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THE ARMY INDUSTRIAL COLLEGE
Washington, D. C.

Industrial Mobilization Course

LECTURE

Policies and Procedures in Procurement

Lecture XVIII - "Profit Limitations II (Statutory Renegotiation)"

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I. Introduction.

A. Earlier this morning an effort was made to show the place of STATUTORY RENEGOTIATION in the general scheme of profit limitations.

B. At this time, attention will be concentrated upon the broad principles, policies, organizations and procedure involved in statutory renegotiation. An attempt will be made not only at discussion but also some evaluation, inasmuch as I understand that there is some question as to whether the Purchase Policy Committee will give any attention to renegotiation. We shall touch only upon the high spots of this subject. In the first place, it is not the purpose of this group to become negotiators, and in the second place, it would require months not minutes to cover the subject of renegotiation fully. In fact, a former chairman of the War Department Price Adjustment Board, Mr. Maurice Karker once stated that "negotiators are born and not made". For these and other reasons few details will be included. If anyone thinks many details are included, I should like to say to him that he ought to see the details that are left out.

C. While renegotiation seems to have a logical place in the field of profit limitation it is a subject which has been widely discussed and criticized in the "public press" and has been investigated by not less than four committees of Congress. These were the House Ways and Means and House Naval Affairs Committees, and the Senate Finance Committee and Special Senate Committee investigating the National Defense Program. Two years ago discussion of renegotiation became so widespread that it even reached the cartoons. I recall one cartoon of a small boy standing in a candy store who stated to the proprietor, "This candy costs 5¢ and I got 4¢. Will you renegotiate?" In my humble opinion any subject that reaches the comic strips or cartoons (especially "Dick Tracy" or "Terry and the Pirates") has definitely "arrived". Perhaps some of you other "comic strip intellectuals" will agree with me.

II. Coverage and Exemptions.

A. First let us consider what contracts and contractors were covered by renegotiation and which ones were not. Renegotiation proceedings normally covered the over-all "renegotiable" Government sales on prime and/or subcontracts for a contractor's entire prior fiscal year, not upon individual contracts.

B. This policy of dealing with sales for an entire fiscal year made it possible for contractors to offset their losses or low profits on some contracts against higher profits made on other contracts. Besides being fair to contractors for this reason this policy also vastly decreased the administrative problem faced by the various war procurement agencies and

the necessity for allocating costs to each contract separately. Of course, individual contracts could be dealt with separately, if circumstances warranted.

C. We have already seen that the prime and subcontracts of nine government agencies having procurement functions were subject to renegotiation. Agencies dealt directly with subs, not through primes.

D. Of course, all sales to civilian customers were exempt from renegotiation, although profits on such sales were subject to excess profits taxes.

E. Besides civilian sales, there were other important mandatory exemptions from renegotiation. Under the 1943 Act, these mandatory exemptions included:

1. Contractors having receipts or accruals from prime and subcontracts (including exempt contracts) with the nine government agencies aggregating less than \$500,000. This exemption was made partly to lighten the administrative burden and partly because of pressure from "small" business interests.

2. Contracts between departments of the government or between a federal department and any state or foreign government agency.

3. Contracts for mineral and agricultural products up to the first form in which such products have an established market. For example, crude oil, gas, coal, grains, tobacco, cotton in the bale, etc. Both administrative and political considerations played a part in determining this policy.

4. Contracts for products of trees and animals in a natural state. This would include resins, saps, wool, eggs and milk. Animals themselves, such as cattle, hogs, poultry, and sheep before slaughtering were exempt.

5. Contracts for products of tax-exempted, religious and educational institutions were also exempt.

6. Contracts for construction of buildings and facilities or improvements of these which were awarded by competitive bidding were also exempt. And, finally, subcontracts under exempt prime contracts, as well as subcontracts for office supplies were exempt. These exemptions were made partly for administrative reasons, that is, to expedite renegotiation, and partly for political reasons.

7. Subcontracts for real property. (Prime contracts were subject.)

E. Discretionary Exemptions under 1943 Act.

1. There were also certain exemptions which might be made of the discretion of the War Contract Price Adjustment Board. These included:

a. Contracts on which profits were determinable with reasonable certainty in the beginning.

b. Contracts whose provisions were considered otherwise adequate to prevent excess profits, such as contracts with adjustment articles or target price provisions.

c. Contracts for "standard commercial articles having OPA ceilings, if competitive conditions were considered satisfactory.

d. Standard commercial articles were those in general civilian or business use before 1940 and substantially the same in type or use as a competing article.

e. Wherever it was not feasible to separate renegotiable from non-renegotiable profits.

f. Contracts performed outside of United States or in Alaska. Here again the reasons for exemption are administrative and fairly obvious.

2. War Department Procurement Regulations gave to chiefs of technical services the power to exempt from statutory renegotiation individual contracts or subcontracts for less than \$5,000,000 of the types discussed above in connection with exemptions which may be made at the discretion of the War Contracts Price Adjustment Board. In practice this authority was generally exercised by the field representatives of the Chiefs of the various Technical Services, the contracting officers. This power of exemption of individual contracts could be exercised only where productive experience of at least six months made it possible to estimate cost and profit with reasonable accuracy and when price and cost analysis had been undertaken in accordance with approved accounting principles.

(PR 1205.7)

3. Organization and Administration.

How were the principles and policies involved in renegotiation carried out? The answer to this question requires consideration of the organization, administration and procedure involved in renegotiation. In the early days of renegotiation the various procurement agencies were left pretty much alone to work out their own renegotiation procedures. Early in the game, a need was felt for formulation of uniform policy and procedure, which resulted in a "Joint Statement of Principles" and, in September 1943, the Joint Price Adjustment Board, to which the chiefs of departments

delegated policy-making and review powers. The 1943 Act attempted to improve on the over-all organization by setting up a War Contracts Price Adjustment Board to formulate uniform policy and procedure for all nine renegotiating agencies and to review the largest cases and impasse cases or unilateral determinations. This Board had power to act only on cases covering fiscal years ending after 30 July 1943.

B. The new board confined its activities to general policy forming, supervision, and review and published regulations and manuals. The Navy had a Price Adjustment Board in the Office of Procurement and Material to form Navy policy, and carry on operations. As a result of redelegations, operations for the Navy were actually carried out by four divisions of the Navy Price Adjustment Board. Policy, supervision and review for the War Department as a whole, including AAF and ASF, were under the Chairman of the War Department Price Adjustment Board, who was also Director of the Renegotiation Division, ASF. Renegotiation operations for the Army were carried out by the Price Adjustment Sections of the War Department Technical Services and the Army Air Forces. Cases of all sizes were handled in the first instance in field offices. Most of the War Department Field Offices had the power to make final agreements on cases where not more than \$5,000,000 of renegotiable sales were involved. Cases involving between 5 and 10 million dollars required final approval by technical service headquarters, while cases over 10 million dollars required final approval by the War Department Board. Each of the other War Procurement Agencies had its own Price Adjustment Board.

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C. The WCPAB, through the Assignments and Statistics Branch of the Renegotiation Division, Army Service Forces, usually assigned cases to those services and bureaus having predominant monetary interests. In some cases assignments were made to services having specialized experience in renegotiating contracts with certain industries, regardless of what service had the predominant monetary interest. The renegotiating services had authority to settle for all government agencies. This proved to be a great labor-saving device.

D. Personnel in the field offices which actually carried out most renegotiation operations was both military and civilian. This personnel had been selected on the basis of experience in accounting, banking, or other business. Some of the personnel acted as financial analysts or cost analysts and other personnel acted as negotiators. The analysts analyzed accounting data which contractors were required by law to file with Price Adjustment offices. After the accounting data were considered adequate and had been analyzed by negotiators, meetings were held with contractors to discuss and negotiate. At such meetings efforts were made to arrive at agreements as to the amount of "excessive" profits, if any, made during a prior fiscal year on renegotiable business.

III. Let us proceed step by step through the different processes whereby so-called "excessive" profits were determined and recovered, assuming that we are dealing with fixed-price contractors.

A. In order to determine on an over-all basis whether the profits received or accrued by a contractor on renegotiable contracts and subcontracts were "excessive", it was necessary first to determine the amount of

his renegotiable business and the profits thereon. The first step was to separate civilian from renegotiation sales. This was not difficult for prime contractors since they could refer to their records of prime contracts. It was more difficult for contractors whose government business was accounted for wholly or partially by subcontracts; for example, a spinner of cotton yarn might have difficulty in determining what proportion of his yarn sales actually had a government end-use. He might make a rough estimate by checking priority ratings on his subcontracts or he might go to the trouble of writing all the weavers to whom he sold yarn for information as to the end-use of his yarn. In any case it was difficult to make a segregation of renegotiable from civilian sales for such subcontractors.

B. The next step after renegotiable sales had been separated from other sales was to determine the allocability and admissibility of the costs applied to renegotiable sales by the contractor's accountants. This was also often a tedious process.

C. Disallowances of costs and expenses by negotiators and financial analysts in the Price Adjustment Offices often resulted from consideration of the system of allocation used by the contractors.

D. Contractors not having cost systems often allocated costs and expenses to renegotiable sales on the basis of the ratio of such sales to their total sales. This was permitted where there was no alternative and where the products sold to the government were similar to or identical with products sold to the civilian trade. Contractors who had good cost systems usually used actual costs or standard costs adjusted to actual costs.

E. Whatever system of allocation were used, disallowances were sometimes made because prohibited items like reconversion reserves or reserves for postwar contingencies had been included in cost of production. Of course, such reserves could be included as part of surplus but it was thought that the cost of reconversion should be allowed through revenue legislation or through some other process rather than through renegotiation. Reconversion cost estimates were considered too unpredictable to be allowed as a deduction in renegotiation.

F. Disallowances by the Price Adjustment personnel also often resulted from excessive:

1. Officers' salaries. During the war years, salaries were often inflated out of proportion to the wartime increase in volume of sales.

2. Depreciation and amortization. Accelerated depreciation on machinery was allowed where it could be justified by increases in the number of shifts during which the machinery was operated. Many contractors, however, accelerated their depreciation out of proportion to the increased use of machinery and some of the increase in depreciation made by the contractor had to be disallowed. Amortization of the cost of equipment purchased under Certificates of Necessity was allowed on the 60-mo. basis provided by law. This policy was more liberal than that followed in original contract negotiations, where amortization was not an allowable cost.

3. Inability to buy certain types of new machinery made it necessary for many contractors to increase repairs and maintenance

expenses for old equipment. Some used this as an excuse for artificially inflating repairs and maintenance and thereby actually gaining larger depreciation allowances. This had to be watched and disallowed.

4. Selling expenses: Selling expenses should be non-existent or small on sales to the Government but sales through regularly established agents and brokers were allowed. Consequently, reasonable selling expenses were allowed. Institutional advertising, but not advertising to market a specific product, was allowable. The former was considered a cost of Government business.

G. The costs or expenses disallowed were added to renegotiable profits. When admissible costs had been determined they were subtracted from renegotiable sales to determine renegotiable net profits. CPFF contracts were renegotiated separately from fixed price contracts.

V. Profit rate to be allowed:

A. The next step after we determined renegotiable net profits was to determine the rate of profit justified by the contractor's individual performance and circumstances, including:

1. Efficiency and reasonableness of costs as indicated by comparison of prices and costs with those of other contractors in the same industry and comparing base-period profits with those of other contractors. Efficiency in meeting delivery schedules and quality standards (minimizing rejects). Efficiency varies greatly in production of exactly same items for many reasons.

2. Risk-taking, as indicated by reductions in price during life of contract, close pricing in the first instance, or use of private

capital rather than government fixed or working capital. It is obvious that a contractor whose plant was furnished by the Government in whole or large part or who make large use of advance and partial payments was not taking much risk and did not deserve any great reward for any risks. A case in point was the Jack and Heintz Company in Cleveland, whose plant was furnished largely by the Government.

3. Inventive and Developmental Contributions:

Contractors who originated or developed items of material should and did get the advantage of higher profit allowance.

4. Cooperation with the Government:

Contractors who converted a large proportion of their plants to production for the Government and thereby ran the risk of losing many old civilian customers, should and did get higher rates of profit in renegotiation. Other evidences of cooperation, such as general attitude and willingness to make frequent changes in specifications, production record, etc., were considered.

5. Character of Business, complexity, subcontracting, rate of turnover: integrated businesses and those having complex processes should and did receive higher rates of profits than those otherwise situated, other things were equal. Businesses whose rates of turnover were low usually received somewhat higher rates of profit in renegotiation than those with higher turnover. Those which cooperated in spreading subcontracts received consideration for this factor.

B. Obviously, rates of profit allowed in renegotiation, being based on these varying factors, varied considerably. For some businesses,

three or four percent was deemed adequate, whereas, others might receive 12 percent for reasons already brought out. This policy was both desirable and inevitable. Any individual who tries to discredit the renegotiation process by inferring that 12 or 15 percent was usually allowed and that where it was allowed it was too high, either does not know the facts, does not understand the principle of renegotiation or maliciously intends to give it a black eye by making a false implication.

VI. Recoveries, Clearances, Impasses.

A. After the rate of profit considered allowable was determined on the basis of the factors just discussed, any appreciable profit deemed "excessive" would be recovered by cash refund, or reduction in future prices, leaving a rate based on renegotiatiable sales minus the amount recovered, that is, on "adjusted" sales.

B. Credit was allowed for Federal income and excess profit taxes applicable to the amount of "excessive" profits, whether already paid or to be paid. It is estimated that about 70 percent of "excessive" profits recovered by all nine procurement agencies up to 1 February 1946 (6.2 out of 8.9 billion dollars), was accounted for by such federal tax credits. It is estimated that several billions of dollars were saved in price reductions resulting in part from existence of renegotiation statutes. No exact figures or estimates have been released. The total administrative expense of renegotiation from April 1942 through December 1945 was \$29,772,000.

C. Contractors not having renegotiable profits deemed excessive were granted "clearances".

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D. We have been considering cases settled by mutual agreement. When contractors refused to agree to proposed settlements, cases were submitted to higher authority for further consideration. As a last resort, after cases had been considered by headquarters of technical services, and/or Price Adjustment Boards in the War and Navy Departments and the WCPAB, the Tax Court of the United States could consider appeals, according to the 1943 Act.

VII. The Public Attitude Toward Renegotiation.

A. Con:

1. Those against renegotiation have argued that it was arbitrary, that it operated without standards, that it depended upon subjective rather than objective measurements and was, therefore, "government by men, not law".

2. Others have argued that renegotiation was unnecessary because of OPA ceilings, the existence of excess profit taxes, and the ability of contracting officers to predetermine fair prices and profits. Arguments against this line of thought have already been given in the last lecture.

3. Producers of "standard commercial products" such as textiles and others have argued that costs and profits could be predetermined for such products and that renegotiation was not necessary (in contrast to strictly military items like planes, ships, tanks, guns). Of course they did not also add that increases in volume of production and lower unit costs made it difficult to estimate costs even on such "commercial" items.

4. Some have contended that renegotiation has discouraged and penalized production for the Government. Producers who held on to their civilian business partially or altogether were not subject to renegotiation at all or as much as producers who converted largely or 100% to government business. They paid excess profits taxes only. This is an argument which cannot well be denied or explained away.

5. Finally, many responsible persons have contended that renegotiation often did not allow enough profit after taxes to provide sufficient reserves for postwar reconversion and other contingencies. It is undoubtedly true that profit after taxes and after renegotiation was sometimes low in relation both to sales and to net worth. This is a question which will deserve careful study in connection with any future plans for limiting wartime profits.

B. Pro:

1. Advocates of renegotiation, including those in Congress and the highest officials in the military departments, have considered it a necessary wartime control which had a place not filled by any other method of profit limitation.

2. Such advocates feel that as long as hindsight is more accurate than foresight as to cost of production and profit and as long as cost accounting remains an inexact science (a very long time in my opinion), some sort of "backstop" similar to renegotiation would be necessary to limit war profits. Of course, no such device as renegotiation could ever expect to be popular either with those who administer it or those who are squeezed by it. Like dentistry, it is not too pleasant either

for the patient or the doctor unless the doctor happens to be a sadist.
While I am certain that some dentists are sadists, I am not aware of
any renegotiators whom I would consider such.