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Testimony before the Senate Committee on Banking, Housing and Urban Affairs; by Robert F. Keller, Deputy Comptroller General.

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The proposed Senate bill to revise and extend the Renegotiation Act of 1951 (S. 1594) should lead to major improvements in the renegotiation process. The Renegotiation Act is essential to provide one last opportunity for the Government to assure that contractors are making no more than a reasonable profit. An extension of the act for a 5-year period could enhance the Renegotiation Board's ability to recruit qualified personnel and provide an incentive for long-range planning. The elimination of the use of the percent of-completion method of accounting and the required use of a "units delivered" or "completed contract" method of accounting for renegotiation purposes, as proposed in the bill, would add necessary objectivity to the renegotiation process. The provision in the bill that would require contractors to report renegotiation business on the basis of division and product line is a much needed reform in the act. The elimination of the oil- and gas-well exemption from renegotiation also provides needed reform. The penalties included in the proposed legislation for knowingly failing to file or submitting false information should increase compliance with the act's filing requirements. Congress should eliminate the partial exemption of sales of new, durable, productive equipment from renegotiation. It should consider including a provision requiring the Board to establish guidelines for applying statutory factors for determining excessive profits in the legislation. (SC)

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Statement of
ROBERT F. KELLER, DEPUTY COMPTROLLER GENERAL
OF THE UNITED STATES
before the
Committee On Banking, Housing, and Urban Affairs
United States Senate
on
S. 1594 To Revise And Extend The Renegotiation
Act of 1951

Mr. Chairman and Members of the Committee:

We are here today at the request of your Committee to present our views on the proposed legislation to revise and extend the Renegotiation Act of 1951. The General Accounting Office has maintained an interest in the renegotiation process through its continuing audits and varied assistance to the Congress.

As you know, we conducted a study of the operations and activities of the Renegotiation Board, and reported to the Congress in May 1973. We note that several of our recommendations have been included in the legislation under consideration.

We have reviewed S. 1594 and want to express our support for this legislation. We believe it should lead to major improvements in the renegotiation process.

The Necessity for Renegotiation

Many individuals have said that there are vast numbers of people performing numerous steps in the procurement process that prevent excessive profits, and therefore there is no need for renegotiation. While some of the procurement functions performed are designed to provide the Government with fair and reasonable prices, they are not always performed successfully for a number of reasons. The pricing activity that is done usually involves a prospective determination of contract prices. The Government has no right to adjust a contract price for the sole reason that a contractor's profit was excessive, other than through the renegotiation process. Further, under the present procedures for pricing negotiated defense contracts, profits are largely determined as a percent of anticipated costs. An apparently reasonable profit rate based on costs can result in an excessive rate of return on the contractor's capital employed in contract performance. Even the new profit policy being put into effect by the Department of Defense bases only about 10 percent of the profit factor on return on contractors' investment in capital assets with the balance based on costs.

Renegotiation, on the other hand, is concerned with eliminating excessive profits that may result, for example, when conditions different from those anticipated at the time of contract

award result in excessive profits, or the forces of the market place are inoperable or ineffective.

Further, as discussed in our report on "Causes of Excessive Profits on Defense and Space Contracts," dated December 31, 1975, during the period covered by our review, excessive profits were usually not caused by inadequate procurement procedures or poor implementation of procedures by Government procurement officials. Excessive profits frequently resulted from a seller's market aggravated by increases in Government demand on an industry operating at, or near, capacity. With lessened competition, price increases were often unrelated to production costs. We found instances where contractors volume rose, and unit production costs diminished, resulting in greatly increased profits because prices were not reduced.

It is also interesting to note that half of the high-profit contracts we reviewed were awarded on the basis of price competition, indicating that neither formal advertising nor competitive negotiation were effective in preventing excessive profits. In addition, price or cost analyses were made for most of the negotiated awards and the cost data was audited by the Defense Contract Audit Agency for the sole-source prime contract awards.

To further illustrate the value of renegotiation, title I of the Defense Production Act provides for mandatory contractor acceptance of defense contracts, and for giving them priority over

other work, but there is no provision in that law for pricing such contracts. Contractors can, and do, insist on very high prices in certain circumstances. The only means of recovering excessive profits in those cases is through the Renegotiation Act. It provides a means of moderating unreasonable demands where the Defense Department has to deal with sole-source contractors that maintain a "take-it" or "leave-it" position. In summary, we believe the Renegotiation Act is essential to provide one last opportunity to assure that contractors are making no more than a reasonable profit.

Termination Date

We support an extension of the act for a 5-year period. We believe a longer extension could enhance the Board's ability to recruit qualified personnel and provide an incentive for long range planning. This was also recommended by the Commission on Government Procurement.

Method of Reporting Contracts

We support the provision in section 4 that the percentage-of-completion method of accounting no longer be used for contracts which are subject to renegotiation. One of the problems we see with the percentage-of-completion method of accounting is the lack of a precise method of estimating percentage of completion. Engineering estimates are frequently involved that are largely subjective. There are opportunities for such estimates to be manipulated to improperly minimize the possibility of an excess profits determination. However, we do not know whether such manipulation has actually taken place. We believe

that elimination of the use of the percentage-of-completion method of accounting and the required use of a "units delivered" or "completed contract" method of accounting for renegotiation purposes would add necessary objectivity to the process. We recognize that for projects of long duration with a single unit to be delivered, costs and related revenues will need to be excluded from renegotiation until the project is completed.

The principle advantage of the completed-contract method is that it is based on results as finally determined, rather than on estimates of cost to be incurred on uncompleted work. In our opinion, profits can be determined with reasonable certainty only when units are delivered or at contract completion.

Product Line Renegotiation

Section 4 of the bill also requires contractors to report renegotiable business on the basis of division and product line. We believe this is a much needed reform in the Renegotiation Act. The current method of renegotiation appears to favor large, diversified corporations because they can offset the results of high profit activities against the results of low profit or loss activities. We believe this constitutes an advantage over smaller, single product-line firms. Use of a product-line approach would be more effective in minimizing the number of firms that are now escaping renegotiation and place both large and small firms on a more equal footing.

We do not believe that the requirement for division and product-line reporting will create an administrative burden.

We believe that most contractors maintain their accounting records on a divisional basis and the incidence of multiple product lines within divisions is generally not high. We recognize, however, that this requirement has caused considerable concern among contractors and we would have no problems with providing some discretion to the Board with respect to waiver of the requirement in appropriate cases, such as the approach taken by the House Banking, Finance and Urban Affairs Committee in its report on H.R. 5959.

Elimination of Exemptions

Durable productive equipment

As we previously reported, in drafting the act during the Korean conflict, the Congress believed that new, durable, productive equipment purchased by prime contractors to produce defense articles would revert to commercial use after the war and that the entire productive life of this equipment would not be used in defense-related production. Thus, potential commercial sales would not be realized because the need would be filled by equipment purchased initially for defense work. To offset this, the Congress provided that a portion of the sales of new, durable, productive equipment to prime contractors or subcontractors, for use in performing renegotiable Government contracts, would be exempt from renegotiation.

In 1954, the Congress provided that a portion of the sales of equipment directly to the Government would also be excluded from renegotiation. It felt that, since the Government

had purchased large quantities of new, durable, productive equipment during the war, the Government's disposal of stockpiled equipment could threaten future sales of this equipment.

At the time of our review we were unable to discern any impact that prime contractor's procurement of new, durable, productive equipment during the war had on producer's sales of such equipment after the war. We were told that the Government's purchases of this equipment, under the act, have not affected producers' sales because the expected disposal of the stockpile held by the Government has not occurred in the 20 years succeeding the Korean conflict. We recommend that the Congress eliminate the partial exemption of sales of new, durable, productive equipment.

Standard Commercial Articles

We found that it is not possible to determine, on the basis of information available to the Board, the extent to which a contractor may have excluded standard commercial articles and services sales with high profits and included sales with low profits in its report on renegotiable sales because of the absence of cost and profit data on exempted items. Though the Board has recommended that the Congress repeal this exemption, it lacks the data showing that substantial profits escape renegotiation due to the exemption.

It is apparent that a significant amount of sales has escaped renegotiation in recent years due to this

exemption, but the amount of profits escaping is indeterminate. Moreover, if the rationale for the exemption assumes that competition exists for all standard commercial items, thus insuring reasonable prices and profits, it may not be valid in all cases. For example, a commercial item which is produced by a sole-source supplier and which qualifies for the exemption has not necessarily been subject to competition, and the price quoted in a contractor's catalog may include an unusually high profit margin. Yet the existence of effective competition is assumed. It is for these reasons we have recommended that the Congress require the Board to obtain and analyze profit and cost information relating to standard commercial articles and services to determine whether large amounts of excessive profits are escaping renegotiation.

We are pleased to see a provision in section 5 for a comprehensive study of the standard commercial articles and durable, productive equipment exemptions by the Board.

Oil and Gas Well Exemption

The present raw materials exemption was included in the 1951 act to recognize the fact that, at that time, the world market gave the Government immediate access to price information. This rationale was formulated long before the present era of multinational oil companies, boycotts, etc.

Present conditions have distorted the world market price for oil so that it no longer reflects the true costs of production. Simple reference to the world commodity market,

therefore, gives no assurance that contracts for unrefined oil, or gas are not providing the contractor with excessive profits.

The theory that the raw materials exemption would encourage exploration and production of crude oil or gas was an additional rationale for the exemption at the time it was enacted by Congress. In light of currently high oil and gas prices and the scarcity of these commodities, this rationale appears questionable. Therefore, we concur with the elimination of the oil and gas well exemption.

Similarly, the Committee may want to reconsider exemptions for products of mines or other minerals which have not been processed, refined, or treated beyond the first form or state suitable for industrial use. We believe that where the prices of these raw materials are no longer determined by the market, but rather are controlled by a cartel or monopoly, the case for exemption is no longer valid.

Minimum Amounts Subject to Renegotiation

Section 6 of the bill contains provisions to raise the minimum levels of annual sales subject to renegotiation from \$1 million to \$5 million. We have reservations with respect to raising the minimum amount. We do not think it is inequitable to recover clearly excessive profits made on Government business regardless of the size of contractor. Our 1973 report included an analysis of the number and amounts of excessive profit determinations made during fiscal years 1970-72 to determine those that would have escaped renegotiation if the minimum had

been \$5 million. This analysis showed that, of the 450 excessive profit determinations for \$139 million, about two-thirds of the determinations amounting to an estimated \$46 million, would have escaped if the floor had been \$5 million.

On the other hand, we understand the intent of raising the floor to \$5 million is to lessen the impact of renegotiation on smaller firms by not requiring them to file with the Board and not seeking to determine and recover excessive profits. In addition, it is also expected by proponents of the current bills that excessive profit determinations will not diminish, but will, in fact, increase as a result of such other provisions as product line renegotiation and elimination of exemptions.

Knowingly Failing to File, and Knowingly Submitting False Information

We have advocated civil penalties aimed at discouraging delinquent filings, and for failure of contractors to furnish data or information required by the Board. The penalties now included in section 7 of the proposed legislation, in our opinion, should increase compliance with the act's filing requirements.

Interest on Excessive Profits

Section 8 provides that interest on profits found to be excessive shall begin to accrue on the day following the end of the fiscal year in which the excessive profit was made. We support the provision for interest charges. Since penalties cannot be applied to late filers and nonfilers unless their actions are proven to be willful, there is no inducement for them

to file on time. Rather, contractors stand to gain financially by not filing with the Board or by delaying their filings as long as possible. Contractors should not be allowed to utilize excessive profits without paying interest on those funds.

Subpoena Power

Section 10 authorizes a majority of the Board to issue subpoenas requiring the production of any records, books, or other documents required under this act. We concur in the provision. The Board has been faced with the problem of obtaining accurate and complete information to make its analyses. At the present time, the Board has no practical means of requiring contractors to provide timely information which it deems necessary. Although the penalty provision of the act may be imposed when the contractor refuses to furnish adequate data, the Board must prove that the contractor's refusal was willful.

Audit Provision

Section 10 also requires the Board, or its authorized representative, to verify by audit, on a selective basis, any financial statement submitted to the Board by contractors or subcontractors. We fully support this provision. The Comptroller General has previously stated that such a provision would be a valuable and appropriate addition to the act. However, we hope that the resources of the Defense Contract Audit Agency will be utilized to assist the Board in this endeavor. This Agency has considerable knowledge and experience in this area and we understand it has indicated a willingness

to undertake the work, subject to approval by the Department of Defense.

Guidelines for Applying Statutory Factors

We believe that there is a need for the Board to establish guidelines for applying statutory factors for determining excessive profits. In our previous work, we found that in making its excessive profit determinations, the Board does not have written guidelines for applying and weighting the statutory factors. Rather, the amount of excessive profit is determined by subjectively applying the statutory factors.

The lack of guidelines and documentation supporting Board determinations makes it almost impossible to tell whether they were made in a consistent and uniform manner. We believe that written guidelines are needed to assist review officials in evaluating each factor and to allow all review levels to arrive at essentially the same decision. Guidelines would also enable the Board to more accurately tell contractors how excessive profit determinations were made.

There is no indication that the Board has made progress in implementing this recommendation. It may be advisable to cover this matter in the proposed legislation.

This completes our statement, Mr. Chairman. We will be glad to respond to any questions.