profits tax laws

passed in 1917 and 1918. However, while yielding substantial revenues, only certain types of “excess” profits were covered and the taxes were too inflexible and too low to effectively limit profits, according to several congressional committees and other experts on the subject.

The period between the two World Wars saw much public criticism of American industry for taking in unreasonable profits during World War I. Some 200 bills and resolutions dealing with limits of wartime profits were introduced in the Congress. The Vinson-Trammell Act of 1934 limited profits on naval ship and aircraft contracts to 10 percent of the total contract price, and was later extended to Maritime Commission contracts for merchant ships, and to Army aircraft contracts, with 12 percent profit allowed on aircraft.

Senator Gerald Nye’s Committee was at work in the mid-1930s to investigate the munitions industry. The Committee noted that the War and Navy Departments had practically no information on costs of war production or on profits, making it hard for contract negotiating officers to evaluate estimates from industry.

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## World War II—More Legislation

With the war’s outbreak in Europe and the rising defense procurement in the United States, the Congress passed the Excess-Profits Tax Act of 1940, mainly as a revenue measure. The Act suspended the profit limitations under Vinson-Trammell, which appeared to be impeding the placement of defense contracts.

The Supreme Court said in a 1942 opinion on *United States vs. Bethlehem Steel Corporation*

“... if the Executive is in need of additional laws by which to protect the nation against war profiteering, the Constitution has given to Congress...the power to make them.”

It was wartime, and there was no legislation addressing excess profits except the tax act. The Congress later passed the Renegotiation Act of 1942 enabling the government to renegotiate the price on certain defense contracts on which excessive profits were realized. Unlike the suspended profit ceiling imposed by Vinson-Trammell which covered only ship and military aircraft contractors, this law extended profit limits to war contracts generally. It led to the recapture of a reported \$11 billion in excess profits, and expired when the war ended in 1945. With the expiration and the repeal of the excess profits tax, the Vinson-

Trammell Act was reactivated and left as the only statutory control over profits.

The Congress passed the Renegotiation Act of 1948 to reinstitute renegotiation on a limited basis. Vinson-Trammell was not applicable to contracts subject to the 1948 Act. For many years renegotiation was the prevailing method for recovering excessive profits. Coinciding with the involvement in Korea, the Renegotiation Act of 1951 created a Renegotiation Board and extended the review of government defense contracts, seen as too profitable, to contracts with defense-related civil departments and agencies and broadened the category of contracts not subject to Vinson-Trammell but did not repeal it. The controversial Renegotiation Act was reauthorized repeatedly before it expired in 1976. The Renegotiation Board did not receive an appropriation in 1979 and ceased operation.

When the Renegotiation Board ceased operations, the Vinson-Trammell Act once again became effective. The Congress abolished the peacetime application of Vinson-Trammell in 1981 and provided that in wartime, the President would have the discretion to set limits on contractor profits.

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### Congress Requires More Accurate and Consistent Cost Data

During the 1960s, the Congress took a hard look at contractor costs, particularly costs for large defense contracts, and in 1962 and 1970 passed two laws intended to ensure better information on contractor costs.

Because of concern over some contractors inflating their cost estimates and obtaining excessive profits, the Congress passed the Truth-in-Negotiation Act of 1962. It requires contractors to certify that their cost or pricing data is current, accurate, and complete, and authorizes the government to recover any overcharge attributable to defective data. Although the Act's effectiveness has been questioned and its implementing regulations in DOD have been criticized, Truth in Negotiations is clearly a useful tool for obtaining good data for negotiations which in turn is used as a basis for determining individual contract profit objectives.

During the late 1960s, cost measurements applied to government procurements by contractors were being severely criticized. The criticisms centered on the contractors' ability to use any generally accepted method of determining costs. To build more consistency into cost accounting practices for government contracts, Public Law 91-379 was

enacted in August 1970 creating the Cost Accounting Standards Board (CASB). During its 10-year existence, the Board issued 19 separate cost accounting standards that have made it possible to achieve increased uniformity and consistency in cost accounting.

DOD procurement outlays for the Vietnam War peaked in 1968, the year the Congress' Joint Economic Committee and its Subcommittee on Economy in Government began investigating defense procurement and publicizing cost overruns. The Subcommittee's 1969 report criticized the absence of comprehensive profit reports and studies and the lack of uniform accounting standards. The report also asserted that "Perhaps the most glaring fact about defense profits is that not enough is known about them."

In 1969, the pressures on the Congress to limit military spending, and growing exasperation with what some members saw as DOD's failure to report accurate data on its costs, led the Congress to address these issues in the Armed Forces Appropriation Authorization Act for Fiscal Year 1970. Among other things the Act directed GAO to make a study of the profits made by defense contractors and subcontractors. The study was made on a one time basis and our report was issued in 1971.<sup>1</sup>

This study, defining profit as a return on stockholder's equity, found little difference between profits on defense work and on commercial work for large defense contractors.

The study, citing previous analysis performed by the Logistics Management Institute, noted the concern expressed in congressional hearings that contractor capital requirements had not been considered in negotiating contract prices. Instead, profit objectives were being developed as a percentage of expected costs, which in the long run was penalizing investments in cost reducing equipment. We recommended that governmentwide guidelines be developed for determining profit objectives that emphasize consideration of the capital investment required to perform a contract. The facility capital investment factor was first included in weighted guidelines as a result of the DOD Profit '76 Study.

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## Present Situation

Statutory standards to directly regulate government contractor profits are not present, except to a limited extent on an individual contract

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<sup>1</sup>Defense Industry Profit Study (B-159896, March 17, 1971).

basis.<sup>2</sup> The expiration of the Renegotiation Board and the peacetime repeal of Vinson-Trammell, have further reduced the opportunities for government to control defense contractor profits. The determination of profit policy, therefore, is primarily left to the agencies to address administratively. Efforts in Congress to reauthorize the Renegotiation Board have been unsuccessful.

Some of the initiatives for determining and regulating government contractor profits that evolved over the years were clearly necessary and have been useful. The law establishing cost accounting standards and the Truth-in-Negotiation statute were major initiatives. However, except for profit studies conducted since 1970, none of the prior initiatives, either individually or collectively, addressed the primary objective of this report, which is to design a system to help answer the question "is the government's profit policy working?."

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## Profit Studies Since 1970

Studies of profitability on government contracts can be used to determine if profits on government business are in line with the goals of government profit policy. Studies can also be used to find out whether profitability on government contracts is comparable with commercial contractors for similar goods and services. The aggregate profitability of contractors supplying goods and services primarily to civil agencies of the federal government has not, as far as we can determine, been studied. However, over the past 15 years the profitability of defense contractors has been the subject of five separate studies. Such studies have provided valuable data and information on this complex and sensitive issue. However, the studies have been based on data not verified by the government, volunteered by contractors willing to participate in the study, and the data has been analyzed using various methodologies. As a result, study conclusions have been inconsistent and the results have been criticized because of the inconsistent or inappropriate methodologies that have been used.

Following the congressionally mandated GAO study, four separate studies have been performed, two by DOD—Profit '76 and the Defense Financial And Investment Review (DFAIR)—, one by the Air Force Systems Command, and one by a consultant for the Navy. All the studies

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<sup>2</sup>Cost-plus-fixed-fee contracts are limited to a 15 percent fee on estimated costs for experimental, development, or research work, and 10 percent for other types of work. Cost-plus-incentive-fee and cost-plus-award-fee contracts are similarly limited but the limits may be waived. Fees for architect engineering services are limited to 6 percent of the estimated cost.

compared the profitability of government work to commercial work and some resulted in changes to government profit policy.

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### Inconsistent Study Methodology Produces Different Profitability Conclusions

Profitability measures derived from aggregated financial data supplied by government contractors have produced different conclusions depending on how the measures were calculated and what time period was analyzed. For example, DFAIR concluded that between 1970 and 1979 the return on assets (ROA) for defense contractors, on defense work, was approximately the same as the ROA earned by durable goods manufacturers; for the period 1980 to 1983 defense contractors' ROAs were slightly higher. If DFAIR had subtracted government progress payments from the asset base to compute the ROA, as DOD did for Profit '76, it would have concluded that between 1970 and 1979 defense contracting was 35 percent more profitable than commercial manufacturing, when defense contractors and commercial manufacturers earned 19.4 percent and 14.4 percent respectively. For the period 1980 to 1983 the profitability gap increased as defense contracting became 120 percent more profitable earning 23.3 percent ROA versus 10.6 percent for commercial manufacturers.

Data from the defense studies covers a 15 year time frame, with some of the studies overlapping in coverage, which is enough time to identify profitability trends. However, because criteria and methodology for the studies have been inconsistent, and because the most recent studies have not built upon earlier studies, trends cannot be accurately noted. A review of the four defense studies highlights the differences:

- Each study covered a different sample of government contractors with no standard criteria for their selection.
- Each study used a different methodology to analyze contractor profitability.
- The two most comprehensive studies, Profit '76 and DFAIR, were based on data not verified by the government and volunteered by contractors. A significant number of contractors refused to participate in either study and several provided data that were not usable.
- Each study was performed on an ad hoc basis and the length of time between studies varied.
- For the Navy study, annual financial reports were used to determine profitability. Although these reports are valuable for their intended purpose, which is to inform the investing public, they are not adequate for profitability studies because government business segments are not consistently defined.

All these differences have contributed to a problem in establishing a reliable data base from which to observe profitability trends and make profitability comparisons. This is essential if reliable profit studies are to be undertaken and profit policy is to be revised.

Although the four defense studies conceptually used many of the same analytical ratios to compute profitability, the components of the ratio were not always the same for each study. Appendix VI highlights the different profitability measures used and the conclusions reached on the relative profitability of government versus commercial work.

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## Profit Studies and Profit Policy Changes

As a result of Profit '76, DOD added a new incentive to its profit policy—a percentage of the total profit objective for contractor investment in facilities capital. To ensure that the addition and the concurrent introduction of Cost Accounting Standard 414 (Cost of Money) would not result in increased profit levels, DOD reduced the objective allowed for cost related policy elements. DOD increased the share of the total profit objective for facilities capital in 1980. However, it did not make further offsets to cost related items. The result could cause an unintended increase in total profits of \$1.4 billion in 1 year. This problem was not uncovered until DFAIR was completed. DOD is planning to introduce major changes to its profit policy in early 1987. These changes allocate almost half of the total profit objective for investment and greatly reduce the amount of profit based on cost. The new policy is also intended to reduce overall profit levels. Because DOD is not required to routinely evaluate the effect of its policy changes, the results of these changes will not be known until the next ad hoc study is completed.

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## Conclusions

Profits earned on government contracts have been and probably always will be a subject of interest to the Congress, the President, and the American people. History suggests that such interest has increased as there is substantial growth in DOD expenditures. This interest centers on the defense industry because it consumes such a large share of the total federal procurement dollars; however, profitability of civil agency contractors is also important. Profit ceilings have been removed from the Vinson-Trammell Act and the Renegotiation Act expired in 1976 reducing government awareness of contractor profitability. Although recent profitability studies have shed some light on the effectiveness of government profit policy, there is no requirement to perform such studies on a recurring basis. If various government agencies periodically

study profitability, the results of the studies will be subject to interpretation and misunderstanding unless the studies are based on a fixed criterion, and the data provided for the studies are verified by government auditors. We believe it is feasible and desirable to statutorily require periodic profitability studies that

- Provide reliable data to monitor contractor profits and investment.
- Provide a basis for reliable comparative studies, both historical and inter-industry, and
- Establish a reliable basis for modifying profit policy as required.

# A Profit Reporting Program for Government Contractors

The proposed Profit Reporting Program (PRP) will allow the government to gather data and study contractor profitability on a regular and consistent basis for the first time. The proposed PRP requires the minimum amount of data and analysis needed to study company profitability. In configuring PRP, the requirements of previous profit studies, and the capability of the companies to provide the data and the costs or providing such data were considered.

Under PRP, the larger government contractors will be required to submit annual financial data to a central government office for the purpose of

- studying levels of profitability and efficiency of the companies and comparing their profitability with companies in the private sector which provide similar goods and services;
- reporting the results of the studies to the President of the United States, Congress, and heads of executive agencies;
- providing indications when changes to the profit policy may be needed; and
- recommending to procuring activities within executive agencies, changes needed in profit policies to achieve stated objectives.

Additionally, the PRP will serve to increase public trust and confidence in the government's procurement system.

The costs of the PRP are unknown at this time for several reasons as discussed on page 35. However, data requirements, which many company representatives said affect costs, are substantially less for PRP compared with DFAIR and other profit studies. We believe that in the long run PRP costs will be reasonable in comparison to the benefits—ensuring implementation of profit policies which are designed to provide adequate profits to contractors and to minimize the costs of the goods and services procured by the government.

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## Framework of the Profit Reporting Program

The PRP structure is contained in the draft PRP bill. (See Appendix II.) It would require the President to establish an Office of Profit Studies and Analysis (OPSA) within the executive branch, headed by an Administrator. The bill defines the principal responsibilities of the Administrator, contains criteria for determining which companies will be subject to PRP, and sets forth other essential requirements of the program.

The bill requires the Administrator to establish a uniform system for collecting company data, analyzing it, and reporting on the results of the

analyses. Companies receiving awards or payments from the federal government on negotiated contracts totaling \$50 million or more in 1 year will submit financial data to the Administrator at the segment<sup>1</sup> level.

Based on the financial data, the Administrator will analyze at least once every 3 years profitability and investment of companies using various ratios. The Administrator will then aggregate the study results and issue a report by December 31 of each year. The reports will contain recommendations to revise or develop profit policy when necessary and be sent to the President, Congress, and the Comptroller General. The Administrator is required to keep all company data confidential, that is, no company specific data is authorized to be disclosed.

The draft bill contains several provisions to ensure the reliability of the company data and profitability studies. They include validation of the data by the companies' certified independent public accountant in accordance with generally accepted auditing standards and review of the supporting records and documents by the OPSA. The Comptroller General is authorized to review and evaluate the profitability studies and all supporting records and documents as needed.

The Administrator is permitted to arrange with another government activity or to contract with a third party for assistance in carrying out PRP functions.

The proposed bill does not define all the data needed to do the studies. Rather, it authorizes the OPSA to prescribe the precise information required for the analysis.

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## Administration and Regulation of the PRP

The President will initiate PRP by designating an activity and Administrator to assume the functions of the OPSA. In addition to implementing the PRP as mandated in the proposed bill, the Administrator will be responsible for issuing rules and regulations to administer and regulate the program. Among these, the Administrator will need to establish safeguards to protect the confidentiality of company data as provided in the draft bill. The Administrator can, when deemed appropriate, revise

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<sup>1</sup>Segments are defined as a division, product department, plant, or other subdivisions of a company usually identified with responsibility for profits and/or producing a product or service. A company that is not subdivided into segments will be considered as a segment. Segments for the purposes of the PRP are based on the criteria developed by the Cost Accounting Standards Board (CASB).

the company dollar reporting threshold, exclude certain classes of companies, and exempt company segments from reporting.

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**Who Should Administer PRP?**

The PRP functions could be performed by each executive agency that buys goods or services or by one of several other government activities. From the standpoint of uniformity and consistency of the studies and in the application of profit policy, centralized administration of the PRP should be more efficient and effective. Having one office perform the studies provides the additional advantage of a single point of contact for the companies to deal with and should minimize the opportunities for unauthorized disclosure of company data.

Consideration should be given to delegating PRP responsibilities to the Office of Federal Procurement Policy (OFPP) within the Office of Management and Budget. OFPP is responsible for formulating procurement policy for all federal agencies and can demonstrate an independent attitude in evaluating profit policy because it does not award contracts for goods or services.

We discussed implementation of the PRP with representatives of some government activities that collect, process, and publish statistical data obtained from the private sector. These included the Federal Trade Commission, Bureau of the Census, Bureau of Labor Statistics, and the Bureau of Economic Analysis. Representatives of these agencies stated they would not want to assume the role of the OPSA because PRP would not be compatible with their mission. We have no opinion as to whether PRP would adversely affect the agencies' missions; however if it is found that missions are not affected we believe it may be feasible for one of these activities to assist the OPSA in collecting or processing data reported by the companies.

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**Ensuring Confidentiality of Company Data Is Important**

Disclosure of contractor specific data could seriously affect the competitive or other advantages that a company may enjoy. Confidentiality or protection of data was a major concern of the companies that we visited. Under PRP, access to company data will be limited to OPSA (or its agent) and the Comptroller General and prohibits any officer, employee, or contractor of the OPSA or the GAO from disclosing any contractor specific data to any individual or establishment not specifically authorized by the PRP Act (See Appendix II). This prohibition includes all others in any branch of the Federal Government. Penalties of fines or imprisonment or both are imposed for unauthorized disclosure of data.

The Administrator will be responsible for ensuring that adequate safeguards are established and maintained by the OPSA or a third party over the data received and files created from the data.

Strong measures are needed to ensure industry their data will be protected. Confidentiality provisions in the DOD studies prohibited disclosure of contractor specific data. For government agencies authorized in the bill, PRP substantially expands access to both government and commercial company data and it provides enhanced guarantees to industry over their sensitive financial information.

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**Administrator May  
Regulate the Number and  
Type of Companies and  
Segments That Will Be  
Required to Report Data**

An analysis of fiscal year 1985 procurement data showed that 321 companies, including over 1,126 segments, received \$10 million or more of negotiated prime contracts from defense and civil agencies. Two very important items to consider when selecting a reporting sample are (1) ensuring that, in terms of total dollar value, a majority of the government's prime contract awards are included and (2) including the companies that are annually negotiating the largest contracts and/or receiving the largest payments on prior year negotiated contracts. To ensure adequate coverage the PRP studies should always be based on at least 60 percent of the dollar value of the annual prime awards from defense and civil agencies, but the specific number of companies required to report segment data should be a decision of the OPSA. For example, if the reporting threshold for 1985 were set at \$50 million in negotiated prime contracts, 131 companies would be required to report data for 923 segments;<sup>2</sup> if the threshold were raised to \$100 million, 90 companies would be required to report 828 segments. The former would include about 67 percent of the total prime awards for 1985, the latter about 64 percent.

We are proposing that companies receiving \$50 million or more in negotiated government contract awards or payments in 1 year be subject to the PRP. This threshold includes approximately the same number of companies requested to provide data for prior DOD studies, and because the amount of data required for the PRP is significantly less than that required for DPAIR and Profit '76, the OPSA will have less data to control and analyze than previous studies.

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<sup>2</sup>Does not include segments for 15 of the 131 companies which do business solely with civil agencies, since they are not subject to CASB requirements. Under PRP, they would apply segment criteria for reporting purposes.

However, the Administrator is authorized to revise the \$50 million threshold if deemed appropriate, which will result either in an increase or decrease in the number of covered companies. The Administrator's only restriction is that the number of companies reporting must account for at least 60 percent of the total dollar value of the prime contracts awarded.

The Administrator also has the authority to exclude certain companies based on types of products or services provided. For example, these could be nonprofit companies or manufacturers of products whose prices are set by law, regulation, or whose prices are based on competitive market conditions.

Further, not all company segments need to report. Companies can submit a request for waiver to the Administrator to exclude a segment or segments if the volume of government business for the segment is less than 10 percent of the companies' total government business. The Administrator may approve the request upon a determination that the waiver would not substantially affect the profitability studies.

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## Profitability Analyses, Reporting, and Data Requirements

Companies subject to PRP are required to submit selected income statement and balance sheet data to the Administrator annually. The Administrator will analyze the companies' profitability and certain elements of efficiency and issue reports, at least once every 3 years.

The data submitted by the companies is required to be attested to by their independent certified public accountant and reconciled to their current financial statement filed with the Securities and Exchange Commission. The Administrator is also authorized to review and verify the companies' and certified public accountant's records and documents.

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## Profitability Studies

The PRP studies are intended to provide overall indicators and information on how well the government's profit policy is working. Based on the financial data submitted by the companies/segments, profitability under PRP will be studied by computing return on assets and other ratios as the Administrator deems appropriate. Other analyses can include the return on sales and capital to labor ratios. (A discussion of the ratios and their use in measuring profitability and efficiency is contained in Appendix IV.)

Profitability studies will be performed at least once every 3 years. Using cumulative data will help reduce the effect of fluctuations in profits and other economic conditions that affect profits. The data will provide a better basis for measuring segment profitability, making the profitability comparisons described below, and evaluating the effects of profit policies.

Profitability data (ratios) will be aggregated for similar companies/ products and comparisons of the companies' profitability made

1) under its government negotiated cost and fixed price contracts where cost of pricing data were submitted and with all of its other business, and

2) with profitability of companies in the private sector providing similar goods and services.

Over a period of time, these analyses should provide information on how well the government's profit policy is working by assessing

- whether variations between levels of profitability are reasonable; (See Part IV, Appendix IV)
- how the use of pricing (for example, the use of cost versus fixed price contracts) motivates company efficiency and the relative efficiency between the companies' government and commercial business; (See Part IV, Appendix IV)
- the relationship of payment policy (for example, progress payments) and contract pricing; (See Part IV, Appendix IV) and
- the companies' capital investment and the relative investment between the companies' government and commercial business. (See Part V, Appendix IV)

In addition to the regular profitability studies, the Administrator is authorized to make special studies as appropriate. These may include studies by certain classes of products, companies, federal agencies, or on the effectiveness of government financing techniques.

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## Administrator's Reporting Requirements

The Administrator is required to submit reports on the profitability studies and any other interim studies that may be made to the President, the Congress, and to the Comptroller General. The reports will include those actions or recommendations the executive agencies or the Congress need to take to change or modify profit policies to ensure that

profit policy objectives are being met. No specific format for the reports is defined under PRP, but the Administrator is required to ensure that the reports will contain only aggregated data and other safeguards to prevent disclosure of sensitive contractor data.

The reports are to be issued no later than December 31 of each year. Annual reporting is suggested because, even if a study was not done the year before, the Administrator may have taken actions or made recommendations which would be of interest to the Congress.

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### Company Financial Data Reporting Requirements

The bill requires companies to report financial data for each segment in a manner that distinguishes between its government business and all other business. The data submitted will include a reconciliation with the financial statements filed with the Securities and Exchange Commission. This requirement will ensure that the data submitted to the OPSA is based on the companies' financial systems and is consistent with the companies' annual financial statements and that any differences are adequately explained.

Companies will report segment data separately for negotiated cost reimbursable contracts, and negotiated fixed-price contracts where cost or pricing data were supplied, and all other company business.

Income statement and balance sheet data should be broken out for each type of contract and for commercial work and include such items as: sales, cost of sales, net operating results for the income statement, both current and fixed assets, and accounts receivable for the balance sheet. Some information will be requested on a segment-wide basis, such as depreciation cost, labor cost, cost of money, and number of employees.

To enable the Administrator to make studies and comparisons of profitability by product classes or federal agencies, companies will be asked to report the two major products sold to the government using the Office of Management and Budget 3-digit Standard Industrial Classification codes<sup>3</sup> and also to identify the main federal agencies for whom the products were made.

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<sup>3</sup>The Standard Industrial Classification codes are used to classify establishments or kind-of-activity units on the basis of their primary activity which is determined by the product or group of products produced or handled or services rendered. The major activity of an establishment is assigned a 2-digit code. A 3-digit code is assigned to the industry groups within the major activity (assigned a 2-digit code). Chemicals and allied products is a major activity; industrial inorganic chemicals, drugs, soaps, etc., are industry groups (assigned a 3-digit code) within the major activity.

A proposed format for reporting the financial data is contained in Appendix III.

Segments Are the Most  
Appropriate Level for Reporting  
Company Financial Data

Many companies have numerous divisions and subdivisions of which all or only some may perform work for the government. We believe segments like those used by the CASB are the most feasible and appropriate level for reporting company financial data because they are discrete reporting units which are frequently aligned with the companies' divisions, subdivisions, or products. We also believe that reporting by segments will provide a uniform and consistent data base for studying profitability since segments are required (1) to be used by companies doing business with DOD and some civil agencies and (2) segments are required to follow a set of uniform cost accounting practices. Some companies are not now required to establish segments, those companies would apply the CASB type segment criteria, for reporting purposes only. (See footnote, page 19)

The feasibility of using CASB segments for reporting was demonstrated in the DFAIR study. That study successfully obtained financial data at the CASB segment level. Further, representatives of most of the companies that we interviewed confirmed that they could report financial data by the CASB segment. Some stated that CASB segments were the most appropriate form for submitting the data.

Validation of Company Data

To establish the validity of the company data, PRP provides for the companies' independent certified public accountant to attest to the data and authorizes the Administrator to review and verify company and CPA data.

Attestation requirements are set forth in the American Institute of Certified Public Accountants Statement On Standards For Attestation Engagements, published in March 1986. As defined in that publication the attest function is used to express a conclusion about the reliability of a written assertion that is the responsibility of another party.

Attestation can take three forms—examination, review, or use of agreed-upon procedures. The use of agreed-upon procedures requires the asserter (company) and user (government) to establish the procedures the independent certified public accountant must follow in forming an opinion on the company's data.

Agreed-upon procedures is appropriate for the PRP. The scope of work is less than required by an examination. The Administrator will be responsible for establishing the procedures with the companies and will be in a position to limit the independent certified public accountant's effort to the minimum needed to assure that the data are reliable and thereby minimize attestation costs.

It is also necessary for the Administrator to have access to company records to ensure that the requirements for submitting data are interpreted and reported on a consistent basis. This access is also needed to ensure the integrity of the data and to determine what changes are needed to improve the system.

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## Making the PRP Work

Since disclosure of company data is prohibited and profitability reports will contain only aggregated data, several provisions have been included in PRP to ensure the integrity of the program. The provisions requiring companies to have their independent certified public accountant attest to the data submitted and for OPSA to review and verify supporting company and independent certified public accountant records and data are for this purpose.

However, to further ensure the Congress and the public that the PRP studies are providing reliable information on the relationships of government contractors profitability and profit policies, PRP legislation authorizes the Comptroller General when deemed appropriate to make independent reviews of the profitability studies and supporting records and documents of the independent certified public accountants and contractors. The Comptroller General will assess the adequacy of the OPSA studies and may do limited testing of supporting company and independent certified public accountant data.

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## Cost of the PRP Cannot Be Determined Now

Most company representatives said that implementing the PRP would be costly but added that they could not provide a cost estimate until the specific requirements of PRP and effect on their systems are evaluated. They said costs will be directly related to

- the number of company segments subject to reporting;
- the extent of the data requirements and allocations of costs to the breakouts required, that is, by type of contract, commercial business, and so forth, availability of the data from the companies' accounting and financial reporting systems; and

- independent certified public accountant attestation fees.

Because neither DOD or the contractors we visited have records detailing the costs of previous studies, we were unable to make cost estimates for the PRP based upon prior study experience. PRP, as structured, requires less company data than prior studies obtained, and after initial system set up costs, annual data submission for PRP, especially if done in conjunction with certification of annual financial statements, may be more efficient than reconstructing data from several prior year segment records, as was the case for previous studies. DFAIR and Profit '76 collected 9 to 10 years of data. This required considerable time, effort, and cost for the contractors to gather the data, as well as for reviewing, reporting and processing the data. The DFAIR study recommended that the availability and quality of data would be improved and obtained with less effort if the period of time between studies was 3 to 5 years.

We are proposing that company data be submitted annually. Annual data will allow the OPSA to perform profitability studies on a more frequent basis if the Administrator believes it is appropriate, and to also make special interim studies. Many company representatives said that the greatest costs would be incurred in setting-up the PRP system; but some added that recurring costs should be less. Thus, we believe that the additional cost of requiring annual company reporting, rather than less frequent reports, should not be significantly higher.

The costs to the government will depend on staff, space, and equipment needed to collect, process, analyze, and issue profitability reports. These can vary depending on whether the functions assigned to the Administrator and OPSA are delegated to an existing agency or whether a new office is created for this purpose; whether other federal agencies that collect and analyze data received from companies (Federal Trade Commission, Bureau of Economic Analysis, Bureau of the Census, and others) can perform or assist in performing these functions for the OPSA; or whether part or all of the data collection and analyses are contracted out to a third party.

In summary PRP parallels but attempts to improve upon the profit studies made in recent years. Under the proposed system contractors would report less financial data, and avoid the costs associated with reconstructing older periods of financial data. Some major contractors who were not asked to or declined to voluntarily report would be required to report under PRP. Study requirements and data aggregation

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**Chapter 3**  
**A Profit Reporting Program for**  
**Government Contractors**

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costs would be similar to previous studies but would be done more frequently. Audit verification of the company data and the final study would be more comprehensive. These enhancements will improve the quality of the studies and the underlying data.



# Offices, Contractors and Other Parties Visited

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## Government Contractors

AEL Industries, Inc., Lansdale, Pennsylvania  
The Boeing Company, Seattle, Washington  
Burroughs Corporation, Detroit, Michigan  
Dynalectron Corporation, McLean, Virginia  
Eastman Kodak Company, Rochester, New York  
Emerson Electric Company, St. Louis, Missouri  
Fairchild Industries, Inc., Chantilly, Virginia  
General Dynamics Corporation, St. Louis, Missouri  
General Electric Company, Fairfield, Connecticut  
General Motors Corporation, Detroit, Michigan  
Hazeltine Corporation, Commack, New York  
Litton Industries Incorporated, Beverly Hills, California  
Lockheed Corporation, Calabasas, California  
Martin Marietta Corporation, Bethesda, Maryland  
McDonnell Douglas Corporation, St. Louis, Missouri  
Raytheon Company, Lexington, Massachusetts  
RCA Corporation, Fairfield, Connecticut  
Rockwell International Corporation, Pittsburgh, Pennsylvania  
Sun Chemical Corporation, Merrimack, New Hampshire  
Texas Instruments Incorporated, Dallas, Texas  
Textron, Inc., Providence, Rhode Island  
Westinghouse Electric Company, Pittsburgh, Pennsylvania

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## Industry Associations

Aerospace Industries Association of America Inc., Washington, D.C.  
Electronic Industries Association, Washington, D.C.  
Federal Executives Institute, Washington, D.C.  
Machinery and Allied Products Institute, Washington, D.C.  
National Security Industry Association, Washington, D.C.

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## Federal Agencies

Department of Commerce, Washington, D.C.  
Bureau of Economic Analysis, Department of Commerce, Washington, D.C.  
Bureau of Census, Department of Commerce, Washington, D.C.  
Department of Defense, Office of the Assistant Secretary (Acquisition and Logistics), Washington, D.C.  
Defense Contract Audit Agency, Department of Defense, Cameron Station, Alexandria, Virginia  
Defense Systems Management College, Fort Belvoir, Virginia  
Bureau of Labor Statistics, Department of Labor, Washington, D.C.  
Department of Transportation, Washington, D.C.  
General Services Administration, Washington, D.C.

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**Appendix I  
Offices, Contractors and Other  
Parties Visited**

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National Aeronautics and Space Administration, Washington, D.C.  
Office of Procurement Policy, Office of Management and Budget,  
Washington, D.C.  
Federal Trade Commission, Washington, D.C.  
Securities and Exchange Commission, Washington, D.C.

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**Federally Funded  
Research and  
Development Center**

Logistics Management Institute, Bethesda, Maryland

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**Public Accounting**

Touche Ross and Company, Washington, D.C.  
American Institute of Certified Public Accountants, Washington, D.C.

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**Consulting Firm**

RRG Associates, Arlington, Virginia

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**Consultants**

Admiral Stanley S. Fine (Ret.), McLean, Virginia  
Mr. Robert C. Moot, Annandale, Virginia  
Mr. Tom Morris, Bethesda, Maryland  
Mr. Barry Shillito, La Jolla, California

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# Government Contractor Profit Reports Act of 1986

## **A Bill**

To improve Federal Government accountability over profits made by contractors under negotiated Federal contracts by requiring periodic profitability studies, among other things.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

## **Short Title**

**Sec. 1.** This act may be cited as the "Government Contractor Profit Reports Act of 1986."

## **Declaration of Purpose**

**Sec. 2.** It is the policy of the Congress that the procurement of goods and services by the Executive Branch of the Federal Government be conducted in an economical, efficient, and effective manner. This policy can be fulfilled only if the Congress and the executive agencies are informed of the level of profits and relative efficiency of government contractors under negotiated contracts. The purpose of this act is to provide the Federal Government with the information needed to develop profit policies and to assist procuring agencies in negotiating contracts which (1) provide profits that encourage related capital investment and (2) are reasonable in light of, among other things, the profits contractors earn on other government and similar private sector business.

## **Sec. 3. Definitions**

In this act—

- (1) "Office of Profit Studies and Analysis" means an office in the Executive Branch responsible for coordinating the implementation of this act;
- (2) "Administrator" means the head of the Office of Profit Studies and Analysis;
- (3) "covered company" means a company which received negotiated government contract awards and modifications or receives payments, from the federal government, the total of which amounts to at least \$50 million in a year; and

(4) "segment" means a division, product department, plant, or other subdivision of a covered company usually identified with responsibility for profit and/or producing a product or service; and reports directly to an office of the company which (i) is responsible for directing or managing two or more divisions, product departments, plants or subdivisions, and (ii) typically provides policy and guidance to segments in their operations. A covered company is, for the purpose of this act, considered a segment if it is not segmented.

**Sec. 4. Responsibilities of the Administrator of the Office of Profit Studies and Analysis**

(a) The President shall establish in the Executive Branch an Office of Profit Studies and Analysis, to be headed by an Administrator appointed by the President.

(b) The Administrator shall—

- (1) develop a uniform reporting system to govern the submission of information by Government contractors under section 5 of this act;
- (2) establish criteria and procedures for the profit studies to be conducted under section 6 of this act; and
- (3) provide recommendations to revise and develop profit policies relating to the negotiation of Government contracts.

(c) Notwithstanding section 3(3), the Administrator by regulation—

- (1) may exclude classes of Government contractors from coverage as covered company based on the nature of, or the types of products and services provided by the class; and
- (2) may revise the dollar threshold contained in section 3(3) as the Administrator deems necessary to fulfill the purposes of this act. Revisions to the dollar threshold shall be designed to ensure that the total value of all contracts that were awarded by the federal government to the companies covered under the revised threshold is at least 60 percent of the total value of all contracts awarded by the federal government.

(d) The Administrator is authorized to contract with a firm or organization, and to enter into an agreement on a reimbursable basis with an agency, for services to assist the Administrator in carrying out the requirements of this act.

**Sec. 5. Annual Reporting by Covered Companies**

(a) A covered company shall annually transmit to the Administrator balance sheet and income statement information reflecting the financial position and operations of each of its segments, and such accompanying information as may be required, including investment data and labor expenses. A covered company shall report for each segment the required financial information in a manner which distinguishes between the information related to its negotiated Government contracts awarded on the basis of cost and pricing data and the information related to all of its other business. The information transmitted shall include a reconciliation with the financial statement the covered company filed with the Securities and Exchange Commission, and such other information as may be necessary to explain the reconciliation.

(b) The Administrator shall prescribe by regulation the information required by subsection (a). A company shall provide the information in such form and at such time as the Administrator requires. A covered company may request that the requirement in subsection (a) for the company to report information for each of its segments be waived for any segment which contributed less than 10 percent of the revenues the covered company received in the preceding year from contracts with the Federal Government. The Administrator shall grant the request if the Administrator determines that the information concerning the segment for which a waiver is requested would not substantially contribute to the analysis required by section 6. The Administrator shall not require a company to report information for a segment to the extent the President determines that disclosure of such information would be detrimental to the success of a classified project and injurious to the national security. The Administrator shall identify all waivers granted under this subsection in the annual report required by section 7 of this act.

(c) A covered company shall have the independent certified public accountant who opined on the fair presentation of the company's annual financial statements attest to the accuracy of the information furnished under subsection (a). A covered company shall include the attestation by the independent certified public accountant in the transmittal to the Administrator required by subsection (a).

(d) The Administrator shall prescribe standards and procedures for the attestation required by subsection (c).

(e) The Administrator, in coordination with the Office of Federal Procurement Policy, shall take the necessary steps to ensure that compliance with the requirements of this section is a condition of every contract negotiated with the United States.

### **Sec. 6. Profit Study Requirements**

(a) The Administrator shall conduct at least once every 3 years a study of profits made by covered companies under negotiated contracts with the United States,

(b) Based on an aggregation of the information provided under section 5, a study shall contain a determination of the profitability of segments of covered companies providing the Federal Government with goods and services under negotiated government contracts based on cost and pricing data. Profitability shall be determined by calculating the return on assets of the segments and by such other measures of profitability as the Administrator determines to be appropriate to achieve the purposes of this act.

(c) The study shall provide a comparison of the profitability of the segments, as determined under subsection (b), with—

- (1) the profitability of the segments under all of their other business; and
- (2) the general profitability of other companies in the private sector for similar goods and services.

(d) To the extent applicable, the study shall include analysis of—

- (1) whether variations between the levels of profitability are reasonable under the circumstances;
- (2) capital investment and the relative investment between the covered companies' Government and commercial business;
- (3) the use of pricing to motivate cost efficiency and the relative efficiency between the covered companies' Government and commercial business;
- (4) the relationship of payment policy and contract pricing, and
- (5) any other information useful to understanding the comparisons required by subsection (c).

(e) In addition to the information provided under section 5, a covered company shall provide to the Administrator any additional information the Administrator determines is necessary to make the determinations and perform the analysis required by this section.

### **Sec. 7. Profit Study Reporting**

No later than December 31 of each year, the Administrator shall transmit a report to the President, the Congress, and the Comptroller General of the United States. The report shall identify any studies conducted in the preceding fiscal year, the relationship of the findings resulting from such studies to existing profit policies, and any actions taken or to be taken relating to the responsibilities of the Administrator under this act.

### **Sec. 8. Access to Information**

The Administrator shall have access to all papers, documents, and records of a covered company and its independent certified public accountant relating to the information furnished under sections 5 and 6(e). The covered company and its independent certified public accountant shall permit the administrator to make and retain copies of such papers, documents, and records, and shall make available such officers and employees as the Administrator requests.

### **Sec. 9. Comptroller General Review**

The Comptroller General is authorized to review a profit study conducted under section 6 and shall have access to all papers, documents, and records of the Administrator used in conducting the study, and of the company and its certified public accounting used in providing the information required under sections 5 and 6(e). The Administrator, covered company and its independent certified public accountant shall permit the Comptroller General to make and retain copies of such papers, documents, and records, and shall make available such officers and employees as the Comptroller General requests.

### **Sec. 10. Confidentiality**

Notwithstanding any other provision of law—

(1) any officer, employee, or contractor of the Office of Profit Studies and Analysis or the General Accounting Office who publishes or otherwise discloses any information provided by a covered company under section 5 or section 6(e) in a manner which allows

the covered company to be identified to any individual or establishment not specifically authorized by this Act to receive such information, shall be fined not more than \$10,000, or imprisoned not more than three years, or both,<sup>1</sup> unless such information is made publicly available by the covered company.

(2) No person receiving information provided by a covered company under section 5 or section 6 (e) shall be subject to subpoena or other legal process to compel disclosure of information which is prohibited by paragraph (1).

**Sec. 11. Authorization of Appropriation**

There is authorized to be appropriated to the Office of Profit Studies and Analysis such sums as are necessary to carry out this act.

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<sup>1</sup>The penalties included in section 10 are for illustrative purposes.

# Proposed Form for Contractor Reporting of Financial Data

**United States Government Contractor's Annual Reporting Form**  
**Schedule I - Selected Income Statement Items for the Period Ended \_\_\_\_\_, 19\_\_\_\_**  
*(In Thousands of Dollars)*

Corporation Name: \_\_\_\_\_

Segment Name: \_\_\_\_\_

Segment's Major Products Identified By 3 Digit Standard Industrial Code: Number 1 \_\_\_\_\_ Number 2 \_\_\_\_\_

Percentage of Government Sales By Federal Agency:

Number 1 \_\_\_\_\_ Number 2 \_\_\_\_\_ Number 3 \_\_\_\_\_ Number 4 \_\_\_\_\_ Number 5 \_\_\_\_\_

Percentage of Government Sales Prime Contracts: \_\_\_\_\_ Percentage of Government Sales Subcontracts: \_\_\_\_\_

**Profit Reporting Program**

**Government-Wide Negotiated Contracts\* Based on Cost and Pricing Data**

| Line No. | Financial Information                               | Cost  | Fixed | Commercial** | Segment | Footnote |
|----------|---|-------|-------|--------------|---------|----------|
|          |   | Type  | Price |              | Total   |          |
|          |   | (1)   | (2)   | (3)          | (4)     | (5)      |
| 01       | <b>Sales</b>  | _____ | _____ | _____        | _____   | _____    |
|          | <b>Cost of Sales and Operating Cost:</b>            |       |       |              |         |          |
| 02       | Cost of Sales                                       | _____ | _____ | _____        | _____   | _____    |
| 03       | Other Allowable Operating Costs                     | _____ | _____ | _____        | _____   | _____    |
| 04       | Total Operating Costs (Lines 02 + 03)               | _____ | _____ | _____        | _____   | _____    |
|          | <b>Unallowable Costs</b>                            |       |       |              |         |          |
| 05       | Interest  | _____ | _____ | _____        | _____   | _____    |
| 06       | Other Unallowable Costs                             | _____ | _____ | _____        | _____   | _____    |
| 07       | Total Unallowable Costs (Lines 05 - 06)             | _____ | _____ | _____        | _____   | _____    |
| 08       | Net Operating Results (Lines 01 - 04 -07)           | _____ | _____ | _____        | _____   | _____    |
|          | <b>Statistical Information</b>                      |       |       |              |         |          |
| 09       | Depreciation and Amortization Expense: (Memo Entry) | _____ | _____ | _____        | _____   | _____    |
|          | <b>Labor Costs: (Memo Entry)</b>                    |       |       |              |         |          |
| 10       | Segment Labor Costs                                 | _____ | _____ | _____        | _____   | _____    |
| 11       | Number of Employees                                 | _____ | _____ | _____        | _____   | _____    |
|          | <b>CAS 414 Cost of Money: (Memo Entry)</b>          |       |       |              |         |          |
| 12       | Total Imputed Cost of Money                         | _____ | _____ | _____        | _____   | _____    |
| 13       | Amount Eligible                                     | _____ | _____ | _____        | _____   | _____    |
| 14       | Amount Not Eligible                                 | _____ | _____ | _____        | _____   | _____    |

\*Sales under negotiated procurements related to U.S. Government prime contracts and subcontracts under either fixed priced or cost type contracts. Foreign Military Sales that are direct sales to U.S. Government made under negotiated contracts for eventual resale to a foreign government are included.

\*\*Sales to customers other than the U.S. Government plus sales to the U.S. Government which are not based on cost or pricing data, such as catalog or established market price items, sales of items whose prices are established by law or regulation, sales made under sealed bids, and direct sales to foreign governments are included and all other sales not included in columns (1) and (2).

**Appendix III  
Proposed Form for Contractor Reporting of  
Financial Data**

**United States Government Contractor's Annual Reporting Form**  
**Schedule II - Selected Balance Sheet Items for the Period Ended \_\_\_\_\_, 19\_\_\_\_**  
*(In Thousands of Dollars)*

Corporation Name: \_\_\_\_\_

Segment Name: \_\_\_\_\_

| Line No. | Financial Information   | Profit Reporting Program   |                  |              |               | Footnote |
|----------|---|--|------------------|--------------|---------------|----------|
|          |   | Government-Wide Negotiated Contracts* Based on Cost and Pricing Data |                  |              | Segment Total |          |
|          |   | Cost Type  | Fixed Price Type | Commercial** |               |          |
| (1)      | (2)   | (3)  | (4)              | (5)          |               |          |
|          | <b>Account Receivable (Gross)</b>   |  |                  |              |               |          |
| 01       | Billed  | _____  | _____            | _____        | _____         | _____    |
| 02       | Unbilled  | _____  | _____            | _____        | _____         | _____    |
|          | <b>Inventories (Gross)</b>  |  |                  |              |               |          |
| 03       | Common  | _____  | _____            | _____        | _____         | _____    |
| 04       | Contracts in Process  | _____  | _____            | _____        | _____         | _____    |
| 05       | Total Accounts Receivable and Inventory (Gross) (Lines 01 + 02 + 03 +04)                | _____  | _____            | _____        | _____         | _____    |
| 06       | Less: Progress Payments and Advancements  | _____  | _____            | _____        | _____         | _____    |
| 07       | Net Accounts Receivable and Inventory (Lines 05 - 06)                                   | _____  | _____            | _____        | _____         | _____    |
| 08       | <b>Other Current Assets</b>   |  |                  |              |               |          |
| 09       | Total Current Assets (Lines 07 + 08)  | _____  | _____            | _____        | _____         | _____    |
|          | <b>Tangible Fixed Assets (Facilities Capital):</b>                                      |  |                  |              |               |          |
| 10       | Equipment: Net Book Value   | _____  | _____            | _____        | _____         | _____    |
| 11       | Building: Net Book Value  | _____  | _____            | _____        | _____         | _____    |
| 12       | Land and Land Improvements: Net Book Value  | _____  | _____            | _____        | _____         | _____    |
| 13       | Total Contractor Owned Tangible Fixed Assets (Facilities Capital Lines 10 + 11 + 12)*** | _____  | _____            | _____        | _____         | _____    |
| 14       | <b>Intangible Assets: Net Book Value</b>  |  |                  |              |               |          |
|          | Total Assets  | _____  | _____            | _____        | _____         | _____    |
|          | <b>Statistical Information</b>  |  |                  |              |               |          |
| 15       | Construction in Progress (Memo Entry)   | _____  | _____            | _____        | _____         | _____    |
|          | Segment Capital Expenditures (Memo Entry)   | _____  | _____            | _____        | _____         | _____    |
| 16       | Equipment   | _____  | _____            | _____        | _____         | _____    |
| 17       | Building  | _____  | _____            | _____        | _____         | _____    |
| 18       | Land and Land Improvements  | _____  | _____            | _____        | _____         | _____    |

\*Sales under negotiated procurements related to U.S. Government prime contracts and subcontracts under either fixed priced or cost type contracts. Foreign Military Sales that are direct sales to U.S. Government made under negotiated contracts for eventual resale to a foreign government are included.

\*\*Sales to customers other than the U.S. Government plus sales to the U.S. Government which are not based on cost or pricing data, such as catalog or established market price items, sales of items whose prices are established by law or regulation, sales made under sealed bids, and direct sales to foreign governments are included and all other sales not included in columns (1) and (2).

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# Proposed Profit Policy Analysis Plan

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## I. Introduction

This appendix briefly discusses a suggested methodology for analyzing the relative profitability and efficiency of U.S. Government contractors. Both the requirements of the proposed legislation and the proposed contractor reporting forms, included as Appendix III are incorporated in this discussion.

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## II. Purpose of the Legislation

The purpose of this legislation is to enable the Office of Profitability Studies and Analysis (OPSA) to measure the relative profitability and efficiency of U.S. Government contractors. The results of the periodic profit/efficiency studies performed by OPSA could then be used to feed-back to the profit (payment) policies of the U.S. Government.

The primary goals of each Department's profit policy are to provide a competitive rate of return to contractors that would neither be too high resulting in unnecessary expenditures, nor too low which would discourage firms from seeking U.S. Government business. At the same time, appropriate contract incentives to promote cost-saving investment and efficiency should result in reducing the total cost of each contract to the U.S. Government.

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## III. Requirements of Legislation (Profitability)

Section 6 of the proposed legislation provides a list of the "Profit Study Requirements." Specifically, "profitability shall be determined by calculating the return on assets" of covered companies providing the Federal Government with goods or services under negotiated government contracts. Section 6 also authorizes the Administrator to use such additional measures of profitability as deemed appropriate. Furthermore, the profitability of "government" business will be compared with that of "commercial" business of these contractors as well as with the profitability of other companies in the private sector that are supplying similar goods and services.

These calculations are performed to permit a comparison between the rate of return being realized on non-competitive negotiated Government contracts with those earned in the competitive environment of the commercial marketplace.

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## IV. Analytical Framework - Profitability

### A. Selection of "Return on Assets" Measure

A study of how government contractor profits compare with those of non-government firms or segments requires (1) a meaningful measure of profitability, and (2) a standard against which the measure of profitability of government contractors can be compared. (The term "profitability" represents a measure of rate of return calculated by dividing profits by a base such as sales, assets, or equity.)

The standard measures of profitability that have been used most frequently in studies of this type are: return-on-sales (ROS) and return-on-investment (ROI). Since all firms compete for funds in the capital markets, and these funds are likely to be attracted to those opportunities offering the highest expected rates of return, the preferred measure of profitability would be a ROI standard. There are two ways to raise capital, i.e., by issuing debt and by selling equity shares. One frequently used ROI measure, ROE, indicates the return to equity. The other, ROA, represents the return to total assets whether acquired by debt capital or equity capital.

The use of ROS as a measure is less desirable than the ROI measures since it is a profitability measure based on output, and not input or how effectively a firm invests its capital. As mentioned above, since firms compete for funds in the capital markets, investors (individuals and institutions) are concerned with the rate of return on their investment, which is an input measure to the firm. A rate of return on sales is less likely to be related to a return on an investor's capital but more to the products being sold, or the specific industry. For example, retail food stores generally earn a relatively low return on sales, but an average return on invested capital. Thus, a ROS comparison across industries would appear to be of questionable value. On the other hand, comparing ROS among firms in the same industry may, in this limited case, provide useful information of the relative profitability of those firms.

One can utilize ROE, or after-tax accounting profits divided by shareholder equity for firm-level comparisons. However, since there is no generally accepted methodology for allocating either equity or taxes to the

segment level, the ROE measure cannot be used to make segment level comparisons in the context of the Profit Reporting Program.

Finally, with respect to the other ROI measure of profitability, ROA, profits would be divided by the book value of the segment's total assets. Since both the numerator and denominator for this ROI computation at the segment level are available from the contractor reported data, the ROA measure of profitability is recommended for use in the Profit Reporting Program.

#### B. Calculation of ROA

The profitability of negotiated contracts can be calculated from the contractor reporting forms: "Schedule I—Selected Income Statement Items" and "Schedule II—Selected Balance Sheet Items." (See Appendix III)

For each reported segment, the return-on-assets (ROA) computation can be performed by dividing the sum of line 08 (net operating results) and line 05 (interest) of Schedule I by the sum of the line 09 (total current assets), and line 13 (net book value of contractor owned tangible fixed assets at the segment) and line 14 (net book value of intangible assets) of Schedule II. [Interest payments are added to the numerator to permit a comparison of profitability between firms without regard to the amount of debt (versus equity) financing used by the firm. Thus, the total return to capital (investment) is calculated. Finally, net operating results are computed by subtracting the sum of the cost of sales (line 02), other allowable cost (line 03), and total unallowable cost (line 07) from sales (line 01) of Schedule I].

It is important to note that in computing a firm's total assets for the demoninator of the ROA calculation, "progress payments and advances" (line 06 of Schedule II) is subtracted. This is appropriate since progress payments represent assets of the U.S. Government and not assets of contractors.

The contractor data also permit a comparison of the profitability of "cost-type" contracts (column 1) with "fixed price" contracts (column 2). Since fixed price contracts present a higher risk to contractors than do cost-type contracts, one would expect to observe higher rates of return on the former in order to compensate contractors for the higher risk.

Each segment's major products will be identified by the "3-Digit Standard Industrial Codes." Therefore, some comparisons of profitability between government business and non-government business can be performed by product class.

Additional comparisons of the profitability of government contracts versus non-government work may also be performed by examining the pre-tax ROA of non-defense durable goods manufacturers by utilizing the Compustat data base as well as the Quarterly Financial Report (QFR) published by the U.S. Commerce Department.

The Compustat data base is available on an annual basis from the Standard & Poor's Corporation. It contains income statement and balance sheet data for over 6,000 companies at both the firm level and SEC segment level. However, the SEC segments are not as precisely defined as CASB segments. The QFR presents estimated statements of income and retained earnings, balance sheets and related financial and operating ratios for all manufacturing, mining, and trade corporations. The statistical data are classified by industry and asset size.

Section 6(d)(1) of the proposed legislation requires the determination of whether variations between levels of government business and non-government business profitability are reasonable. These variations can refer to (1) differences between the profitability of government and non-government business in a given year as well as over several years, and (2) variations (as measured by the standard deviation) of profitability over time by firm to measure the relative risk of government versus non-government business. Since investors tend to dislike risk and will demand a higher rate of return from firms facing greater risk, profit comparisons might be misleading without a risk measure being considered.

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## V. Requirements of Legislation (Investment - Efficiency)

Section 6(d) of the proposed legislation states:

"To the extent applicable, the study shall include an analysis of ... (2) capital investment and the relative investment between the covered companies' Government and commercial business."

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## Analytical Framework (Investment) - Efficiency

### A. Selection of "Capital-To-Labor" Ratio

The capital intensity of government contractors is of great interest because it can have a substantial impact on efficiency.

In order to make judgments about the relative use of capital and labor by government contractors consideration should be given to (1) an ideal measure of capital intensity, (2) a meaningful measure of capital utilization that could be calculated from the sample reporting format, and (3) a standard against which the measure of capital intensity for government contracts can be compared.

An ideal measure of the capital intensity of a specific line of business is the capital-to-labor ratio, (K/L). Theoretically, capital would be measured by the market value of the property, plant, and equipment of a line of business. Given the unavailability of these data, capital could be represented by the book value of "net property, plant, and equipment" associated with that line of business. Similarly, "total labor expenses" would ideally be used as a measure of "L" by line of business.

If commercial durable good manufacturing lines of business of government contractors use similar technologies as the government work, and these non-government lines are disciplined by the marketplace to operate in the most efficient manner, (i.e., produce at minimum cost) a calculation of K/L for these lines would provide a standard or benchmark for an optimal capital-to-labor ratio. A comparison of the capital intensity measure for government business with other closely related lines of business would, therefore, provide an indication of whether government contractors are utilizing their factor inputs of capital and labor in approximately the same ratio. If K/L for government work is significantly below that for commercial work, this would suggest that the contractor may not be facing the proper incentives to minimize cost by incorporating the same capital/labor mix that is used in commercial work. One concern, however, with the K/L ratio is the "capacity utilization" of a firm's capital. For example, if Firm A and Firm B are identical in all respects except that Firm A utilizes its capital during one 8-hour shift a day, while Firm B hires additional labor for a second 8-hour shift, the K/L ratio for Firm B would be lower than that of Firm A (unless an appropriate adjustment is made such as calculating Firm B's average labor expense for one shift and using this number in Firm B's K/L ratio).

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B. Calculation of K/L Ratio

The Capital-to-labor ratio (K/L) for government contractors may be calculated from "Schedule I—Selected Income Statement Items" and "Schedule II-Selected Balance Sheet Items." For each reported segment, the K/L computation can be performed by dividing the sum of line 13 (net book value of contractor owned tangible fixed assets at the segment) of Schedule II by line 10 (segment labor costs) from Schedule I.

The individual segment K/L calculations can be aggregated by SIC code (from columns (1) and (2)) and compared with the K/L ratio of commercial work performed by government contractors (column 3).

Finally, the asset breakdown on Schedule II by net book value of equipment (line 10), buildings (line 11) and land (line 12), permits an analysis of the impact changes to profit policy have on the type of fixed assets acquired by the contractor. This classification of assets also facilitates a comparison between type of investment undertaken for government versus non-government business.

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VI. Limitations

The ROA measure is sensitive to the accounting methodology used by each firm. The denominator of this ratio represents the book value of a segment's assets. However, the book value is a function of which depreciation method (accelerated or straight line) is used by the firm as well as by the age of these assets. An alternative, conceptually preferred, measure for book value is the "market value" of the assets. Since the market value of assets is generally not available, this measure cannot be used. Thus, despite its potential shortcoming, financial analysts and accountants generally use the book value of assets in their ROA calculations.

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VII. Conclusions

The performance of periodic profit studies utilizing the contractor data as outlined above would permit policymakers to determine how the relative profitability and efficiency of government contractors has changed over time. This analysis would enable the proposed OPSA to examine the effect of changes in profit policy on both the profitability and investment of government contractors.

The analyses outlined in this Appendix will permit the determination of whether variations between levels of government business and non-government business profitability are reasonable. Moreover, Section 6(d)(3) of the bill can also be used to determine "the use of pricing to motivate

cost efficiency and the relative efficiency between the covered companies' government and commercial business." OPSA can examine what effect changes in contract pricing and investment incentives are having on the amount and type (equipment, assets, land) of assets being acquired. Finally, the results of this analysis can be used to modify payment policy and contract pricing policies (Section 6(d)(4)). The administrator of OPSA can use the results of these studies to alter profit policy in order to adjust the profitability of government business as well as encourage additional cost-saving investment.

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# Summary of Comments Contractors, Industry Associations, Federal Agencies and Others

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We discussed our profit reporting proposal with contractors, industry associations, federal agencies, and others including Certified Public Accountants, and private sector analyst. In summary, except for some federal agencies and commercial activities that could potentially benefit by contracting with the OPSA, (1) most see no need for the program, (2) they all believe incremental accounting and auditing costs will be high, and (3) uniformly they see the program as high risk in terms of improper disclosure and use of proprietary and individual company data.

Comments were directed at a PRP framework and reporting form that have since evolved to the draft legislation contained in appendix II, and the reporting form outlined in appendix III. The changes we have incorporated include reduced data requirements and increased discretion over the reporting universe for the OPSA which should reduce overall contractor's cost and strengthen confidentiality provisions which severely limit access to individual company data. However, even with the changes, the draft PRP legislation will probably still be debated in terms of need, cost, and access to company data.

This appendix highlights contractor, industry association, and government agency comments on these and other areas of concern.

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## Need for the Program

The contractors and industry associations generally view the program as an attempt to level or lower profits. Some believe that the government system of procurement, audit and evaluation, the cost accounting standards, and laws, such as the Truth in Negotiations Act, are sufficient to ensure that costs are effectively disclosed and as a result minimize the potential for inappropriate profits. Although not unanimous, most view any additional government oversight as unwarranted intrusion. A spokesperson for one industry association said that after the government negotiates what it considers to be a best price it should be satisfied and not be concerned with profit levels. Several industry officials pointed out that the level of contractor profit is irrelevant. However, what is important is investment in facilities capital, which puts downward pressure on unit price trends and produces improvements in the quality of the products being delivered. Some contractors and industry associations said higher profit is viewed as an incentive to accomplish the latter, while lower profits will result in increased costs.

Federal agencies have differing views about the program. DOD believes its past efforts are appropriate and sees no need for a PRP. National Aeronautics and Space Administration officials are concerned that a legislated PRP could mushroom into more centralized control. They also stressed the point that DOD will dominate the statistics which may mask the effect of other agency's profit policies. Department of Transportation officials believe a PRP is premature, especially since the results of DFAIR have not been given a chance to address the current policy. Other procurement agencies believe PRP can be useful, but have no strong feelings pro or con because they do limited negotiated procurement.

We believe the potential return to the federal government of a recurring PRP will outweigh its cost. The fact that both recent DOD studies, Profit '76 and DFAIR, identified flaws in the profit policy demonstrates the value of periodically testing to determine how well the policy is achieving its objectives. If PRP results in changes in profit policy or, as was the case with DFAIR, adjustments in applying existing profit objectives, the PRP will be effective.

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**Federal Agency Responsible  
for Administering the PRP**

One point is clear, none of the federal agencies we spoke with wants to administer the program. The responsible federal agency, which we are calling the OPSA, has some logical executive branch locations. However, for one reason or another each views the prospect as unworkable.

- OFPP argues that it is a policy office not an operational office. It is too small and it does not possess the skills or capability to receive and protect the data, perform the analysis, and prepare the studies.
- The Federal Trade Commission based on its decision to abolish its line of business program, would not want to be involved. The agency clearly has the capability to administer the PRP. Staff from the Federal Trade Commission believe that with minor modification the now dismantled line of business reporting program could provide the data needed for a PRP.
- The Bureau of the Census has the capability for gathering and analyzing the data but believes such a role would adversely affect reporting of data by contractors for its other programs, such as the Quarterly Financial Report, and is not interested in administering the PRP.
- The Bureau of Labor Statistics might have the capability, with some augmentation of staff with accounting backgrounds, but they also are not interested for somewhat the same reasons as Census.
- The Securities Exchange Commission liked the idea of more government business reporting, but it would only consider a role that was in line

with its current functions, making information available to the general investing public.

- Commerce's Bureau of Economic Analysis cautioned that no statistical agency should be considered for the OPSA. Citing the possibility of losing the voluntary cooperation of corporations on which their current analytical efforts rely as the reasons, Bureau of Economic Analysis said potential losses were too great to risk.
- The Defense Contract Audit Agency acknowledged it possesses the skills needed to administer the proposed PRP; however, such a role would not be in line with its charter, to audit contract cost and pricing data. Defense Contract Audit Agency officials also pointed out that if it were selected to administer the program other functions would have to be cut back unless additional staff were provided for the PRP.

Contractor views on who should run the program included DOD, Defense Contract Audit Agency, GAO, and private firms.

We believe that selecting the right control point is critical. The attitude of the agency and how the agency is perceived by the contractors could make or break the PRP. Statistical agencies can do the job but, they suggest, the potential risk may be too great.

We believe OFPP is the best location for the OPSA. We also believe the President could reduce overall costs and improve the integrity of the PRP by requiring support from other executive agencies. For example, contractor data for the PRP could be provided to another agency, one that has demonstrated it can receive and protect such information; for example, the Quarterly Financial Reports division at the Bureau of the Census. OFPP, using aggregated industry data provided by the Bureau of the Census, could analyze the data and prepare profitability studies. The work could be done in-house or contracted out. Contracting will serve two purposes, first it will allow OFPP to regulate the PRP with minimum increase in people, space, or equipment, and second it will place the actual data analysis into a private enterprise professional arena which most contractors would prefer.

## Program Costs Estimates Are High

The contractors and associations believe PRP costs will be high. While few contractors were willing to make estimates of the cost, those estimates that were provided varied widely. Estimates varied from more than one million dollars annually for several large companies with many government segments to about 10 thousand dollars for a single industry segment.

We had hoped to obtain cost data on DOD's DFAIR study to get a better understanding of the costs of the proposed PRP from both a government and contractor perspective; however, previous study cost data is not available. Thus, the issue of PRP cost to contractors remains unresolved until the legislation is implemented.

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### Confidentiality—Access to Data a Major Issue

A general unwillingness to give the government access to detailed segment performance data on government and commercial business was a paramount issue with everyone. The contractors and industry associations are worried about individual company data being made available to anyone in government for any purpose. They believe the data will ultimately be made available to competitors and for use in the public and political environment.

The Federal Trade Commission faced similar problems with its line of business reporting. To deal with the problem, the Federal Trade Commission issued regulations to limit access to company unique data to only those employees whose duties required access. The regulations prohibit the Federal Trade Commission from disclosing individual company data to anyone outside the office, including the Congress. Penalties were applicable for noncompliance. We believe the protection we have provided by including language in the draft legislation similar to the Federal Trade Commission's line of business reporting, and by including provisions in the law restricting release of data by our office to any office not specifically authorized in the PRP Act will minimize the potential for unauthorized disclosure and help ameliorate the contractors' concern.

Audit access is also a major concern. The contractors and industry associations were almost unanimous in their objections to GAO having access to data underpinning the profitability reports. One reason for their concern is our relationship with the Congress. They believe we will not be able to withhold company specific data if the Congress asks for it. However, the contractor's reservations are not only with us, they apply to any other government audit agency. Basically, the question is why is government audit necessary, given the requirement for CPA's to attest to the reliability of the data and to reconcile the contractor's reports to its annual statements.

Responding to the contractors' concern, we have prohibited access to individual company data by anyone not specifically authorized in the Act. In so doing, and notwithstanding the independent certified public

accountant attestation, which is less oversight than certification or examination, the Congress needs assurance that the data underpinning the profit studies has been verified. We will provide those assurances for the PRP by selectively accessing and selectively testing data whether at the OPSA, independent certified public accountant, or the company.

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## **Level of Audit by Independent Certified Public Accountants**

A final issue explored in our discussions which included representatives of the American Institute of Certified Public Accountants (AICPA), was the independent certified public accountant's audit role. We believe, as do the AICPA officials we spoke with, that the OPSA should develop a detailed set of agreed upon audit procedures. These procedures could be used by independent certified public accountants to render an opinion on the reliability of PRP data and perform the reconciliation required under the act. The basis for such an opinion is outlined in the AICPA's new attestation standards. Agreed upon procedures are now being used by the Interstate Commerce Commission to audit regulated railroads. Because 1986 is the first year for the program, the Interstate Commerce Commission is unable to advise as to how well the program has worked.

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# Summary of Profitability Study Measures and Conclusions

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## DFAIR

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### Return on Assets (ROA)

#### Calculation<sup>1</sup> :

Economic Profit/Assets (includes government progress payments but does not include Cash)

#### Conclusion:

Based on Cost Accounting Standard Board segment data analyzed for 76 participating companies, between 1970 and 1979 defense contractors and commercial contractors earned similar returns. Because of the early 1980s recession, which, according to DFAIR affected commercial business more than defense business, defense contractors, on defense business, earned higher returns between 1980 and 1983 than commercial manufacturers.

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### Return on Sales (ROS)

#### Calculation:

Economic Profit/Sales

#### Conclusion:

Same as for ROA.

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## Navy

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### ROA

#### Calculation:

Operating profit/Identified Segment Assets (does not include Cash)

#### Conclusion:

Using annual financial statements and industry segments defined by Financial Accounting Standards Board Statement of Financial Standards Statement Number 14 as the basis for study, for 22 contractors between 1977 and 1984, on average, return on assets for government business (mostly defense) was higher than returns earned on commercial business.

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<sup>1</sup>Economic profit is a calculation devised by DFAIR to compare profitability on defense contracting with profitability of commercial manufacturers. The calculation of economic profit yields a lower return on assets for both defense and commercial contractors than conventional ROA calculation. Inappropriately adding progress payments to the asset base reduced contractor defense profitability more than it reduced commercial rates of return.

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ROS

Calculation:  
Operating Profit/Segment

Conclusion:

Between 1977 and 1980 commercial sales showed higher return than government business; however, from 1981 to 1984 return on government business was higher than for commercial business segments. Very small and negative returns are more common in commercial business than government business.

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## Air Force Systems Command

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ROA

Calculation:  
Calculated for commercial manufacturers but not for defense contractors.

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ROS

Calculation:  
Profit/Sales

Conclusion:

Return on defense segment sales for 15 companies studied was lower than total company ROS for 1979 but was about the same for 1981. Air Force concluded that in 1981 profitability of defense business was about the same as for commercial business.

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## Profit '76

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ROA

Calculation:  
Profit/Assets (does not include Cash or Government Progress Payments)

Conclusion:

Based on government profit center data analyzed for 64 participating companies, between 1970 and 1974, average ROA for government profit centers was higher than for commercial manufacturers.

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**Appendix VI  
Summary of Profitability Study Measures  
and Conclusions**

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ROS

Calculation:  
Profit/Sales

Conclusion:

Return on sales was higher for commercial manufacturers than for government profit centers.

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**GAO (1971 Defense  
Industry Profit Study)**

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Return on Total Capital  
Investment

Calculation:  
Profit/Assets

Conclusion:

GAO studied 151 defense contractors, categorized as: large or small prime contractors, government owned contractor operated plants (GOCO), and subcontractors. Between 1966 and 1969 large and small prime contractors earned lower returns but subcontractors earned higher returns on defense work than on their commercial work.

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Return on Equity Capital  
Investment

Calculation:  
Profit/Equity

Conclusion:

For defense work compared with commercial work, large contractors' returns were about the same, small contractors' returns were lower and subcontractors' returns were higher.

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ROS

Calculation:  
Profit/Sales

Conclusion:

Returns on defense work for large and small contractors were lower, but they were about the same level for subcontractors compared with commercial work. For GOCO, returns for other defense agency business (National Aeronautics and Space Administration and Atomic Energy Commission) were higher than for DOD business.

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