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Statement of

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BEFORE THE

SUBCOMMITTEE ON PROCUREMENT AND MILITARY NUCLEAR SYSTEMS
HOUSE COMMITTEE ON ARMED SERVICES

ON

PROFIT LIMITATION LEGISLATION

Mr. Chairman and Members of the Committee:

At your request, we are here today to present our views on profit limitation legislation. As the Committee is aware, we testified in June 1980 before the Subcommittee on Investigations in support of legislation to waive the application of the Vinson-Trammell Act until October 1, 1981. One objective of that legislation was to allow appropriate Committees of the Congress an opportunity to carefully study the need for profit limitation, consider alternatives, and decide what the Federal policy should be in this complex and important area. We are pleased to be able to assist in these deliberations.

Our basic position on profit limitation continues to be that, as a minimum, a profit limitation statute should be in place that would become operative during a period of national emergency when contract activities increase significantly.

In addition, during periods of rapid expansion in defense spending, such as the one currently projected, we believe some type of profit limitation statute is in the public interest.

Significant increases are being proposed in defense spending over the next few years, and new defense policies call for increased production and procurement of weapon systems and related supporting equipment. In constant dollars, budget projections for Defense expenditures are about three times larger than during the Vietnam war buildup. Defense sales for some contractors are expected to double over the next 2-year period. The effects of this on a defense industry with pockets of fully utilized industrial capacity could, in some cases, be substantial.

Although the Government now has the means available to require production from private firms for national defense needs, there is no provision to assure reasonable prices for this mandated production. Title 1 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 assuring reasonable prices for such contracts. This frequently puts contractors in strong negotiating positions where they can and do insist on very high prices. A profit limiting statute would provide a means of moderating unreasonable demands and would be the only way the Government could recover any excessive profits that may result.

Existing legislation does not protect the Government against unreasonable profits. The Truth in Negotiation Act was designed

to place both parties to certain noncompetitive Government contracts in a position of equality at the bargaining table with regard to the cost and pricing data available to the contractor. The Act functions as a limitation on profits only to the extent that it provides the Government with recourse if a contract price is increased due to a contractor's failure to provide accurate, current, and complete cost or pricing data as required by the Act.

Cost accounting standards and regulations promulgated by the Cost Accounting Standards Board are designed to achieve uniformity and consistency in cost accounting under certain negotiated defense contracts. Although the Board is no longer in existence, defense contractors and subcontractors are still required to disclose their cost accounting practices and to follow Cost Accounting Standards in estimating, accumulating, or reporting costs on covered contracts. Both of these provisions represent major improvements in the contracting process which were unavailable at the time of enactment of either the Renegotiation Act or the Vinson-Trammell Act. We support these efforts and their continuing improvement. However, they do not provide any means of controlling profits when a vendor is not in a price competitive environment and seeks to exploit its position.

In our previous work, 1/ we found that excessive profits were usually not caused by inadequate procurement procedures or

1/ Causes of Excessive Profits on Defense and Space Contracts, PSAD-76-56, December 31, 1975.

poor implementation of procedures by Government procurement officials. More often, they resulted from a seller's market aggravated by sharp increases in Government demand on an industry operating at or near capacity. With lessened competition, price increases were often unrelated to production costs. For example, we found instances where contractors realized greatly increased profits by simply not reducing their selling prices to recognize unit production cost reductions due to large volume increases.

Even on procurements where price competition was obtained, we found that neither formal advertising nor competitive negotiation can be totally effective in preventing excessive profits. In addition, although price or cost analyses were made for most of the negotiated awards and the cost data were audited by the Defense Contract Audit Agency for the sole-source awards, high profits were still made on some contracts.

We remain concerned about the need to protect the Government's interest in sole-source situations, especially where sole-source contractors may attempt to take advantage of a "seller's market." As we have stated in the past, even during periods when no national emergency exists, a profit limiting statute provides a means of moderating unreasonable demands where Defense has to deal with sole-source contractors who maintain a "take-it-or-leave-it" attitude.

In this regard, Defense currently procures over 70 percent of its needs under sole-source or other contracts without price competition. In these noncompetitive situations, contractors

could fully comply with cost accounting standards; submit accurate, current, and complete cost data that is verified; and still demand and obtain unreasonable profits.

One of our recent reports on a Navy contracting situation illustrated the difficulties of negotiating with a sole-source contractor. The contractor's unique position, combined with other factors, resulted in an environment where the contractor avoided risk, the Government's negotiating position deteriorated, and the Navy was forced into using a contract type that was not in the Government's best interests. Even the occurrence of subsequent overruns would not prevent the contractor from realizing increased profits from this situation.

Critics of profit limiting legislation point out that average profit returns on defense business are not unreasonable. To some extent, we must agree. At the time of our "Defense Industry Profit Study," dated March 1971, we reported that average profits before Federal income taxes, measured as a percentage of sales, were significantly lower on defense work (4.3 percent) than on comparable commercial work (9.9 percent). When profits were considered as a percentage of total capital investment (total liabilities and equity but excluding Government capital) used in generating the sales, the difference narrowed to 11.2 percent for defense sales versus 14 percent for commercial sales. However, average profits are made up of a very broad range of profits on individual contracts and the rates of return can vary significantly. For example, data developed on an individual contract basis during

our 1971 study showed that the positive rates of return on total capital investment ranged from one-tenth of a percent to 240 percent.

More recently, Defense conducted a 1-year study (Profit '76) on defense contractor earnings. This study showed that defense contractor profits, when measured on the basis of sales, on the average were still lower than those generated in commercial endeavors. However, when measured on a return on investment basis, defense rates averaged 13.5 percent, whereas the average rate of return for the comparable durable goods manufacturers was 10.7 percent. It should be noted, however, that the defense study dealt exclusively with average profits and did not discuss the range that made up these averages as was done in the GAO study.

Although we have not made any recent studies on defense profits, we have no reason to believe that the profit levels previously found, measured as a return on investment, have changed appreciably. From our contract pricing work, there are indications that the annualized rate of return on facilities capital employed for some individual contracts is high.

As we have previously stated, the Vinson-Trammell Act, in its present form, is outdated, unworkable, administratively burdensome, and inequitable. It should either be replaced or modified. As one alternative to enacting new legislation, we believe that the Act and its existing regulations provide a framework that could be updated and modified to correct its objectionable defects. Specific changes can be made to

substantially reduce the administrative burden in complying with the Act, especially on small businesses.

Whether the Act is replaced or modified, in order to recognize legitimate concerns of Government and industry, we suggest that the following general guidelines be considered:

--Expand coverage to include all defense items, not just ships and aircraft.

--Limit its application to completed noncompetitive negotiated contracts and first-tier subcontracts.

--Increase the dollar threshold from $10,000 to at least $5 million.

--Compute profit on the basis of a predetermined return on investment rather than on a percentage of contract costs or prices.

--Adopt Section XV, Defense Acquisition Regulation cost rules as the basis of determining profits.

--Provide specific criteria for offsetting certain losses against profits.

--Simplify reporting.

--Permit audit sampling of profit reports to monitor compliance.

--Provide stiff administrative penalties for contractors who do not comply with reporting requirements.

In summary, we do not advocate totally eliminating profit limitations, particularly on noncompetitive procurements. As a matter of public policy, some assurance is needed that defense contractors will not make "unreasonable" profits at the taxpayer's expense. This is of particular importance during a period of increased defense spending and when significant non-defense budget cuts are occurring.

This concludes my prepared statement. My associates and I will be happy to answer any questions you may have at this time.