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COST PRINCIPLES AND PROFIT MARGINS

8 January 1953

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Mr. Victor Z. Brink, Assistant Controller, Ford Motor Company, Dearborn, Michigan, was born in Iowa in 1906. He was graduated from the University of Nebraska with an A.M. degree and holds a Ph.D. from Columbia University. He was chief of the Contract Audits Branch, Office of the Fiscal Director, Army Service Forces, during World War II as a lieutenant colonel, Finance Department Reserve. Mr. Brink was an associate professor of accounting at Columbia University and a partner in the firm, West, Flint and Company, certified public accountants, New York City. He is the author of the book, "Internal Auditing," and several accounting articles. Mr. Brink is a founder and a past national president of the Institute of Internal Auditors.

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COLONEL JOHNSON: We have presented military procurement from the viewpoint of the military itself, from the Congress, in the international field with a representative from another government, and by one member of industry.

It has been said that military contracting is a battle between the lawyers and the accountants. As you remember our other representative from industry was a lawyer. This morning we complete that phase by offering the accounting or financial side.

Those of you who read the biography of our speaker this morning, Mr. Victor Brink, Assistant Controller of the Ford Motor Company, may have wondered whether we were bringing him here as Colonel Brink to tell us of his experiences in the Contract and Audit Branch of the Army Service Forces. Some of you may have wondered if we were bringing Mr. Brink here to relate accounting to us from the objective point of view as a student, a professor, and a practicing accountant. We promised you that we would have another representative from industry; so some of you may have decided that we have another representative from the automotive industry to give us a critical point of view of our application of cost principles and profit margins in military procurement.

Now, those of you who looked at the over-all picture realize that Mr. Brink--and he assures me he prefers that manner of address--is a triple personality man in this field, and that probably he will draw from his experiences in all three areas of this problem.

It is indeed a pleasure to welcome again to this platform Mr. Victor Brink, of the Ford Motor Company, who is going to speak to us on "Cost Principles and Profit Margins".

MR. BRINK: I have heard of dual personalities, but this is the first time I have thought of myself as having a three-way personality. But in any event, I am very happy to be here and to have the opportunity to appear before such a distinguished group as this one and to discuss with you some of the problems which exist in this very important area.

First of all, however, I should like to make the usual disclaimer, that I am expressing my own personal opinions and not those of either the Ford Motor Company or the War Department.

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We can start out with the general assumption, I believe, that America is dedicated to the free enterprise system; and that, therefore, if we are going to procure goods and services for war purposes, whether for industrial use or military use, we should deal on the basis of price to compensate properly the person from whom we obtain the goods and services.

Now, the range of price varies from one extreme to the other. At the one extreme, we have the ultimate situation where prices are determined in advance; and, on the other hand, there is the situation where it is impossible to determine the price at the time of contractual negotiations. In the latter case, we are compelled to approach the problem from a cost standpoint.

Taking first the situation where the price is established in advance, the most clear-cut case, of course, is where one buys goods or services on the open market. For example, if one buys potatoes and coffee---something for which there is an established market---the price is set without any question and that price is paid or the product is not obtained. Then we range backward to the situation where there is no free market. Under such circumstances, we deal on a bid basis. We may put out bids to three or four producers and whoever gives us the best price---that establishes the price. Thus, we can establish a fixed price in advance through negotiation, on an individual negotiation basis.

When this establishment of a fixed price in advance is not possible, we have to resort to some intermediate type of arrangement. The most common one probably is the escalator type. Under this arrangement, we will say: "Yes, we will agree on the price; but there are certain factors here with respect to which there is considerable risk---labor rates, for example." The Government recognizes that the contractor cannot control the labor rates. So the Government agrees that to the extent that labor prices advance, the price will be adjusted accordingly. We might have the same arrangement on materials. Actually, it is possible to extend this escalation technique to any factor in the situation which has a degree of risk which it doesn't seem reasonable to resolve or settle in advance.

The next stage in this cycle from escalation is to have a price redetermination type of contract---with which you are all, I know, familiar---where under various types of arrangements we carry out part of the job and then take a look at the facts at that point of time and redetermine the price. It may be that we will determine both a retroactive price and a forward price, or we might redetermine a single over-all contract price.

Then, finally, if it is not feasible even to carry out that type of arrangement, we have to resort to a cost-reimbursement type of contract.

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If profit is to be allowed, a cost-plus-a-fixed-fee type of arrangement will be used---this in view of the fact that the cost-plus-a-percentage-of-cost is an illegal type of arrangement. In some cases, however, for special reasons, the fee may be waived.

I would like to compare for a moment the fixed-price contract with the cost-plus-a-fixed-fee contract, or, I might say, with the cost-reimbursement type of contract.

I think the distinction is very important, because there are certain advantages in the fixed-price type of arrangement which are important to both the Government and the contractor. All through this type of discussion it is important that we recognize that in the last analysis the interests of the Government and the contractor are the same. They may not seem to be so in the first instance, but in the long run their interests are bound to be the same---a point which will become increasingly clear.

A very important advantage of the fixed-price contract is that people know at the outset exactly where they stand. The Government knows exactly what its cost is going to be and can plan accordingly. Industry on the other hand knows exactly what its revenue will be and that maximization of profit will depend entirely on cost reduction. It thus has a real incentive to achieve maximum efficiency. That seems a very simple statement, but it is so basic to our whole free enterprise system that it must not be overlooked.

Secondly, there is considerably less administrative burden to fixed-price contracts. We all avoid the burden of auditing and the inevitable quibbling about the allowability of costs which is bound to be the case where we are operating under the cost-reimbursement type of contract. The role of the General Accounting Office is also very much more restricted under a fixed-price contract than, for example, it would be under a cost-reimbursement type of contract.

The advantages of less administrative burden to the contractor represent important benefits, because they free him from the burdens of dealing with auditing people, dealing with the General Accounting Office, keeping certain kinds of records, and presenting the kind of documentation which is necessary in the case of the cost-reimbursement type contracts. More important, however, from the contractor's standpoint, he likes fixed prices, because then he can impose upon his organization the same kind of cost-control discipline that he wishes to impose in the case of his commercial product and which he knows in the long run is the only thing that will insure his long-run success in relation to other companies in his industry.

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From the standpoint of the Government, the extent to which the Government provides incentives to industry which results in low-cost performance, obviously results in lower-cost procurement and more goods and services for the dollar expended. Thus, the mutuality of interest is established.

Now, because of these important advantages of fixed-price contracts, there has been a real effort in these price-redetermination type contracts to extend these advantages to a kind of situation where it is very difficult to deal on the basis of advance fixed prices--situations where the product is new and where there is no experience on the part of the contractor with the particular product; so the alternative is to delay the negotiation to a point of time where information is available which will be a basis for a sound negotiation of a fixed price.

Because of the aforementioned delay, there is one school of thought which takes the position that up to the time of the redetermination we have a cost-type contract. I wish to protest vigorously against that concept, because I do not believe that was the intention of the people who developed the price-redetermination type of contract. I think it would be quite unfortunate if we went backward to the view that we had first a cost-reimbursement type of contract and then that it was not until later that we converted to a fixed-price type. Rather, we have only a delayed negotiation of a fixed-price.

By avoiding the emphasis on cost reimbursement--even though, as I will point out later, we have to deal with costs when they are the only means of appraising the situation--we put our emphasis on the price of the product, and, thus, we most maximize the benefits of fixed-price contracting and we emphasize the point that we are interested in getting the best product for the least money.

Now, taking fixed prices again, there are these two general concepts, it seems to me, of a fixed price: it can be viewed as a best price and related to something that the company has previously done or to something which can be obtained from other sources. Under this concept, the price is judged by the criterion that it is the best price obtainable under the circumstances after giving consideration to the various factors that any good purchasing man keeps in mind--quality of product, timeliness of delivery, the performance with the product, the kind of service which is subsequently provided by the contractor, and the like. That is a normal concept that is applied when you go out to buy a Ford Motor car or a General Motors car or a Chrysler car---judging by the standard---the best price obtainable for the product being obtained.

The other concept of a fixed price is that we can't look at the price in itself, but rather at the components of the price--that is, the

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kinds of costs which are incurred in producing the product plus a fair or reasonable profit margin added to those costs. Again, this is essentially a situation where we cannot deal in advance, but where we must, of necessity, deal on a delayed basis.

I should like to emphasize very strongly that the approach directly on the basis of best price is the objective at all times, even though we must at times, on a temporary basis, resort to the component approach. In other words, we always abandon a best price approach reluctantly and withdraw to the cost-plus-a-profit type of approach only insofar as it is necessary. Then, just as soon as it is possible, we go back to the basis of dealing on the best-price approach.

We had a good example of this in one of our own contracts where we have had several price redeterminations. The contract involved was for the 3.5-inch rocket. When we started on that particular program, we had little knowledge of the product we were to produce. We went into the program with a Form II-B price-redetermination type contract. We had a price redetermination at the usual 30 or 40 percent point, which, in our case, was about 35 percent.

It really worked out very well, as judged by what I have learned of the experiences of other contractors. The basis of the entire matter was that we prepared in advance to get the auditing job done promptly through the advance review of our system and procedures. Then we were able to work out a time schedule covering all aspects so that we actually negotiated a price within about 75 days after the effective date of price redetermination. We took about 30 days to close our books and to get our proposal ready. The auditing people then completed their report in another 20 days, and in the remaining time we negotiated our prices with the Detroit Ordnance District.

In this first price redetermination we dealt almost entirely on the basis of reasonableness of costs that we had incurred because there was no such criterion as the best price under those circumstances. This was an unavoidable feature of Ordnance acquiring the desired expansion of capacity by bringing us into the rocket program.

However, once prices were established for the forward period-- which by agreement was fixed at six months from the effective date of price redetermination, or about three and a half months beyond the final date of our negotiations---we have subsequently dealt primarily on the basis of best price. Actually we do come in and show them our cost data at the end of each 90 day period and our experienced profit performance. But the whole temper has now changed. There are many other producers in the market and comparisons by the Detroit Ordnance District are now based on competitive prices. As a result, the contractors who are doing

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a good job because of better cost performance are earning better profits than the contractors who are coming in with higher costs.

It is very gratifying to me to see how this cycle has changed in this case under proper administration on the part of the services and the contractors, from the cost-reimbursement approach or the cost-recovery approach to the best-price type of procurement. Believe me, it makes us all sit up and take notice when we think that our price on some item may be a little higher than that of our competitors. There exists a pride in the best-price approach, which is really a remarkable thing in the way of a stimulus to industry and, as a result, in the way of benefit to the Government.

I would like to turn again to cost recovery. As I previously indicated, we want the best price always just as quickly as we can, but there are conditions where we cannot use this approach immediately and, therefore, we are forced to the other type of approach. I again wish to emphasize the word "forced," because it should be an interim or temporary phase. But as long as we are in that situation, we are faced with the problem of looking at cost data and appraising what are good costs as a basis for negotiation and what is a proper profit margin.

In this connection, in our own case we have another excellent illustration in the new J-57 jet engine which we are building in Chicago. We are going into that program on an engine that is not yet fully designed. Since it is still very much in the developmental stage, engineering changes are still coming through in great volume. We would have no basis whatsoever for negotiating a price on the J-57 engine, which will not actually be produced until late in 1954. Consequently, we don't have enough knowledge about the product we are going to produce to properly develop a price. We are, therefore, forced to some other type of arrangement--cost recovery with a fair margin of profit--until we have sufficient facts on the basis of which to complete that which we would like to have done immediately--the negotiation of a price on a best-price basis.

Going back to cost recovery, I would like just to trace briefly its general background. We are going back probably far enough if we go to World War II, to TD-5000, which was in a sense the mother of all cost principles. It was a section in the Revenue Code, section 26.9, which was promulgated by the Commissioner of Internal Revenue as a basis for recapturing profits in excess of those provided for in the code with respect to contracts for vessels and aircraft. However, it was adopted by the services and injected in many cases in the early part of World War II into the cost-reimbursement type of contracts as a criterion for the recognition of costs.

From that sprang other developments. One of the developments, that you may be familiar with, was the so-called Green Book, which came out

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about 1942. The official designation was "Explanation of Principles for the Determination of Costs Under Government Contracts." It was adopted by the Navy; and, while it was never officially adopted by the Army and the Air Force, it did still have a considerable influence on cost principles throughout the entire military procurement program. Later, however, the Army proceeded somewhat on its own and developed some cost interpretations that were published in what was called TM-14-1000---"Administrative Principles for CPFF Contracts." This represented still a further development of cost principles.

The next important development in the way of cost principles was the statement in the Contract Settlement Act of 1944 designated as the "Statement of Principles for the Determination of Costs upon the Termination of Fixed Price Supply Contracts." This particular set of cost principles was later incorporated in the Joint Termination Regulations, referred to as JTR, and also in the Joint Termination Accounting Manual--JTAM.

As we move down to the present day, the next major development was the development of a statement of cost principles in section XV of the Armed Services Procurement Regulations. The section has several parts, but the part that we are chiefly interested in is part 2, which covers supply and research contracts for commercial organizations. This statement of cost principles is applicable only to the cost-reimbursement type contracts and not to fixed-price contracts; although, as I will point out a little later, it has been used indirectly to some extent in the fixed-price field.

The most recent development has been the development of the statement of cost principles in section VIII of the Armed Services Procurement Regulations for use in connection with terminated fixed-price contracts.

Of course, in the case of termination costs under cost-type contracts, the statement of cost principles contained in section XV will be applicable. This is consistent with the sound principle that the same set of cost principles ought to be applicable to claims arising out of terminated contracts as are applicable to the going prices under such contracts. Actually, a termination is simply a contraction of the fixed-price contract itself. Similarly it would logically follow that if a statement of cost principles has been developed for terminated fixed-price contracts--as was done in section VIII--it should be applicable to going contracts. But in this case it is specifically, by agreement, limited to terminated contracts.

This rather illogical situation was the result of a compromise. The general view of industry was that they were willing to agree as a

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compromise to section VIII for the one purpose--terminated fixed-price contracts--but that they were not willing to adopt it as the standard for regular fixed-price contracts. The reason for this position was that the section VIII principles had certain objectionable features which I will describe further a little later on.

Down to the present day there is still a desire and an effort to develop a statement of cost principles for use in connection with negotiation of prices under fixed-price contracts. The people over in Mr. Bordner's office have in fact been working on this now for several years. They first selected Mr. Henry Sweeney of New York as a special consultant to work on this problem. It was hoped that he would come up with something rather promptly; but again, like most things of that type, nothing really definitive has been accomplished. More recently, Mr. Bordner tells me, he has gotten another man to assist on this problem-- a Mr. Harry Howell, who is also quite well known in the accounting industry.

There have been two schools of thought as to the kind of statement of cost principles which is needed. One is what we ought to leave the statement of cost principles for cost-type contracts as it is and develop a separate statement of cost principles for fixed-price contracts. Then there is the other view that we ought to develop one statement of cost principles that would be applicable to all contracts. I believe that the current view is to lean somewhat to favoring the development of a statement of cost principles which would be applicable to all contracts.

I should now like to mention very briefly some of the major features of these various statements. Obviously it is impossible to go into a great deal of detail in a short period of time, but I think it may still be worthwhile to indicate the general scope of each.

The principles incorporated in the Contract Settlement Act of 1944 were in general the most reasonable. In part, this was undoubtedly due to the temper of the times. When the Contract Settlement Act was developed, there was a great feeling that cost principles were needed which would enable us promptly to dispose of the termination problem and, thus, get people back into production at the earliest possible moment. Thus, everybody was psychologically adjusted to the most practical type of approach.

In that statement of cost principles, for example, advertising was considered a good cost to the extent that the particular expenditures were consistent with the prewar program or reasonable under the circumstances. The latter standard of reasonableness of course set the stage for great flexibility in actual negotiations. Experimental and research expense was allowable to the extent consistent with the established

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prewar program or to the extent related to war purposes. Here again we have a broad and flexible approach. Interest on borrowings was also allowable. The exclusions on the other hand were relatively limited.

In section XV, we have a more restrictive approach. This is due primarily to the fact that these principles are limited to the cost-reimbursement type of contracts. However, these principles reflect the now different temper of the times. In this peace-war type of economy, we do not have the type of situation where we are either in total war or emerging from it as was the case when the previously mentioned statement of cost principles were developed.

Under section XV, for example, advertising costs are restricted to "advertising in trade and technical journals, provided such advertising does not offer specific products for sale, but is placed for the purpose of offering financial support to journals which are valuable for the dissemination of technical information within the contractor's industry." This, of course, covers only a small portion of a normal advertising program. Research and development expense is allowable when specifically applicable to the supplies or services covered by the contract. This has the effect of putting the burden on the contractor to prove the direct relationship of the research and development expenditures to the defense contracts. Interest on borrowings is excluded. Contributions and donations are excluded. There is also a more detailed list of exclusions, plus a list of some items which might be given special consideration under certain circumstances.

Section VIII is somewhat broader. When they wrote section VIII, they did bring into it, to a considerable extent, some of the atmosphere of the earlier Joint Termination Regulations of World War II and the Contract Settlement Act of 1944. In fact many of the sentences are borrowed, such as those indicating the desirability for incentive, the recitation that cost is only one factor in the negotiation, the desirability of a speedy and fair settlement, and the like, all of which was supposed to give the contracting officer more courage to deal on the basis of general business judgment rather than on the basis of strictly accounting data.

In this section VIII there is a recognition of the cost of general research, for example--a broader approach than in section XV. In this and in many other respects the statement has a much more liberal and reasonable tone than section XV.

There were two exclusions with respect to which industry protested, and this was the major reason that it was finally agreed that it would not be applicable to going fixed-price contracts. One was interest expense. In this case many of the companies felt that it was unfair

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to deny interest expense as a proper and legitimate cost item in their base when they had to borrow money and pay the interest. The other exclusion was contributions and donations. This was an exclusion that I personally felt very strongly about. I say this because anyone who is exposed to business knows that there are contributions and donations which are just as much a part of the normal business expense as any other expense that a company incurs.

I always object to the argument that just because some particular item of cost is subject to some abuse, we should just legislate it out of existence. We might just as well legislate salaries out of existence because salaries are abused at times. In this connection one could say that many people are getting higher salaries than they ought to get. In many of these cases, however, the companies still have to answer to a board of directors, and satisfy the directors that the salaries are being earned. But we can't legislate salaries out of acceptable cost data. No more do I feel we should legislate contributions and donations out of the picture because, more and more--and this is true in our case--a corporation is a member of the community, and it has to assume its obligations just like any other member of that community.

I would like also to say a word about the cost definitions of some of the other agencies. In the case of the Bureau of Internal Revenue, the applicable principles are reflected in the criteria measuring deductions to determine taxable income. Actually these are not very good criteria, because the income tax laws have been developed for the most part to maximize taxable income. Definitions of deductions are considered to be based upon acts of grace rather than sound accounting and, hence, are frequently arbitrary. For example, the Bureau might, as it has frequently done, limit depreciation on the bases of their own formulae. Since their basic objectives are different, they frequently wander from the path of what we would call true and proper cost principles.

Because of administrative expediency, renegotiation has been linked to the income tax basis. Undoubtedly this has been done chiefly to avoid argument through tying to a basis which is already available. However, even in the case of renegotiation they have provided for deviating from the income tax regulations in particular respects where the income tax basis is not appropriate. This is accomplished through a written accounting agreement. Thus, if there is some aspect of the income tax regulations which distorts cost for revenue purposes in such a way that profits are not properly developed for purposes of renegotiation, there is an opportunity to negotiate an agreement as to a different and more appropriate treatment. We have thus far found the renegotiation people very fair in considering such deviations.

There is one other agency which has an interest in cost principles. That is the General Accounting Office. In the case of cost-reimbursement

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type contracts, this interest is of particular significance since in these cases the costs reimbursed are subject to audit.

Traditionally the General Accounting Office has taken a point of view which industry has considered to be rigid and frequently arbitrary. More recently, however, the General Accounting Office has gone through quite a reorganization and general transformation, and I think that the present thinking of this office is more in line with the views of the services.

Now, I should like to cover briefly what I consider to be industry's point of view on cost principles. With respect to whether there should be a number of statements of cost principles, I should say that industry is inclined to the view that there really ought to be only one statement of cost principles; that it is not really theoretically right to think of cost principles for this purpose and cost principles for that purpose and cost principles for another purpose.

Actually, any other approach reflects a certain confusion of thought and involves confusing profit margins with cost principles. Rather the correct approach is that there are basic costs that are legitimate and proper. Then, if we want to adjust the total compensation for the degree of risk which the contractor is exposed to--and the degree of risk is quite different in some fixed-price contracts, a price-redetermination type of contract, and the cost-reimbursement type of contract--the thing to do is adjust the profit rate to reflect that risk.

I think industry also feels that we try to go too far into detail in defining the specifics of cost principles, and that the better view is to determine costs in the individual situation as to whether they are fair and reasonable in the light of normal business practice and standards.

For example, take the matter of contributions which I mentioned previously. A contribution expenditure can either be reasonable or unreasonable and, hence, justified or not justified as an item of cost just the same as anything else. For example, do you think the Ford Motor Company could live in the Detroit area and not give a certain amount to the community chest or give a certain amount to the hospitals there? Take away altruism or any kind of philosophy that may be involved. It is purely self-interest for the company to have good will in the community from which it draws its labor and where it is going to sell its product. On the other hand contributions could be distorted. Some company could develop a special interest in cancer research, let us say, and give large sums of money to this favorite charity where, by any test of reasonableness, it would not be a proper business expense.

I use those illustrations to show the dilemma that comes into the picture once you start making up statements of cost principles. Is a

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contribution allowable or not allowable? Well, stated either way it gets you into trouble. If you say it is not allowable, you deny the company a legitimate business expense. If you say it is allowable, then people may try to misuse the concession and use it as a basis of trying to defend any and all contributions. I know that the pressure from the hundreds of field auditors is to have everything clearly stated on a yes and no basis. Actually that is not the right way.

Now, so far as the basic philosophy back of cost principles goes, the reasoning goes something like this: Each company has to be considered on a somewhat separate basis. When a service goes out under a procurement program--in such a manner as the services have been doing for the last two or three years--it goes to a particular company because that particular company has developed a kind of know-how that is attractive to it. Whether it is Ford Motor or whether it is General Motors, Chrysler, General Electric, or some other company, that company is there because it has functioned in a certain way. It has followed policies and it has had procedures which have stood the test of competition and have made it a successful producer under competitive conditions.

Thus, when a service goes to that particular company, I feel as a matter of principle that it is in effect endorsing the policies and principles and procedures which put that company where it is and made it attractive as a supplier of government services.

Now, this means that, if there are particular ways that a company operates, the burden of proof is on somebody else to say that those are not proper and legitimate. For example, the particular company may be paying high salaries to its top executives. Let us take the case of General Motors; in the list of salaries being paid to this company's executives, there are some rather staggering figures. On the other hand General Motors has been a very successful company, and I am certain that the reason it has been successful has been because it has brought together a kind of management team which has earned high compensation.

Contrast that with the approach that existed at one time in one of the services where the rule was in force that no executive would be allowed a salary of more than 25,000 dollars for computing acceptable costs for any kind of defense contract. That is the kind of contrast that I want to bring out. General Motors is what it is because of its own policies; I don't think that anybody can bring General Motors into a procurement program and then second-guess what that company should do and what its policies should be in obtaining its objectives.

Another illustration on a more lowly level, but one which many field auditors raise from time to time, is with respect to pullman accommodations. The narrow view is that the traveler is only entitled

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to a lower berth and not a bedroom. But again I would say: Who is to tell General Motors that its executives cannot travel in a bedroom? That is one of its proven policies and methods, I think, that has attracted the kind of people to General Motors and kept that type there. It is not reasonable to try to impose some newer and narrower standard in such a case.

So I say that the statement should be very broad, with the emphasis on the policies and procedures that have been developed by that company, always, of course, subject to the test of reasonableness, but reasonableness adjusted to the light of what the company has been able to accomplish under the particular kinds of policies and procedures that it has.

Another important aspect of this problem from industry's viewpoint is that when the Government buys from a company it comes in, in effect, as a partner and, hence, should share just like anybody else in the costs of that organization. In other words it buys its pro rata piece of the top management team and the related general overhead. I am not saying that it should buy a part of the time of the people who are directly concerned with the promotion of commercial products. But I am talking about the general type of central administration and general organizational costs.

The foregoing is directly opposed to the view, that is frequently or sometimes taken, that the Government comes in as an incremental buyer; that the same costs are to be carried by the commercial business; and that only the extra out-of-pocket costs are to be borne by the Government.

No one will go to the farthest extreme in this respect; it is always a matter of degree. For example, no one would probably take the incremental viewpoint to say that we must only take the direct materials and the direct variable expense that is incurred and consider those as the only allowable cost under a Government contract. Everybody would, I believe, generally agree that the Government ought to take its share of the manufacturing and administrative overhead. But, again, it is a matter of degree, and there is frequently a chipping away as to items where it is claimed that the contract could have been performed without incurring those particular costs.

Of course, you can carry that kind of viewpoint to ridiculous extremes. Let us take the case of painting of the buildings every two years. We could avoid painting our buildings at the end of two years. We can perhaps let them go five years even though this might not be the most economical approach over the long run. Therefore, one might argue: "Well, there shouldn't be any painting expense in the costs to be allocated to defense contracts because it is a cost which we could have avoided

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incurring this year." It is in my opinion an unreasonable point of view and it is inconsistent with the sound principle that the Government contracts should bear its proper share of those costs incurred in accordance with management's normal business policies.

As I previously indicated, there is no statement of cost principles today for fixed-price contracts. As you may know, section XV has been used by the auditing people as a guide in the preparation of their audit reports. The reason for that is a very simple one--I probably would have made the same decision if I had been the head of a service--that there must be some sort of standard ground rules for the administration of an organization as large as the three auditing organizations in the three services. However, it was recognized in the directive that these cost principles are there as the basis only for preparing audit reports whereas the contracting officer is free to move and act in final price negotiations as he sees fit. Actually, he is not bound by either section XV or by the audit report itself.

That raises the very practical question of how controlling the audit report is on the contracting officer. My view on this matter is that the auditor or the accountant, whether he be in the Government or in Industry, is performing an advisory function to help management do a job. Therefore, the contracting officer should independently weigh the various factors involved and make his own decisions. If the contracting officer simply rubber stamps the audit report, he is not discharging his duties properly.

Recently, there has been a movement to substitute section VIII principles for auditing purposes instead of section XV. This seemed to be a sound proposal on the assumption that findings based on section VIII would be no more binding on the contracting officer than was previously the case with section XV. However, by the time the revised directives took definite form, it had been turned around to become the controlling statement of cost principles for fixed-price contracts. This was done primarily by establishing as "costs disallowed" all costs not recognized by section XV. And at that point I opposed the change, because I wanted it used in exactly the same way that section XV was used before with excluded costs shown only as subject to negotiation. Industry was not ready to accept the solution that section VIII then was the really applicable set of principles for going fixed-price contracts rather than just a stop-gap measure taking the place of section XV. This matter is still being discussed.

Efforts to develop a statement of cost principles are still being continued and I am highly sympathetic with the objective although I have, as previously indicated, some personal views about the undesirability of trying to be too specific in a statement of cost principles

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for fixed-price contracts. If I were writing the statement of cost principles for fixed-price contracts, I would require only about two pages to cover what I call sound business principles. Then I would try to get higher-level people into the auditing organizations to administer the program on the basis of sound judgment.

Because section XV is used as a yardstick now, there is a general feeling on the part of industry and also on the part of many people in the services that section XV is playing a greater role than it should. Just by its very presence we seem to be too much influenced by section XV as being the controlling guide as to costs applicable to fixed-price contracts.

Moreover, I think that there is an overemphasis on costs in general in our present procurement. Again, it is easy to understand why because all the negotiation people like to put their fingers on something that is definite. When you have an audit report, listing all the costs disallowed and for further consideration, it is something tangible for the contracting officer to put his hands on. But actually, gentlemen, costs are still only one factor in the picture. Just blind adherence to costs can lead you into some ridiculous situations. Let us say that on an index basis one company's cost was 100 and we negotiate, let us say, a 10 percent profit. Therefore, the cost is 110. Maybe another company, which is doing a completely better job, may have relative costs of only 80. Certainly, if costs are the only bases used we will not only deal inequitably between the two contractors, but we will, in fact, encourage high-cost operations. Blind adherence to cost and profit rates will lead to situations which will conflict with the Government's ultimate long-run self-interest and with the important retention of incentives for rewarding the company which does a more effective cost-control job and has the lowest over-all price.

I should like to say just a word about profit margins. I have already anticipated the problem somewhat, but there are one or two more things I should like to add.

We are, of course, in this interim phase where we have to deal with price as made up of cost plus profit and we must necessarily think about the kinds of misunderstandings which can develop as to profit rates. Unfortunately, profit information makes good political fodder. Some congressional committee may find that one company was making 15 percent, while another was making only 5, 6, 8, or 10 percent and, on the surface, this can be made to look very bad. But again I should like to point out that the profit margin is just one component of the total price; and always, for our own mutual interest, we ought to keep our eyes on the total price and not on the profit rate.

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On the other hand I am not unmindful of the political misinterpretations that are made on the basis of picking up a particular contract and saying, "Why, this service did a terribly bad job because it allowed company A a 15 percent profit." Somebody says, "Wouldn't it be wonderful if we could say to every contractor that his profit rate is going to be 5 percent?" I am sure a lot of you realize that the story is not that simple; that the cost base may be something quite different in the one case from what it is in the other.

There are no established ground rules for what profit rates should be. Consequently, there is a tendency to standardize the profit rate, which is really very unfortunate. Actually, as I have indicated, the profit margin ought to be something that takes into consideration the kind of performance the contractor is doing and the kind of total price which is being received for the product involved.

Profit margins vary presently within too narrow limits. The problem is to use profit rates properly to reward the contractor who does a good job. Whether it be the Ford Motor Company or whether it be contractor A or B, I don't care who it is, let them stand on their own merits in that connection. Again, the problem is to develop that kind of philosophy in a way that will not be misunderstood by the people who look over our shoulders. And also the problem involves educating these people so that they look at the problem in terms of the total price instead of the profit margin.

COLONEL JOHNSON: There seems to have been some controversy on the definition of the incentive-type contract. I have asked Mr. Brink to take just a minute to give us his interpretation of what an incentive-type contract is, and his appraisal of it.

MR. BRINK: I have used the word "incentive" in my remarks in a very broad sense as anything in a contractual arrangement that provides an incentive. There is, of course, the "incentive contract" used as a term to refer to a particular type of contract. Actually this is a type of contract to which I have not been directly exposed, because the Navy has been the chief user of this in BuAer, and though we are making an engine for the Navy, we have not yet agreed on the particular form of contract which will be used.

From what study I have done so far, I have not been particularly enthusiastic about it. I know that there are many people who have just the opposite view. My point is this:

First of all, my understanding is that the incentive contract is a type of arrangement where at the time you are, let us say, 30 or 40 percent through the contract, you set a target price; and then at the

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end of the contract you take a look and judge your cost performance; and, in accordance with a prearranged scale of percentages, you share the profits or losses between the actual performance and that target, up to the point where there is a ceiling price, which, of course, can under certain conditions eliminate all profit.

Actually, in a sense, the incentive contract is a variation of the price-redetermination type contract. With price redetermination there is 100 percent sharing of profits or losses, while in the incentive type it is a modified scale with lower percentages. So that I would say that the incentive contract is a partial application of what we call the full-incentive contract, the price redetermination contract.

QUESTION: Would you say that it meets the purpose for which it was intended any better than the other kind of contract, particularly the fixed-price contract or the fixed-price with price redetermination, where you do not usually know the cost in advance?

MR. BRINK: The way I look at it--as being a partial application of the price-redetermination contract--it seems to me that it is unnecessary; that, once you have gone through 30 or 40 percent, you ought to be in a position to move to the final fixed price with full sharing of risk.

However, there may well be conditions where some intermediate application of that might be desirable as a substitute. However, it is important to observe that under a Form II-B type contract, either the contractor or the Government can reopen the price after a period of not less than 90 days. In summary I would not say that this type of contract should be ruled out. Rather it should be looked upon as being one type of contracting arrangement that is available. However, it should not be viewed as a type of contract applicable to all situations.

QUESTION: Will you comment on contract renegotiation as a means of profit control?

MR. BRINK: Renegotiation, of course, in a sense is an over-all approach to all defense business. We look at all our profits for the year on all of our defense business. Then if our profits are excessive, a refund of profits is negotiated.

We do not think under the present type of procurement that renegotiation is going to amount to very much. The profit control under our redetermination procedures has been so well applied that our best forecasts at the present time indicate that there were no excess profits for 1951 nor for 1952, and there are not likely to be any for any year.

It is, however, a kind of a backstop in case the services have not done a proper job with their regular contracting procedures. As such,

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I see no harm in it being in the program. I am not necessarily recommending that it be eliminated, except to point out that to the extent that there are excessive profits it is to some extent an indictment of the job that has been done on the individual contracts. From the contractor's standpoint, however, it does give the contractor a chance to offset some poor guesses or losses against some good ones.

COLONEL JOHNSON: Would you put on one of your other suits for a moment and say whether you think that possibly the services need that renegotiation technique to help do as good a pricing job as they are doing now?

MR. BRINK: Actually I never like to encourage anybody to relax efforts by saying, "Here is this backstop on which you can rely." The services might simply look at it from the point of view that "It doesn't make any difference what we do. Renegotiation will pick it up," and, of course, that would be bad. I do not think it should in any sense reduce the effort of the services to do the right kind of job on pricing the individual contracts.

QUESTION: You brought up the point of allowing interest on borrowings in the cost accounting. Would you care to discuss the pros and cons of that?

MR. BRINK: It is very controversial and I can really argue it both ways. From the standpoint of the contractor who has to go out and get extra funds to operate his business, you can make a very good case. In such cases it is just like any other expense that the contractor has to incur to get the tools with which to do his job to help him get his factory, his materials, his people, and his current working capital.

The only argument on which you can rule it out of the picture is to start with the predetermined concept that all businesses ought to be fully financed. If you do that, then, of course, you can say that, if he is not sufficiently financed, borrowing additional funds is his own fault and, therefore, absorbing the interest expense is a proper penalty.

I feel that from the standpoint of general accounting practice and cost concepts, we should regard it as just as much a cost as anything else. It is also consistent with the philosophy I expressed--that you take a business as it is when you deal with a particular company.

QUESTION: Sometimes endowment funds of nonprofit organizations are used, which may be in considerable sums--hundreds of thousands of dollars or half a million. Is there any provision for reimbursement for the interest that they lose during the execution of the contract?

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MR. BRINK: That is somewhat out of my field. But it seems to me that you almost have two issues. First, if you recognize interest as a proper cost, then it is easy to take the next step and say that endowment funds from which you have borrowed are just like borrowed funds from an outsider, and that there ought to be reimbursement for the use of those funds just the same as to an outsider. So I would say that once you have taken the first step, interest is a proper charge.

QUESTION: You made a statement about having one set of figures for cost principles for all contracts. With respect to pricing, is it your idea that this would be a rather broad, general guidance, or would it be two columns saying that these would be allowable and these would not be allowable to the contractor?

MR. BRINK: As I previously indicated, I first of all believe that the statement of cost principle should be fairly general. Then I think the auditors could properly report those costs which they believe were completely acceptable and those which should be considered further by the contracting officer. This does not mean that any costs are not subject to negotiation but it does make the advisory service of the auditors more useful. On the other hand the contracting officer is not unfairly committed through putting costs into a disallowed column.

QUESTION: In your opinion what bearing, if any, should a company's commercial profit have on arriving at a reasonable and accurate margin of profit under a government contract?

MR. BRINK: I don't think there is any positive answer to that. I think, however, it is something that should be given consideration, even though it should not be controlling. However, there is no absolute relationship between the two. If we are making 20 or 25 percent on our commercial product, it doesn't necessarily mean that we should be making it on our defense business. As a matter of fact, we would not want it that way, because a company the size of Ford or General Motors or Chrysler is just as much concerned with public reactions as are the services. We have a joint interest with them. We know that if some outside criticism should develop, through the General Accounting Office or some committee of Congress making an investigation, right or wrong, it can be just as damaging to the Ford Motor Company as it can be to the War Department. So we are naturally conservative with our profit margin.

I would say that it is a factor which helps the contracting officer to make up his mind, but there is no absolute mathematical relationship.

COLONEL JOHNSON: Mr. Brink, we appreciate very much your time and the remarks and conclusions that you have given us. You certainly gave us a fine insight into your view of cost principles.

(21 Apr 1953--250)S/rrb.