

STATUTORY RENEGOTIATION AND PROFIT CONTROL

19 December 1957

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Publication No. L58-75

INDUSTRIAL COLLEGE OF THE ARMED FORCES

Washington, D. C.

Mr. Charles H. Swayne, Director, Office of Review, The Renegotiation Board, was born in Philadelphia, Pa., 26 October 1900. Following completion of education in New York State, he engaged in public and private accounting from 1922 through 1926, in Georgia and Florida. He served in financial research and investment advisory activities in New York City with the firm of Dominick and Dominick, Members of the New York Stock Exchange from 1926 through 1936; he was head of the buying department of Hincks Brothers, investment bankers in Bridgeport, Connecticut from 1936 through 1940. In 1941 he became secretary-treasurer of Automatic Machinery Manufacturing Corp., Bridgeport, Connecticut, and upon the sale of that company in 1943 he entered Government service with the renegotiation authority of the Army Air Corps, at 67 Broad Street, New York City. Late in 1945 he returned to private business until returning to Government service with the Armed Services Renegotiation Board, Air Force Division in April 1949 where he served through 1951. During 1952 and 1953 he worked with the Office of the Assistant Secretary, Department of the Army, on special assignments. In January 1954 he returned to the Renegotiation Board and he became special assistant to Thomas Coggeshall, (the present Chairman of the Renegotiation Board) in March 1955. He was appointed Director of the Office of Review on 19 April 1957. This is his first lecture at the Industrial College.

STATUTORY RENEGOTIATION AND PROFIT CONTROL

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MR. MUNCY: Good morning, Gentlemen: As you know, for many years it has been national policy to eliminate excessive profits derived by prime and subcontractors from defense contracts. Since 1951 the implementing and the enforcement of this policy has been the responsibility of the Renegotiation Board, an independent body composed of five members appointed by the President.

Our speaker this morning is the Director of the Office of Review, of the Renegotiation Board. His professional experience is quite wide, including both public and private accounting, financial research, and investment advisory service with a Wall Street investment firm, and subsequently, he was secretary-treasurer of the Automatic Machinery Manufacturing Corporation of Bridgeport, Connecticut.

He first joined the Government service in 1943 as a member of the Army Air Corps Renegotiation Authority. He has been with the Renegotiation Board during the past four years. His extensive experience both in industry and in Government eminently qualifies him to speak on the subject, "Statutory Renegotiation and Profit Control."

Gentlemen, it is a pleasure for me to introduce Mr. Charles H. Swayne to the Class of 1958 and to welcome you to this platform, Mr. Swayne.

MR. SWAYNE: Admiral Clark, Members of the Industrial College: It is indeed an honor to be asked to address your group. I shall try to make as plain as possible a rather complicated subject.

In order to explain what renegotiation is, it is perhaps best first to explain what it is not. Renegotiation is first of all not a form of taxation. Income taxes apply to a contractor's entire income, regardless of source. The purpose of taxes is revenue. Taxes operate automatically under a definite formula. Renegotiation, on the other hand, so we shall see, is a judgment operation. It applies only to profits accrued from specified Government prime contracts and subcontracts.

The purpose of renegotiation primarily is the prevention of the waste of taxpayers' money in the execution of the Nation's defense program. Renegotiation is not to be confused with redetermination of the price of an individual contract pursuant to provisions in the contract itself. Price redetermination is reserved for specific contracts entered into under conditions which preclude ascertaining in advance a fair and reasonable contract price. Renegotiation although based on a similar justification, is conducted on an overall basis with respect to the total income of a contractor in a fiscal year from all of its renegotiable contracts and subcontracts.

In the broadest sense, renegotiation is a process by which the Government recaptures amounts which have been determined to be excessive profits realized on defense business. The Renegotiation Law in effect during World War II resulted in the recovery by the Government of more than \$11 billion gross, or more than \$3 billion net. By "net" I mean after deducting from the amounts determined as excessive profits, the amounts already paid as income tax on those profits for which contractors were given full credit. No record was kept during World War II of indirect savings attributable to renegotiation.

The present Board, operating in a period not characterized by total mobilization, has made gross determinations in an aggregate amount exceeding \$600 million. Voluntary refunds and price reductions by contractors, directly attributable to the renegotiation process, have brought to more than \$1.25 billion the aggregate amount of recoveries and savings since 1951. Total administrative expenses of the Renegotiation Board since its inception have amounted to less than 2 percent of the latter figure.

Renegotiation is not an exact science. As indicated above, it does not involve an audit, contract by contract, of the vast defense procurement expenditures of the Government. It is rather a broad, overall review of the contractors' operations for an entire fiscal year, based upon information submitted by the contractor itself, and upon its aggregate receipts and accruals during its fiscal year from all of its renegotiable business.

Excessive profits, if any, are determined by the Board in light of certain statutory factors by the application of judgment to the facts and circumstances of the particular case. The results of loss or low-profit contracts thus offset the results of high-profit contracts. Affiliated or related contractors may be considered together in a consolidated or

concurrent proceeding. To the extent allocable to renegotiable business, all items estimated by the Board to be allowable costs for Federal income-tax purposes are required by the statute to be allowed as costs of renegotiation.

We are bound by statute--not by procurement cost principles--in determining the segregation of cost and expenses. If the Government and the contractor fail to agree upon the amount of excessive profits, if any, to be eliminated, a unilateral order may be issued, reviewable in the Tax Courts.

The foregoing is a very brief outline of the renegotiation process. Now, as to the origin of renegotiation, a brief review of the history of renegotiation may be helpful. George Washington, in the earliest days of our Nation, complained of merchants who had charged unfair prices for needed materials during the Revolution, and called on the Congress "to enact and enforce efficacious laws for checking the growth of these monstrous evils." Similar complaints arose during later wars, but the movement "to take the profit out of war" did not come fully into being until the large profits accrued by suppliers in World War I erupted into a nationwide scandal. In more recent years the problem has been immensely aggravated by the impossibility of knowing in advance the right price for making more and more complicated products, some of them never before made.

Between the close of World War I and 1942, some 170 bills and resolutions were introduced in Congress to eliminate or control wartime profits. Early in 1942 the Supreme Court handed down a decision in the case of United States versus Bethlehem Steel Corporation et al, involving certain World War I ship construction contracts. The contracts provided, among other things, that the contractor would be paid its costs plus a profit and one-half of any savings in estimated costs. The Government contended that this extra-payment clause provided grossly excessive profits and was therefore unconscionable and void. The court upheld the contractor and said, "If the Executive is in need of additional laws by which to protect the Nation against war profiteering, the Constitution has given to Congress, not to this Court, the power to make them."

That decision spurred activity for the control of war profits, particularly since Pearl Harbor had already occurred and we were in World War II. Indeed, many of the more enlightened leaders of business realize that, if industry were permitted to realize unduly high profits from war production, the morale of the fighting forces would be undermined and industry would suffer in the eyes of the public.

On 28 April 1942, the first Renegotiation Act came into being. Except for a brief period, renegotiation has been with us continuously since that time. I cannot hope to carry you through all the changes in the act during the war, let alone the reasons for them. But let it be said that the basic idea was so sound that, in its essential features, the Renegotiation Act of 1951 does not differ substantially from the World War II Act.

Renegotiation has not endured without opposition. From the outset it has been bitterly assailed from various quarters. It has been variously described as arbitrary, unfair, confiscatory, unconstitutional, and even un-American. Yet it survives, probably because Government and much of industry alike recognize that some means of control of defense profits remains a national necessity. And renegotiation seems to be the least undesirable method thus far devised. Industry spokesmen, when asked to express their views, have repeatedly indicated a preference for renegotiation, rather than the profit limitation provisions of the Vinson-Trammell Act and similar legislation.

The grounds upon which the constitutionality of the wartime renegotiation law was upheld are of interest. The Supreme Court said, in part: "In total war it is necessary that a civilian make sacrifices of his property and profits with at least the same fortitude as that with which a drafted soldier makes his traditional sacrifice of comfort, security, and life itself. In war, both the raising and support of the Armed Forces is essential. For his hazardous full-time service in the Armed Forces, a soldier is paid whatever the Government deems to be a fair, but modest, compensation. Comparatively speaking, the manufacturer of war goods undergoes no such hazard to his personal safety as does a frontline soldier, and yet the Renegotiation Act gives him far better assurance of a reasonable return for his wartime services than the Selective Service Act and all its related legislation give to the men in the Armed Forces. The constitutionality of the conscription of manpower for military service is beyond question. The constitutional power of Congress to support the Armed Forces with equipment and supplies is no less clear and sweeping."

Now, as to the organization of the renegotiation authority: Throughout World War II renegotiation was conducted by the military departments and other agencies, such as the Maritime Commission and the Treasury Department, whose contracts were subject to the act. Under the 1943 act, sole authority to determine excessive profits was vested in the War Contracts Price Adjustment Board, a policymaking and appeal body composed of the chairman of the several departmental price adjustment boards which conducted initial renegotiation proceedings.

The wartime statute terminated on 31 December 1945, in that it did not apply to profits accrued after that date. When in May 1948 the international situation became tense and defense procurement increased, Congress reinstated renegotiation. The 1948 act was of limited coverage, applying mostly to aircraft and aircraft parts and related items, such as equipment used in communications, fire control, and warning systems.

Renegotiation authority was vested in the Secretary of Defense, who in turn established the Armed Services Renegotiation Board, consisting of the Army, Navy, and Air Force Renegotiation Divisions. He also established the Military Renegotiation Policy and Review Board, composed of the chairmen of the aforementioned three operating divisions.

By the time of the start of the Korean incident, the 1948 act coverage had been expanded to include practically all negotiated contracts of the armed services, and had been extended through 30 June 1951. Early in 1951, Congress enacted a new renegotiation law greatly reminiscent of the one that had proved so successful in World War II. The application of the 1948 act was cut off at 31 December 1950, and the new law was made effective from and after 1 January 1951. By successive amendments it has since been extended to apply through the end of calendar 1958.

The 1951 act effected one major organizational departure--the separation of renegotiation from procurement. A new authority, known as the Renegotiation Board, was created as an independent agency in the executive branch of the Government. Now, this does not imply that the Renegotiation Board and the Procurement Authority are strangers to each other. On the contrary, they have always maintained an active and cooperative working relationship which has been of mutual benefit. It is of vital importance to contractors, to us in renegotiation, and to contracting officers that we get adequate and reliable performance data from procurement personnel. We do our best to develop performance data on a basis that will involve the least administrative burden on procurement and on industry. We do not request data unless and until the case has been carefully examined and the need for such data is clear.

The Renegotiation Board is composed of five members, all appointed by the President, who also designates one member as Chairman. The appointments are made with the advice and consent of the Senate, and are preceded by four nominations--one each from the Secretaries of the Army, the Navy, and the Air Force, with the approval of the Secretary of Defense,

and one from the Administrator of General Services. The fifth member is appointed by the President without departmental recommendation.

The Board functions by delegation of authority through regional operating boards, of which there are three currently in existence, located in New York, Detroit, and Los Angeles.

Framework of the Act

Now let us examine the mechanics of renegotiation and the framework of the act. The term "renegotiation" connotes a procedure whereby the parties to a contract, having negotiated a price at the outset, sit down at a later date and negotiate a new price. That is what the 1942 act contemplated. Very quickly, however, it became apparent that the renegotiation authorities could not, as a practical matter, reset the price stated in each of the vast number of war contracts and subcontracts.

Within a few months the law was changed to provide for overall renegotiation on a fiscal year basis. There were other reasons, too, for this change--reasons of fairness and contractor convenience. Overall renegotiation enables a contractor's profits from its entire defense business to be examined for a specific fiscal period. Loss or low-profit contracts may thus be offset against more profitable contracts.

Until early in 1957 the 1951 act applied--ignoring exemptions, for the moment--to all contracts of 21 separate Government departments and agencies and related subcontracts. Early in the current calendar year, 14 of these were eliminated from the act, it having been determined that little, if any, of the procurement of those agencies any longer related directly to the national defense. Those eliminated included such agencies as Housing and Home Finance Agency, Tennessee Valley Authority, the Geological Survey, and the Bureau of Mines.

Renegotiation coverage today is confined to what may be considered the hard core of defense agencies--the Departments of Defense, Army, Navy, and Air Force; the General Services Administration; the Atomic Energy Commission; the Maritime Administration; and the Federal Maritime Board.

Any contract entered into by any one of the departments or agencies covered by the act, whether by negotiation or by formal advertising and competitive bidding, and regardless of amount, is subject to renegotiation, unless exempted by the act or by the Board, likewise any subcontract

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thereunder in any tier. Not every contractor or subcontractor, however, is subject to renegotiation action by the Board. That depends on the total amount received or accrued by a particular contractor in the course of its fiscal year under contracts with the department and subcontracts.

The act establishes a minimum amount, or "floor" and provides that a contractor or a subcontractor shall be renegotiated only for a fiscal year in which its aggregate receipts or accruals from its renegotiable business exceed that minimum. Originally, in 1951, the floor was \$250,000. It was later raised to \$500,000. At present it is \$1 million.

Since 1943 the act has also applied to agents and brokers whose compensation is usually in the form of commissions representing a percentage of sales. It was found that, in a period of expanding defense procurement, such income can, and often does, balloon to unreasonable heights without corresponding effort on the part of the recipient. To control this situation the term "subcontract" is defined in the act to include any agreement in which compensation is contingent upon the procurement of such a contract or subcontract or is measured by the amount thereof. A separate floor of \$25,000 has always existed for agents and brokers.

Now, what of a parent and subsidiaries? Do they each enjoy a separate \$1 million floor? No. Affiliated companies are considered together for this purpose, and all may be renegotiated if their combined renegotiable receipts or accruals for a fiscal period aggregate more than \$1 million. The same rule applies to companies related by common ownership. Renegotiation proceedings with affiliated and related contractors are conducted either separately or, if the contractor so requests, on a consolidated basis.

The Renegotiation Process

Now, the renegotiation process begins with a filing by the contractor. Every contract or whose renegotiable receipts or accruals exceed the floor for a fiscal period is required to file with the Board a financial statement setting forth certain prescribed information with respect to its sales, costs, and profits for the year. This filing must be made not later than the first day of the fifth month following the close of the contractor's fiscal year. The Board must commence renegotiation within one year thereafter or the contractor is discharged from liability. When commenced, renegotiation must be completed within two years thereafter.

The time for completion may, however, be extended by agreement. These limitation periods run only in the absence of fraud, malfeasance, or willful misrepresentation of a material fact.

When a filing is received by the Board, it is first put through a screening process in the Washington Office. By this means the Board is enabled to screen out those filings in which it appears that the contractor either sustained an overall loss from renegotiable business or realized profits that plainly were not excessive. Filings which indicate a possibility of excessive profits are sent to the regional boards for commencement of renegotiation proceedings.

The proceedings are informal. Meetings are held with the contractor for the purpose of discussion. No testimony is taken; no verbatim minutes are kept. Not every case assigned to the field results in a determination of excessive profits. Quite often it is found that the contractor did not realize excessive profits, and a clearance is issued. When a determination of excessive profits is made, the regional board endeavors to obtain an agreement from the contractor to refund the amount so determined, less, of course, the tax credit. If the contractor declines to enter into an agreement, a unilateral order is issued. In the case of a contractor whose renegotiable profits are not more than \$800,000, the regional board has authority to make an agreement or issue an order. The order, however, is subject to review by the statutory board, either on its own motion, or at the request of the contractor. An agreement in this class of case is final.

In the larger cases, the regional boards may finalize an agreement only after the statutory board has concurred in the recommended determination. In such a case--the larger cases--if the statutory board does not concur, or if an impasse is reached in the region with the contractor, the case is reassigned to the statutory board for completion. Any contractor in whose case a final, unilateral order is issued may obtain a judicial review by filing a petition in the Tax Court of the United States. The proceeding in that court is strictly de novo and is not in the strict legal sense an appeal. In it, the determination of excessive profits made by the Board may be affirmed or it may be lowered or raised by the court.

The contractor whose sales were under the statutory floor was formerly required to file with the Board. Under a recent amendment to the act such a contractor has the option to file or not. Of course the advantage of making a filing is that, barring fraud, the contractor is discharged from liability one year later, unless the Board challenges the accuracy of the filing and commences renegotiation.

Exemptions

Earlier I mentioned exemptions. These are either mandatory or permissive. The mandatory exemptions are specified in the act. They include contracts and subcontracts for agricultural commodities in their raw or natural state, or for the products of a mine or of an oil or gas well, or other raw materials which have not been processed beyond the first form or state suitable for industrial use. They also include, under certain circumstances, public utilities and tax-exempt organizations, and they include contracts and subcontracts for so-called standard commercial articles and services--difficult terms which are elaborately defined in the act.

The partial mandatory exemption for long-lived machinery, tools, and other productive equipment make such items renegotiable only to the extent that they are used in defense production. Other contracts or subcontracts are exempted by the Board pursuant to authority given to the Board in the act to grant exemptions in certain types of cases. These are the permissive exemptions.

The Board has exercised its authority to exempt, among other things, contracts and subcontracts performed abroad by foreign nationals, over whom it would be most difficult to assert and enforce Board jurisdiction, and subcontracts for materials purchased for stock and used indiscriminately in both renegotiable and nonrenegotiable production, because it would not be administratively feasible to segregate the extent of the respective uses.

Segregation of Sales

This leads to a consideration of segregation generally. The fundamental problem of renegotiation is the separation of that part of a contractor's business which is subject to renegotiation from the part which is not. Nonrenegotiable business includes, of course, both exempted sales and sales which had nothing to do with defense work in the first place.

The act imposes upon the contractor the primary responsibility to determine the extent of its renegotiable business. If the contractor is unable to tell from its own records, it has the duty to make reasonable inquiries of the customers who purchased its products and thus to ascertain to what extent they used those products in the performance of their renegotiable business.

So far as prime contracts are concerned, segregation of sales is a relatively simple task. Segregation of subcontract sales presents a more difficult problem. The Board's regulations suggest various methods designed to relieve the contractor from the time and money consuming burden of studying every one of its orders, which often run into very large numbers.

The regulations authorize the use of overall information obtained either from customers or from the contractor's own records in terms of dollars, units, or percentages. Such information is usually obtained or derived after the close of the contractor's fiscal year. When a contractor has numerous customers in the same industry for a single product, the regulations permit the contractor to determine its renegotiable sales of that product by making a representative sampling of such customers. If the contractor prefers to make its sales segregation, order by order, it of course may do so. In general, and the regulations so declare, the Board will not disturb a sales segregation so long as the contractor is able to demonstrate that it is based on reasonably reliable data.

Costs and expenses not directly attributable to renegotiable or non-renegotiable business are allocated on a basis consistent with regularly accepted accounting practices.

The Statutory Factors

Let us assume now that a contractor has made an adequate and a timely filing. If the case has not been screened out, it has been assigned to a regional board. Renegotiation is commenced, and the regional board obtains any additional information it needs to satisfy itself that the contractor has segregated its sales and allocated its costs in an acceptable manner. A meeting, or meetings, are held with the contractor. The regional board then makes its determination, either that the contractor has not realized excessive profits or that it has and, if so, the amount thereof. This is the ultimate object of any renegotiation proceeding.

As indicated earlier, renegotiation is entirely a judgment operation. There is no formula or yardstick, nor is there any ceiling on allowable profits. Certain factors prescribed in the act are applied to the established facts of the individual case. That is how the determination is made.

Before it is made, the contractor is given an opportunity to present, both orally and in writing, its arguments under these factors, its version

of how its performance measured up under them--in a word, a full opportunity "to make a case" for itself. The factors named in the act are: Efficiency; reasonableness of costs and profits; net worth; risk; contribution to the defense effort; and character of business. I shall discuss each, briefly.

1. Efficiency: The act states that, in determining excessive profits, favorable recognition must be given to the efficiency of the contractor, with particular regard to the attainment of quantity and quality in production, reduction of costs, and economy in the use of materials, facilities, and manpower. As may be seen, the act goes as far as it reasonably can to emphasize the efficiency factor and provide incentive to the contractor to reduce its costs and increase its productivity.

2. Reasonableness of Costs and Profits: The act provides that this factor is to be evaluated with particular regard to the volume of production, normal earnings, and comparison of war and peacetime products. Comparisons are made with the contractor's own costs and profits in previous years, and for the year under review, comparisons, where possible, are made with the costs and profits of other contractors in the same industry. Uncontrollable variations in labor, material, or other costs are taken into account. Controllable costs, such as selling, general, and administrative expenses, are closely scrutinized. Increased volume, resulting from stepped-up defense procurement, is carefully analyzed to determine the circumstances and the extent of such impact.

3. Net Worth: Here the act directs that the Board give particular regard to the amount and source of public and private capital employed. Net worth, as many of you know better than I, is the excess of the company's assets over its liabilities to creditors. Total capital employed is the total of net worth, debt, and any assets furnished by the Government or by customers. In renegotiation, assets furnished by the Government can be in the form of financial assistance, materials, or the free use of Government-owned facilities or equipment. Except in the most simple situations, rarely encountered, it is not easy to ascertain or estimate how much of a contractor's net worth has been devoted to the performance of its renegotiable, as distinguished from its nonrenegotiable, business. Most often, and only as a check, when it is reasonable to do so at all, an allocation of net worth is accomplished by applying a cost-of-sales ratio to the net worth at the beginning of the fiscal year.

In determining excessive profits, just as it does not use a fixed formula based on the rate of profits on sales, the Board does not use any

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formula based on the rate of return on net worth or capital employed. Reasonable profits are determined by an overall evaluation of all the statutory factors. The relationship of profit realized on renegotiable business to capital and net worth employed therein is only one of the considerations. The determinations must, of course, permit the retention of profits sufficient to provide a proper incentive for the investment of equity capital, and, where borrowed money is involved, must reflect the additional risk to which the equity capital is subjected.

We are frequently asked what view is taken in renegotiation to the use of large amounts of Government-owned facilities and equipment. As basic policy, the regulations say that a contractor who is not dependent upon Government or customer financing of any type is entitled to more favorable consideration than a contractor who is largely dependent upon these sources of capital. When a large part of capital is supplied by the Government or by customers, the contractor's contribution tends to become one of management only, and profit will be considered accordingly.

To illustrate this policy: Assume a case in which an increase in Government-furnished facilities enables a contractor to achieve greatly expanded volume for defense purposes. In such a case there will often be a significant increase in the rate of return on the contractor's net worth, when compared with preceding years. Certainly the Board must consider this fact, together, of course, with all other relevant factors, in determining whether the contractor's profit on the expanded renegotiable sales bears a reasonable relationship to the expanded volume.

4. Extent of Risk Assumed, including the risk incident to reasonable pricing policy: In certain industries contractors, by obtaining maximum production for defense, face a possible saturation of their post-emergency markets. In some cases, contractors temporarily sacrifice their civilian markets to competitors in order to accept defense orders. Risk is present in both of the instances cited. Risks may appear in many forms. Two of the most important areas for the operation of the risk factor are to be found in the pricing policies of the contractor and in the type of contract under which he operates.

A contractor who reduces his prices periodically, as circumstances warrant, should, and does, receive more favorable treatment under this factor than one who does not follow that policy. Frequently, in anticipation of renegotiation, contractors voluntarily refund a portion of their accrued profits to the Government. When this is done fairly early in the contractor's fiscal year, a greater risk is incurred than would be the case if the refund occurred near the close of the year.

As for contract types from the risk standpoint it is evident that the straight fixed-price contract carries with it the greatest pricing risk. The price stated in the contract is what the contractor gets-- no more, no less. At the opposite pole is the so-called GOCO contract. Here contracts are performed in Government-owned, company operated facilities. The contractor has little at risk. What it receives is in effect a management fee. Between these extremes are found all of the other contractual devices employed by the Government.

Most of you are familiar with the different types of price redeterminable clauses available to contracting officers. These clauses provide variously for negotiated revision of the initial contract price, either upward or downward, or, in some instances, downward only, either retroactively and prospectively, or prospectively only, usually at the 40 percent performance point, either once only at that point, or more than once, at the request of either party, and sometimes after performance has been completed.

Ceiling prices and special escalation clauses are also used when appropriate.

Now, it is obvious that under these pricing provisions contractors face widely varying degrees of risk. I should point out that a contract which provides for downward revision only represents an even greater risk than a fixed-price contract. This form is not in frequent use.

Then there are the incentive types of contracts, in which a target price is set on costs and, under a formula, the contractor shares with the Government in any savings as a result of costs lower than estimated. Since these contracts usually afford the contractor substantial protection, they rarely involve the risk of actual loss. In profit outlook, they differ only according to the soundness of the target price.

Even less pricing risk is present in the cost-plus-a-fixed-fee contract. The contractor has cost protection and is assured of a fee which is calculated to reward his efforts. Of course, if considerable amounts of unanticipated costs are incurred, the fixed fee may become no longer adequate; but this is uncommon.

As may be seen, in evaluating the risks assumed by a contractor in his defense work, the Board must take into account the types of contracts under which the contractor operated. These are considered in light of how much the contractor produced, its pricing policies, and all other relevant circumstances.

5. Contribution to the Defense Effort: It may truthfully be said that any one performing a renegotiable contract is in some form contributing to the defense effort. Not every contractor, however, is entitled to favorable consideration on this score.

Favorable consideration is reserved for exceptional contribution only.

Experimental and developmental work of high value, as well as inventions, techniques, and processes of unusual merit are examples of exceptional contributions. The extent to which a contractor cooperates with the Government and with other defense contractors in developing and supplying technical assistance to competitive sources of supply is a factor which is given favorable consideration.

6. Character of the Business: The matters to be considered under this factor include source and nature of materials; complexity of manufacturing technique; character and extent of subcontracting; and rate of turnover. In other words, the Board must adjust its sights for the type of business in which the contractor is engaged. The highly integrated contractor, who starts with raw materials and processes them through all intermediate stages into finished products, is entitled to more favorable treatment in renegotiation than, say, the contractor who buys finished components and subassemblies from others and assembles them into finished products.

Even among the latter type of contractor the degree of assembly complexity will vary. Likewise, the contractor who furnishes its own materials, with attendant effort, investment, and risk, is entitled to a larger dollar profit than the contractor who uses Government-furnished materials, or customer-furnished materials.

On the subject of subcontracting, the policy of the Board is expressed in its regulations, as follows:

"Although a contractor who subcontracts work may not reasonably expect to be allowed as large a profit thereon as if it had done the work itself, subcontracting of the kind described in this subparagraph, especially the extent to which subcontracts are placed with small business concerns, will be given favorable consideration in the renegotiation of the contractor. A contractor will be given favorable treatment when, by subcontracting, it utilizes, in the defense effort, facilities and services, particularly of small business concerns, which might otherwise have been overlooked or passed by; when it has demonstrated its efficiency

and ingenuity in finding appropriate opportunities for subcontracting; when the amount of subcontracting so accomplished is substantial; when the amount of complexity of technical engineering and other assistance rendered by the contractor to the subcontractor is substantial; and when the price negotiated with the subcontractor is reasonable in view of the character of the components produced."

That about sums up the process of renegotiation. I think you will agree that it is (at least) ingenious; and results over the years have proved its effectiveness.

Gentlemen, I thank you very much.

MR. MUNCY: Gentlemen, I anticipate that there may be many many questions this morning. Who has the first one for Mr. Swayne?

QUESTION: In the establishment of a profit level in the industry with whom you are doing your renegotiation work, do you use an arithmetic average of the industry, which is more or less traditional, the weighted average, or do you work each case on its own merit?

MR. SWAYNE: Let me try to make this clear. Each case is worked on its own merit. One thing that the Board tries to get across every time it can is that there are no established percentages for anybody. We, of course, by the operation itself, try to hold contractors within an industry to approximately level settlements, all things being equal.

Now, the Board attempts to establish an amount in dollars of profit which in their judgment is fair--and as I say, it is a terrifically burdensome judgment operation. Our office agrees or disagrees with the regional recommendation, and gives the reason for doing so and sends it up to the Board. We are reversed many times. We have no authority in the final settlement. It is up to the Board members. They attempt to establish in their minds what is a reasonable profit in dollars on the business done in that fiscal year. It comes out as a percentage.

They are guided by those percentages in their own judgment, in that companies in the industry, everything being equal, should come out approximately near each other. However, you will find sometimes that some percentage is up or down considerably from the average that had been settled in that industry, and, if so, there must be behind it a very well documented record of why.

Does that answer your question?

STUDENT: Yes, sir.

QUESTION: Sir, it would appear to me that this contract renegotiation officer would have to have the wisdom of several Solomons, plus a battery of Philadelphia lawyers to work with him. It would also seem to me that no two renegotiation officers would arrive at the same decision, or within a narrow range of decisions. When a decision is finally arrived at, though, how do you make it stick with the industry member?

MR. SWAYNE: You mean with the contractor.

STUDENT: With the contractor. Is it binding on him, or does he have recourse to the courts?

MR. SWAYNE: Oh yes, To begin with, the regional boards are composed of five men, too. I always sit in the board meetings of the Board here, and I have also sat in regional board meetings on visits. The first remark you made is true. You have to have men of very mature judgment. That has been one difficulty in manning renegotiation. From the start it was realized that, at the authority level, at least, and down to the level of the renegotiator, who deals with the contractor, unless we had men who had been in business and who had met the problems of business, the whole thing would fall right on its face. We have had great difficulty staffing it. We have many times had to operate with a short force, rather than to take on a sufficient number of people who could not adequately do the work.

When a decision is reached in the region, that is finally the judgment of the five man Regional Board. It varies among them, but they finally reach an agreement. The same is true of the statutory board. I can tell you there are some very heated discussions sometimes. They take it very seriously.

Then, when the contractor comes in for a final meeting, and the amount is proposed to him, he is given time to decide whether he wishes to agree. If he wishes to come up with some totally new information, he is perfectly free to do so; or he can ask for a summary of the facts and reasons upon which the decision was based, to help him to decide. If he decides that he will not agree, and if it has been reviewed by the top board, and they are in agreement with the recommended determination, the unilateral order is issued.

That is reviewable in the Tax Court of the United States.

QUESTION: Mr. Swayne, in our study of procurement over the last couple of weeks, our lecturers and our seminar leaders have told us a good deal about procurement officers, particularly in the armed services. I suspect that perhaps the opinions might have been a little bit prejudiced in favor of the procurement officers, considering that they came from people representing those services themselves. Without intending to put you on the spot at all, it strikes me that, at least from the standpoint of price, you are in an enviable position to sort of review the record of those procurement officers as to how good a job they are doing. Would you care to comment on that, please?

MR. SWAYNE: Well, first let me say very emphatically that we do not police procurement. We have very cordial relations with procurement. We used to be in procurement ourselves, as part of it. The procurement officer is dealing with one contract at a time, or maybe a small group of them, and we are dealing with the total subject business of the contractor from all services. Of course we do not go into it contract by contract. If we see one contract that looks like it has a terribly high profit, that is frequently offset against another. In other words, we do not try to run back to procurement and tell them that there is too high a profit on that contract. However, we make available to procurement reports of renegotiation, extracting from them any confidential data of the contractor--I mean anything that has to do with income tax. All of that is out. But we make available to procurement, when requested, for any company, the amount of renegotiable business and the profit and the adjustment, if any, on it. That of course does not show the profit contract by contract. But they can see what the contractor is left with overall. If it is primarily, say, an ordnance contractor. Ordnance can very well tell how it has been going, what the actual profit has been.

QUESTION: Sir, in our reading we have had available the conclusions of the Industry Committee on Renegotiation, and, as we might expect, they don't entirely share your enthusiasm for the process. The major question they ask is, Why should we have it at all, when we are not in a wartime economy with full mobilization, but in a period when we have some pretty hard competition?

MR. SWAYNE: Well, I want to make one thing clear. The last two times the act was extended our Chairman made it very clear to the congressional committees that the renegotiation authority was not advocating extension nor recommending the end of the act. That is entirely the

province of Congress. We are there and we administer to the best of our ability the act while it is on the books.

Now, as to whether it should go on, I presume that Congress remembers that, when the last request was made for the extension, the President remarked that, since over 50 percent of the national income was being invested in defense weapons, it was felt that some form of control should exist.

Now that they are getting into completely unknown production of articles, missiles, and all sorts of things, it is most difficult to anticipate costs, it is most difficult to set a price, and industry has, in hearings, I know, fought the idea of renegotiation. I can readily see why. At the same time in these hearings, when asked by some of the committees whether they preferred the operation of the Vinson-Trammell Act, they said no, that they preferred the judgment of renegotiation--if they have to have anything. Naturally they prefer no control. But, as I say, that is a matter for Congress to decide, and I presume that the reason it continues is the high rate of expenditures on defense.

QUESTION: Sir, you mentioned that renegotiation is on a fiscal year basis. Since many production contracts extend over a number of years, does that mean that the same contract might be reviewed a number of years in succession? Or, after one negotiation, is some effort taken to avoid future reviews?

MR. SWAYNE: No. You see, renegotiation is on a fiscal year basis, except there is one thing I did not point out that I should have. In some cases, where the contractor is on a completed-contract basis--say he is building a couple of battleships--obviously you can't work that on a fiscal year basis. In that case he is put on a completed-contract basis, and, if he has a number of contracts, he is screened out every year until some one contract is completed; and on that business he is renegotiated.

Now as for the continuing contract, where he has a lot of contracts, and he is reporting, for income tax purposes, on the fiscal year basis, the conglomerate of all his defense business, both prime and subcontract, form his renegotiable business, and his profit therefrom, in that one year, is renegotiated.

Some contracts may have ended in that year, and some may have carried over. On those that carry over, the accruals from those same contracts would be in his next year's total. Of course, in some cases

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where a contractor has a program, where he has very heavy make-ready costs, he can, by a special accounting agreement, be taken care of. If he spreads them over the years for his tax purposes, that's all right. He is taken care of. But in some rare cases a contractor will charge all of his tooling off in the first year, for income tax purposes.

We are required to use the income tax method basis, unless we have a special accounting agreement. In those cases, a special accounting agreement is reached with the contractor to spread those costs over the years, so that he won't show two or three years of loss and then suddenly a whopping profit in one year.

QUESTION: Since you are approaching each contractor on a broad basis, sir, why can't the same objectives be achieved through the use of the excess-profits tax laws?

MR. SWAYNE: That again is a matter for Congress to decide. Of course this is not a tax operation. The point is that Congress endeavored in this act not merely to recover by taxes but to, wherever possible, renegotiate so that, when a contractor sees that he is going to be reduced on his profits and to have to refund some, the ultimate objective will be to get that same contractor, wherever possible, in the following years, to either reduce his prices or make voluntary refund. We are delighted to see a company come in with sufficient voluntary refunds or price reductions to obtain a clearance. I can't mention any names, but there are some very large corporations that have received clearances for several years where they would have had quite a few million dollars of refund to pay. But they have shown at the end of the year that their figures are adjusted by periodic refunding payments through the year. That brings them down to the level of clearance.

QUESTION: Mr. Swayne, you clarified the point I was going to ask about. You stated first that you were not a tax service, yet your actions do directly reflect in the taxing medium, inasmuch as they get credit on taxes. My question is, In capital depreciation allowances, whether you follow the taxing procedures where you allow percentage depreciation of capital investment, or whether you go into the capital replacement cost. It is quite a problem, I understand, in both the steel and the chemical industries, to decide. I wish you would clarify that point.

MR. SWAYNE: We are very sympathetic with those industries. We are bound to follow the tax accounting. The only time we can vary from tax accounting is on a special accounting agreement with a repositioning

of costs or receipts. In those cases where it is very obvious that a contractor is apt to be hurt, for those reasons the Board can, in its judgment, give factor consideration to that. The actual accounting figures in the report have to be based on the tax basis, but the Board can, and does, give consideration to those cases where the contractor would be hurt.

QUESTION: Mr. Swayne, I would imagine that the Board would have a particularly difficult time in renegotiating those contracts which are of the incentive type, which you mentioned. A large number of dollars are spent by the departments under this incentive-type contract, and the basic idea of an incentive-type contract is that, as the contractor reduces his costs, he is rewarded by increased profits.

I have heard comments to the effect that certain contractors have in fact reduced their costs and have been rewarded by the procurement department for that reduction and that increase in efficiency by increased profits, and two years later, when they go under renegotiation, the Renegotiation Board takes away those profits which the contractor claims are attributed to increased efficiency. Would you comment on that, please, sir?

MR. SWAYNE: I know. That has come up. We have had quite some arguments on that. Let me say again that on the incentive contracts of a contractor--if he has a mix of incentive, fixed price, price redetermination, and CPFF--the profits on the incentive contract, insofar as the judgment of the Board is applied to his total renegotiable products, all go into the pot.

I know of one case--I won't mention any names--where there was a mix like that, and the refund, unfortunately, came very close to the profits they made on the incentive contracts. In that case it was a matter of coincidence, because it was on the overall mix of everything.

If a contractor has almost exclusively incentive contracts and he comes in and the Board takes a refund from him, the only thing that can be assumed is, that in the judgment of the Board, in light of later information the target had not been realistic. That's the only answer I can see to that.

QUESTION: I have two questions, sir. One is, In your determination of excessive profits for renegotiation, do you take into account profits before taxes, or profits after taxes?

MR. SWAYNE: Before.

STUDENT: If you said "After, : I was going to ask for the basis of your policy."

MR. SWAYNE: From the beginning we were bound by the act to do that. It caused quite a flurry at the beginning, back in 1942. One company came in and, as I recall, there was something like \$12 million or \$13 million it had to refund. They agreed immediately and said, however, that they were worried. It was a case there of ballooning volume. They said, "What will we do about it, for money? We are going to have three or four years of this, and out of this \$12 million, we have already paid income taxes of such and such an amount." Everybody was horrified because we realized that there was nothing in the act or the regulations to cover that. This company was willing to refund, but it would go into bankruptcy very quickly. So they went tearing down to Washington from New York, and out of that grew this arrangement whereby you simply obtain from the Internal Revenue Service the credit applicable to that amount of refund. The contractor then pays the net.

STUDENT: My second question, sir, is, Since you do not have any readily definable criteria as to what constitutes a contract which will be subject to renegotiation, and no fixed criterion as to when a profit is excessive, has your administration ever been challenged in the courts by a contractor, not necessarily on the basis that what you have done to him is inequitable, but that it is inequitable in the light of your administration of other contracts on the competitors in the same industry or in a different industry?

MR. SWAYNE: Yes. That has come up in points with the tax court on their (the contractor's) petitions to the tax court. They have sometimes claimed poor judgment, which of course is anybody's guess, on that. There have been various claims like that made. I will say, though, speaking of the court, that this particular Board has made approximately 3,000 determinations of excessive profit, and in a hazy period of at least not total mobilization we have been gratified to see that only 15 percent of those resulted in unilateral orders. The rest, 85 percent of those 3,000 determinations, have all resulted in agreement. About 6 percent of the orders have gone to the tax court. In other words, about a little less than 2 percent of the determinations have been carried to the tax court.

QUESTION: Mr. Swayne, in your discussion of risks, I understood you to say that the Renegotiation Board would take into consideration the possible loss of the civilian market. In peacetime it would seem to me that the decision of a contractor on the type of work that you would negotiate would be voluntary. I wonder if you would clarify that.

MR. SWAYNE: It is voluntary in peacetime, but not from the saturation standpoint. One of the industries with the greatest fears on that is the machine tool industry, because they were selling machines to the Government of the same type that they would sell to the peacetime industry, and frequently the Government sells surplus machines, and they could see their future market disappearing on them.

So far as the sacrificing of their civilian market in order to produce defense goods is concerned, some companies that are particularly adept in some very complicated scientific or electronic equipment have voluntarily, because of their own patriotism, or whatever you wish to call it, decided to further the defense effort, realizing they were needed, and have deliberately, to a big extent, pulled out of the civilian production in order to perform Government contracts. They have taken a risk, and, voluntary or not, it is certainly given consideration when they do that.

These factors, as I say, are difficult to hold separate. They do blend. Risk goes into contribution, and contribution and risk both go into character of the business. But they are given credit for that.

QUESTION: I seem to remember reading where the General Accounting Office has gotten into the act on several occasions, saying that profits were excessive. Do you discuss regulations with the General Accounting Office?

MR. SWAYNE: Well, we have no direct relations with the General Accounting Office. You are probably thinking of recent publicity about a certain company. We are not a part of that at all. When they call on us for figures, their request is reviewed very carefully by our General Counsel to see that we are not divulging anything of a secret nature, and we naturally furnish them with figures when they want them, and they furnish us with figures, just as the Air Force auditor or anybody else will, when we need help. But in the process of renegotiation we don't work together. It is more or less a case of a request for information, or something like that.

In some cases, where they have been asked to go into a certain contract, they are looking after that one contract. We frankly, are not

interested if a contractor has made 100 percent on that one contract. If he had losses on other contracts he may come out with a reasonable profit, as far as we go, on a mix. GAO is working largely for a service or for a congressional committee, tracking down one contract. We keep to the overall basis.

QUESTION: Mr. Swayne, is the refund on any particular contract subject to interest charges, and what is the period involved?

MR. SWAYNE: He, the contractor, is given a statutory time when he agrees to the refund or has an order issued to him. We are not a collection agency. That goes back to the service which is predominant. There is a certain length of time--60 or 90 days, or something like that. I wouldn't want to say definitely, without the regulations here, there are so many of those limitations. But, after a certain length of time then interest does accrue if he doesn't pay.

A contractor who is in a tight financial spot at the moment can come to us and, at the time he agrees, or, in fact, if he gets a unilateral order--we don't intend to break any contractor--he can say, "I can't pay this now." He can bring us current financial statements and we will work out a schedule over years, if necessary, to keep him going. And he pays interest on those deferred payments.

STUDENT: I was more interested in the interest charges between the contract payments and the decision on renegotiation refund.

MR. SWAYNE: Oh, no. It is after the determination, as far as the interest payments go.

MR. MUNCY: I see many other hands, but I will not be able to take your questions, I apologize. Perhaps some of you will have an opportunity at lunch time to talk with our speaker, or perhaps some of you can ask questions as we adjourn. I am going to take one more question.

QUESTION: Mr. Swayne, I don't believe you are going to answer it, anyhow. I understand, of course, your reluctance to discuss your clients or customers by name. Since the newspapers have played up the recent case of General Motors, or, rather, the Allison Company, on jets, could you clarify for us whether or not you and the General Accounting Office both got in on this particular case? Was that a special case? Or is there anything you can tell us about it that would help to clarify it?

MR. SWAYNE: All I can say is that the General Accounting Office got into it, but not through us. That came from another angle. The General Accounting Office contacted us and told us. But there again, General Accounting Office is interested in only one or two contracts. It was no joint operation, if that's what you mean. I can assure you of that. The case is pending before the Board. It has not been decided. But if you mean that we called the General Accounting Office in, I can say, no. That came from another source.

MR. MUNCY: Mr. Swayne, for myself I want to express my personal appreciation for your great ability to make a difficult subject, and one which in a free economy never can be popular, clearer to us. On behalf of the entire student body we thank you for a very profitable hour and one-half.

MR. SWAYNE: Thank you.

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