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UNITED STATES GENERAL ACCOUNTING OFFICE
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STATEMENT OF

DONALD J. HORAN, DIRECTOR

PROCUREMENT, LOGISTICS, AND READINESS DIVISION

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 pleased to be here today at the request of the Subcommittee to present the General Accounting Office's views on the proposed legislation to revise and reinstate the Renegotiation Act of 1951. As you know, we have had a long and continuing interest in the renegotiation process because of our involvement in audits of the procurement activities of the Federal departments and agencies.

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. We also testified before this subcommittee in March of 1977 in support of HR 4082, a bill to revise and extend the Renegotiation Act.

We have reviewed H.R. 5651 and want to express our continued support for legislation that would help ensure that defense contractors do not realize excessive profits.

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We believe such controls are particularly important during periods of sharp increases in defense spending that could exacerbate the demands on the private sector, creating a sellers market, and reduce or eliminate the opportunities for effective price competition.

I would now like to offer some comments on certain aspects of the renegotiation process that warrant special attention.

Product Line Renegotiation

Section 4 of the bill requires contractors to report renegotiable business on the basis of division and product line. We believe this would be a much needed improvement in the renegotiation process. The prior method of renegotiation appeared to favor large diversified corporations because they could offset the results of high profit activities against the results of low profit or loss activities. We believe this constituted an unfair advantage over smaller, single product line, firms. Use of a product line approach would be more effective in reducing the number of large firms that were previously escaping renegotiation, and would place both large and small firms on a more equal footing.

The requirement for division and product line reporting should not create an unreasonable 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 a reinstated Renegotiation Board that would minimize or prevent any significant administrative or reporting burden for contractors. We believe the Board should be given the necessary flexibility to work out these procedures.

Minimum Amounts Subject to Renegotiation

Section 5 of the bill would raise the minimum levels of annual sales subject to renegotiation from $1 million to $5 million. In our previous testimony, we said we had 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 $5 million. Of the 450 excessive profit determinations totalling $139 million, we found that about two-thirds of these, amounting to an estimated $46 million, involved contractors with annual sales subject to negotiation of less than $5 million. We realize, of course, that during the period of our analysis there was no requirement for product line renegotiation. It is possible that product line renegotiation and the effects of inflation since the time of our analysis would bring in new contractors to offset the loss of revenue involved by raising the exemption level.

Measuring Excessive Profits

Our analysis of the Renegotiation Board's operations in the past led us to conclude that the Board's primary basis for measuring profits, to determine whether they were excessive, was to consider profit as a percentage of cost or price. We believe this is a simplistic approach which produces inequitable results and is not in accordance with the way the business and financial communities measure corporate results.

We believe the primary way to assess the reasonableness of a contractor's profit should be on the basis of "return on investment", with appropriate adjustments to recognize the statutory factors that are embodied in the Renegotiation Act.

In this connection, we have long advocated changes to profit negotiation policies toward the return on investment approach to provide incentives for contractors to acquire labor saving modern equipment for use on Government contracts.

Guidelines for Applying Statutory Factors

In our previous testimony, we pointed out that in making its excessive profit determinations the Board did not have written guidelines for applying and weighting the statutory factors. Rather, the amount of excessive profit was determined by subjectively applying the statutory factors.

The lack of guidelines and documentation supporting Board determinations made it almost impossible to tell whether they were made in a consistent and uniform manner. We believe that clear and specific 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.

We have no indication that the Board made progress in developing such guidelines prior to disbanding. Therefore, it may be advisable to cover this matter in the proposed legislation.

Appeals From Excessive Profits Determinations

During the first 21 years of the existence of the Renegotiation Act, contractors could appeal the Board's excessive profit determinations to the Tax Court. In the vast majority of cases appealed to the Tax court the Board's determinations were upheld. However, in 1972 the Act was ammended to shift appeals to the Court of Claims.

Because the Court of Claims has more detailed and formal procedures, cases take longer to be resolved, and compliance with the Court's procedures is more costly to both the appellant and the Government. More importantly, the Court of Claims appears to disagree with many of the Board's determinations of excessive profits. A greater proportion of case decisions adjudicated by the Court of Claims have been unfavorable to the Government. In part this has come about because the burden of proof under Tax Court decisions was on the contractor, whereas in the Court of Claims it is on the Government. As a result, the Government has not been very successful in providing the type of proof of excessive profits required by the Court of Claims.

With the current pattern of decisions by the Court of Claims, more contractors are likely to avail themselves of the appeal process. Unless the appeals are shifted back to the Tax Court or the Government can produce the type of proof demanded by the Court the benefits derived from the Renegotiation process will be greatly diminished.

This completes my formal statement, Mr. Chairman. We will be glad to respond to any questions at this time.