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The proposed legislation to revise and extend the Renegotiation Act of 1951 (H.R. 4082) is constructive and should lead to major improvements in the renegotiation process. Making the Renegotiation Board a permanent agency of the Federal Government could enhance its ability to recruit qualified personnel and provide an incentive for long range planning. Extending the act to cover contracts of all Government agencies would also be an improvement. Eliminating the percentage of completion method of accounting for contracts which are subject to renegotiation is an important improvement. Excessive profits can be determined with reasonable certainty only when units are delivered or at contract completion. Requiring contractors to report renegotiation business on the basis of division and product line is a much needed reform. The elimination of the oil and gas well exemption from renegotiation is a necessary reform due to changing world conditions. Raising the minimum levels of annual sales subject to renegotiation does not appear to be advisable. Congress should eliminate the partial exemption of sales of new, durable productive equipment from renegotiation. Congress should consider including a provision requiring the Board to establish guidelines for applying statutory factors for determining excessive profits in the proposed legislation. (SC)

UNITED STATES GENERAL ACCOUNTING OFFICE
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STATEMENT OF
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BEFORE THE
SUBCOMMITTEE ON GENERAL OVERSIGHT AND RENEGOTIATION
OF THE BANKING, FINANCE AND URBAN AFFAIRS COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and members of the Subcommittee:

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

In testimony before this Subcommittee in June 1975 we outlined and discussed the findings and recommendations of our study of the operations and activities of the Renegotiation Board. Several of our recommendations have been considered by the Subcommittee for inclusion in your proposed legislation on renegotiation.

We have reviewed H.R. 4082 and, as before, want to express our strong support for this legislation. We believe it is constructive and should lead to major improvements in the renegotiation process. We welcome the opportunity to provide our views on the major issues in the current bill.

Removal of Termination Date; Extent of Agency Coverage

We believe that making the Board a permanent agency of the Federal Government could enhance its ability to recruit qualified personnel and provide an incentive for long range planning. We also agree that the act should cover contracts of all Government agencies. 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 estimate 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, excessive 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. Most contractors maintain their accounting records on a

divisional basis and the incidence of multiple product lines within divisions is generally not high. We believe that reporting procedures could be worked out by the Renegotiation Board with the contractors that would minimize or prevent any additional administrative or reporting burden for contractors. We believe that provision should be made to give the Board the necessary flexibility to work out these procedures.

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. Since some of this equipment was expected to be used for commercial purposes, the Congress provided that a portion of the sales of this equipment to prime contractors would be excluded 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. In view of the above, 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.

In view of the above 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

It is our understanding that the present raw materials exemption was enacted by Congress in 1942. As explained in previous hearings, the provision was included in the original act to recognize the fact that the world market gives the Government immediate access to price information. This rationale was formulated long before the present era of multinational oil companies, boycotts, etc.

As the Committee previously recognized, the creation of international cartels, which control all facets of production, has distorted the world market price for oil where 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 materials, this rationale appears questionable. Therefore, we concur with the elimination of the oil and gas well exemption.

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 $2 million. As stated in our previous testimony, we have reservations with respect to raising the minimum amount. 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 $2 million or $5 million. This analysis showed that, of the 450 excessive profit determinations for $139 million, about one-third of the determinations amounting to $13 million, would have escaped if the statutory floor had been $2 million and about two-thirds of the

determinations amounting to an estimated $46 million, would have escaped if the floor had been $5 million.

In that same report, we also pointed out that the Board made a study to determine the effect that raising the floor to $2 million for contractors would have had on the number of filings received in fiscal years 1971 and 1972. The study showed that about 18 percent less filings would have been received.

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 wilful, 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 wilful.

Audit Provisions

Section 10 also requires the Board or its authorized representative to verify by audit every financial statement submitted to the Board by contractors or subcontractors. A financial audit of all 3500 submissions every year constitutes a considerable workload. However, we understand that it is your intention that the resources of the Defense Contract Audit Agency be utilized. 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. Perhaps some flexibility could be written into the legislation so that a complete audit of every submission every year would not be mandatory.

On the other hand, we see no need for a provision to require by law that the operations of the Renegotiation Board

be subject to an annual review by the General Accounting Office, with an annual report of such review to Congress. In previous correspondence we have indicated our belief that it would be undesirable to establish such a requirement. In order to make the most effective use of our limited resources, particularly with constantly changing conditions and priorities in the various Federal agencies, we believe that the Comptroller General should have the responsibility and flexibility to determine the need for and frequency of General Accounting Office reviews of the Renegotiation Board.

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. As stated in our previous testimony, 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 make 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 arrived at.

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 formal statement, Mr. Chairman. I will be glad to respond to any questions regarding our comments.