PRICE, COST, AND PROFIT MARGINS IN MILITARY PROCUREMENT

6 January 1958

CONTENTS

Publication No. L58-79

INDUSTRIAL COLLEGE OF THE ARMED FORCES

Washington, D. C.

602

Mr. Willis H. Guinn, Divisional Controller, Aircraft Engine Division, Ford Motor Company, was born in 1914. He received the B. S. degree from the University of Arkansas in 1935, the M.B.A. from Northwestern in 1936 and is a Certified Public Accountant. Mr. Guinn joined the Western Electric Company in Chicago in 1936, as an accounting trainee and remained there until April 1942. He served in the U. S. Army from 1942 to July 1946 and was released with the rank of major. During this period he was director of the Contract Termination and Auditing Course of the Army Finance School at Duke University and later at Fort Benjamin Harrison. Mr. Guinn returned to the Western Electric Company organization in New York in July 1946. In April 1950, he was appointed the Manager of Accounting of the Teletype Corporation, a Western Electric subsidiary in Chicago and was made Controller in 1951, with production programing and control as well as financial responsibilities. Mr. Guinn joined the Ford Motor Company in February 1952 as Manager of the Cost Department of the Lincoln-Mercury Division and in February 1953 was appointed Manager of the Central Cost Department on the staff of the Corporate Controller. He has been Divisional Controller of the Aircraft Engine Division since May 1955. This is his second lecture at the Industrial College.

PRICE, COST, AND PROFIT MARGINS IN MILITARY PROCUREMENT

6 January 1958

CAPTAIN STEIGELMAN: Admiral Clark, Students, Faculty, and Guests: Since the Materiel Management Unit commenced, we have had eight speakers, all associated with Government, who have spoken on various aspects of procurement. This morning we are going to hear about another aspect of procurement, but this time from a representative of industry, Mr. Willis H. Guinn. Mr. Guinn will talk to us on the subject, "Price, Cost, and Profit Margins in Military Procurement."

Mr. Guinn is well experienced in this field, having had many years of association with different companies, especially the Ford Company. He has had training in contracts, accounting, and finance. At present he is the Controller of the Aircraft Engine Division of the Ford Motor Company, Chicago. I am sure you will enjoy his talk.

It's a pleasure for me to introduce to you Mr. Guinn.

MR. GUINN: Thank you, Captain.

I must confess that I was relieved this morning, as the Captain and I came over to the College together, to hear that the class had already heard the skunk story that was used to introduce me last year.

I admit I feel at home here at the Industrial College. I had some association with the College during the last war. As a matter of fact, when it moved into contract termination activities, the group that I was in charge of furnished several instructors and members of the staff to the College. I was here a year ago, and when the College made a visit to our installation in Chicago in April I saw some of the students again. I was privileged to attend the presentation of the final problem of the predecessor class last June. I must say I found that problem presentation most interesting and excellently done. I also got a little scared, too, since they were talking about what we should do with regard to our overall military planning and what could happen to us.

Last year I felt reasonably relaxed when I talked to this group. As the Captain has explained, I have charge of the financial matters of the

Aircraft Engine Division of Ford in Chicago; and the biggest financial problem we face every year is negotiating our prices with the Air Force. We are on an annual repricing basis.

Before I talked here on a Monday and Tuesday, we had just finished the preceding Friday negotiating about a billion dollars' worth of prices. So I was real relaxed. This year I'm afraid the converse is true. We are just pointing up to that negotiation. I am speaking about a month earlier this year. I hope you will excuse me if I am a little jittery this time. I've got a big job ahead of me.

By the way, I was impressed last year--and I imagine the same thing applies this year--with the length to which the College goes to make certain that you are exposed to all sides of a question. Not only did General Baker, who was General Thurman's predecessor, speak last year and then I spoke, but the College wasn't satisfied with giving you the military versus the industry viewpoint. They not only had a representative of Ford, but they also had a vice president of, I hope you'll excuse the expression, the Chevrolet Division of General Motors.

Well, I think I will start with a look at prices. After all, I am to talk today about prices, costs, and profits, and prices determine profits. They may or may not be based upon costs. I am going to start out with the assumption that we all agree that we are operating under the American system of free enterprise and private property, which means, of course, that any procurement which the Government makes from industry must be paid for fairly, and that means there must be a price negotiated between the Government service and industry.

Negotiation involves varying degrees of reliance upon cost. We start out at one end of the scale with a pure fixed price for a standard product--the kind of items that maybe the Quartermaster Corps of the Army commonly buys. There are no cost problems there. They are standard articles and there is competitive pricing.

Then we go down the scale until we reach the other end, where we have a pure cost-reimbursement type of contract. I refer now to, let's say, the repair of a ship or to a research and development contract, where it's completely impossible to negotiate what you might call anything like a fixed price. It's necessary that you rely entirely upon the cost to determine reimbursement for that type of contract.

Today I am going to limit my discussion to prices which are based, at least in part, upon costs. That will be, then, the purely cost-reimbursement-type contract, or the fixed-price-incentive or fixed-price-redeterminable-type contract, where reliance is placed upon costs, but costs are not the only things considered in arriving at the final price.

I believe--in fact I feel rather strongly--that the fixed-price type contract should be the ultimate objective in Government procurement--fixed price as opposed again to cost reimbursement--because a fixed price has so many advantages over pure cost reimbursement. In the first place, both parties are better able to anticipate the revenue and the funding problems which will result from the procurement. Secondly, there is less auditing and administrative detail associated with fixed-price contracting. Once you set a price, then you can quit auditing for a while until you get ready to set the next price.

But the most important advantage of fixed pricing is the incentive it offers the contractor to reduce his costs. Once he gets a price, if he goes out and reduces his cost, he makes dollar for dollar more profit for every dollar of cost that he cuts out. I think that this incentive toward cost reduction is the fundamental reason for America's industrial success. It provides management with the best means of bringing pressure to bear upon its own people to reduce cost. No matter how sincere a management may be or how much integrity it may have, in my opinion there is no question that it will be better able to get its costs down if it is getting a dollar of profit for every dollar that it takes out of cost.

The Government also benefits under this setup. Let's take the kind of pricing we have in Chicago, where each year we price next year's products finally. We also set tentative prices for the following year, too. After pricing, let's say, the aircraft engines, which we build in Chicago under our license agreement with Pratt & Whitney, for 1958, we go out then and do our best to make a reasonable profit on that price. In so doing, we bring our cost curve down. Then we start over again and price our 1959 products. But to the extent that we brought our cost curve down in 1958, obviously that favorable experience redounds to the benefit of the Government in pricing 1959. Both the Government and the contractor benefit from any pricing method which places a maximum incentive on cost reduction. By the way, the taxpayer is going to benefit doubly. He not only benefits because the services get our products cheaper, but the contractor makes more profit. So he pays more taxes and everybody is better off. I'm a fixed-price man, myself.

Now we'll get over immediately from looking at pricing into looking at costs. As I mentioned before, I am going to limit my discussion to the types of contract where cost has a bearing on price. I call your attention to the fact that I said "bearing." Cost is not completely price-determining. That's as it should be.

I think you might say: "The determination of costs on a Government contract shouldn't be very tough. We have a well-established profession of accounting. Certainly with all the accounting lore back of us, cost determination should be pretty simple." I regret to say that it is not at all simple.

In the first place, there are many acceptable means of determining costs. There is not just one method of determining them. Each industry has, and many contractors within an industry have, different methods of computing their costs, each of which is quite acceptable.

Further, there are certain costs that contractors incur which the Government objects to sharing. So you have the problem of determining which ones the Government is going to share and which ones it isn't. And for those which are to be shared you have the problem of determining in what proportion the Government will share the costs that the contractor incurs.

There is a need, it seems to me, for something in writing as to how costs should be determined. We have something for cost-reimbursement contracts. There is section 15 of what are known as ASPR, the Armed Services Procurement Regulations, which spells out in great detail how costs are to be computed on cost-reimbursement contracts. Unfortunately, even there, where we have this written manual, cost determination is not easy. But for fixed-price contracts there is nothing that is official in writing.

The Government and industry have striven since the last war to reach agreement on a set of rules which might be applied in cost determination. Up to this point they haven't succeeded. Consequently, the poor auditor on the job has to make recommendations regarding the contractor's costs, so he falls back on section 15. But that is a rather circumscribed publication. The negotiator, when he gets the audit report from the auditor, is very reluctant to go beyond that. In effect, then, we find that this written manual--section 15--is applied to a large extent to both types of contracts.

Presently there is a draft in one of the high-level organizations here in Washington of a single set of cost principles to be applied to both the cost-reimbursement-type and the fixed-price-type contracts. I hope that that draft ultimately becomes an official document. But I don't think we should kid ourselves. Even when it does, there will still be many, many cost problems. I'd like to refer to a few of these cost problems now.

By the way, I'd like to digress here for a minute and say that I have jumped into this cost and profit problem rather quickly, without much introduction, on the assumption that you are studying procurement and I imagine that much of what I am saying you already understand. What I hope to bring to you mainly today is a brief discussion of some of the problem areas in price negotiation between the services and the contractors. I also want to comment on some of the problems relating to the determination of a fair profit.

Starting out, then, with one of the problem areas--and this is the broadest of all--we have the prorata versus the incremental costing of Government business. Let me illustrate the point.

Let us say a contractor is in commercial business. He has his fixed overall costs--his fixed overhead--and he is operating with a fair profit. Then he gets a Government contract. Let's say the Government contract is equal to 25 percent, now, of his total business. The question arises: Should the charge he is making to his commercial business be changed and the fixed overhead now be allocated 25 percent to Government business and 75 percent to commercial business? Or, since it is fixed, should there be no allocation to the Government business, with the commercial business continuing to bear all of the fixed overhead.

Generally, you will find industry insisting that the Government should carry its fair share. On the other hand, you won't be surprised to find that the Government insists that it shouldn't carry any of the fixed overhead, on the theory that the fixed overhead hasn't been increased. Usually, to illustrate the point, those favoring no allocation to Government business will start out with the president's salary. They argue that the president's salary has not been increased; therefore, taking on the Government business did not occasion any further cost. It follows then that none of the president's salary should be charged to the Government contract. We find quite a large segment of opinion in support of this position.

As you get further down the line from the president to the purchasing agent to the controller and get down to plant supervision, you begin to get agreement on the part of the Government representatives that: "Well, maybe there is some time taken from the commercial job by having taken on this Government work. Possibly some of the plant maintenance supervisor's time, let us say, should be charged to the Government contract, even though you still have only one plant maintenance supervisor." I think you can see that some very interesting arguments can come up in this area, and let me assure you, they do.

I want to say that I am on the side of complete proration of these costs. As far as I am concerned, anything less than a proration of the contractor's costs represents subsidization of the particular business that is being held free from charge. It doesn't seem proper to me for the Government to come with its hat in its hand and ask for special favors. And I don't agree that failure to charge the Government business actually favors the commercial. I am sure it appears to you that it does favor commercial. You still have only one president. But here is the point. The managerial talent which is devoted to handling the 25 percent of the business which is Government business could have been used on other commercial business, either on the existing commercial business to do a better job, or in developing new commercial business. The president--still only one president--has to give a lot of his time to this new 25 percent segment of this business--the Government business. Certainly he is not doing as good a job now on the remaining business.

We read a lot today about the shortage of capital and about high interest rates. As far as I am concerned, the most important shortage we have in industry is the shortage of technical and managerial talent. That's what we are talking about here in these fixed-cost areas. I think that the Government will suffer in the long run if it resists taking a share of the overall corporate costs, because the companies which are able to use their managerial talent effectively will tend to spurn Government business if they are not going to be reimbursed for it. Then the less capable companies will be the ones you will find competing for Government business. The Government then will wind up with a second-rate group of contractors.

A specific illustration of a cost about which there is a lot of controversy as to whether it should or should not be shared by the Government is contribution and donations. Contributions and donations are now specifically disallowed in section 15 of the ASPR, to which I have previously referred. In the latest draft of the single set of principles, I have read that the contributions and donations will still be specifically disallowed as a cost factor.

I think our economic system requires the continued support of national and local charities, not only by individuals but also by business firms. There is no legal compulsion, of course, but each firm has a strong civic responsibility to support these charitable institutions. Industry has long recognized its responsibility and has treated such costs as a normal cost of doing business. Also the accounting profession and the Bureau of Internal Revenue agree that this is a normal cost of doing business. I am sure you agree that if the Bureau of Internal Revenue is on your side, that's a big step. But up to this point Government contracting is based upon the disallowance of any portion of such contributions.

Now, I am not certain that that disallowance is always applied. But it's down in writing and it's a big hurdle for a contracting officer to get over if he has something in writing to the effect that contributions and donations are not costs of doing business.

We had an interesting theory once advanced at Chicago. Our headquarters are in Detroit. Not surprisingly, then, the major portion of our contributions are made by the headquarters, and certainly a larger portion are made in Detroit than are made in Chicago. This particular young man from the audit organization suggested: "Even if we do allow it, why should we allow a proportionate share? You fellows aren't making much of a contribution in Chicago. You are contributing over in Detroit to cancer research and all sorts of things, but you aren't contributing much of anything in Chicago. So we don't think, under any circumstances, there should be any consideration given to a proportionate allowance in Chicago."

Now, I think it is normal for industry to make the lion's share of its contributions in the city where it has its headquarters, or at least where it has most of its employees. And let's turn that coin over for a minute. Let's suppose we don't allow any in Chicago, because most of the contributions are made in Detroit. I can hear the screaming all the way down here to Washington if the boys in Detroit, who might have a Government contract, suggested that they charge more than a proportionate share to Government contracts processed there, in view of the fact that all the contributions are made there. We have to consider both sides of the coin throughout in our cost determinations and cost allowances.

Another interesting controversial subject is executive compensation in Government price negotiations. During World War II one of the major services disallowed all salaries over $25,000, or at least so their instructions read. And a directive came out, as recently as last year, requiring approval of all changes in salaries over $25,000 on cost-reimbursement contracts.

Now, related to executive compensation are bonuses paid executives. The Hebert committee in its investigation of the aircraft industry went into this in considerable detail last year and the year before. They found varying practices among the services.

Again I have a pretty strong personal feeling on the subject. /And, by the way, I should like to have recorded here that the opinions I am expressing are merely my own. They do not represent those of the Ford Motor Company. To the extent that I have anything to do with Ford Motor Company policies, possibly they might be parallel; but, nevertheless, they are my own opinions, gentlemen./

I don't see any reason, under normal circumstances, for not considering a bonus a regular part of the salary paid an executive, an employee, and so on. Then if the employee's time should be charged to Government business, so should his bonus.

Now, I recognize, and I'd like to hasten to point out that I recognize, circumstances where there is certainly reason to question the application of what I have just said. I know that there are literally thousands of firms that are working solely on Government business. It's a very simple matter for these firms to offer bonuses based upon a percentage of profit; and if such bonuses are allowed in contract negotiations with the Government, they really haven't cost the contractor anything. The Government has paid for them. They are allowed costs, so there would be no brakes, from the contractor's standpoint, on the amount of bonus he would pay. Under those circumstances, I understand the Government's viewpoint. Where there is a built-in cost-reimbursement situation, I understand the viewpoint of questioning very seriously bonuses of this type.

But there are two other circumstances which are quite common, where I think a different approach should be employed. One is where the contractor has a bonus plan which has been in existence for a long time before he got into Government business. If he has that type of plan and he takes on some Government business, it seems that we have complete evidence that the contractor feels that that bonus plan is a necessary and reasonable cost of doing business, and there should be no doubt that the employees who joined the contractor did so with full knowledge of his bonus plan. If the bonus plan was suddenly snatched out from under them, the contractor would lose a lot of his capable employees. He would lose his management talent--the people who are responsible for his being the presumably successful contractor he is. And I am assuming he is a successful contractor or he wouldn't have been successful in landing a large Government contract. Now, where we have that situation--where we have consistency of practice--then I cannot agree with treating bonuses any different from normal salaries.

Another situation that to me should be similarly viewed is where a small part of a contractor's business is defense and he has a bonus plan consistently applied among all the operations of his company. Let's say he has a bonus plan that he applies across the board and that 90 percent of his business is commercial. I do not see any justification for questioning the bonus plan being applied to the defense portion. I am assuming, of course, that his plan operates identically there as it does on the 90 percent commercial business.

By the way, while I have some notes here, I welcome an interruption any time you wish to ask questions. I understand also that you have a question period later. I'll be glad to go back to this at that time, because I am sure that you aren't agreeing by any means with all that I am saying.

Another cost item which is the subject of a great deal of controversy in Government contracting or price negotiation is institutional advertising. This kind of advertising, according to the written manual, is disallowed as a cost on Government contracts. No part of it is to be prorated to Government contracts. I can't go along with this, either, if the institutional advertising is reasonable and has not been increased since the Government contract was obtained by the contractor.

Again, we are combatting the old theory that this cost has no bearing on Government contracts and the Government shouldn't pay any of it because it hasn't increased the cost. It seems to me that successful contractors who feel that they must continue their institutional advertising are going to shy away from Government business, and the Government will be left with a submarginal group of contractors.

There is no doubt in my mind that the good name of a company--and, by the way, that's all you are advertising in institutional advertising--in part accounts for the company's ability to attract the management team it has. I should like to distinguish institutional from product advertising. Where you are advertising commercial products, not a nickel should be charged to Government business. I completely agree here. I am only referring to where you advertise the corporate name. Someone once said, I believe, that the only business that makes money without advertising is the U. S. Mint, and I think there may be something to that.

I think I'll conclude on the cost part of my talk this morning by more or less summarizing my beliefs as to the view that should be taken in price negotiation regarding contractor's costs.

First, I think costs should be considered as to whether they are fair and reasonable in the light of sound business practices. If they are, then I think they should be viewed as allowable costs and the Government should bear its proportionate share.

Secondly, when the Government selects a company to supply defense products, I think the burden of proof should be on the Government when the company's normal practices are attacked. When I say "practices" I refer to accounting practices and I refer also to practices regarding compensation, regarding the little extras that a company may have. Maybe one company provides a car and another company may provide free telephone service or something of that nature. It seems obvious to me that these extras are considered by the employees who join that company. If so, the practices should be accepted as long as they are not unreasonable, and any buyer of the company's products should pay a fair share of such costs.

Now, having divested myself of that fundamental bit of philosophy insofar as cost determination is concerned, I'd like to take a look at profit and profit margins.

If I have led you to believe that opinions vary on costs, believe me, the situation is worse when you get over to profit, but at least I think we are all able to understand the varying opinions on how much profit a contractor should get. That obviously is a matter for negotiation. I'm afraid I feel that on costs the answer doesn't always appear to be as difficult as it sometimes is.

I think everyone agrees that it is most important that a fair and a sound conclusion be reached regarding profit, because in the last analysis that is what the contractor is working for; it is his own measurement of his accomplishment. Profit is the best means of giving him the greatest incentive to get his costs down.

Mr. Dudley Sharp, the Assistant Secretary of the Air Force, in testifying before the Hebert committee, had this to say about profit:

> "We encourage use of the profit factor in such a manner as to induce the contractor to perform more efficiently by affording him an opportunity to earn more profit thereby. Since costs represent the greatest portion of price, use of the profit incentive to exert a pressure on costs results in the greatest savings to the Government."

Even if Mr. Sharp did not represent our customer, I would completely agree with that statement.

Also in testifying before the Hebert committee, Colonel Thompson of the Air Materiel Command presented these as the factors which are considered in arriving at profit in price negotiation: volume, extent of subcontracting, use of Government facilities, Government financing, risk, and performance. Under "performance" we have these subheadings: design, quality, schedule, and costs. That's a pretty complete list.

In looking at each of these factors, let's bear in mind that the normal method of expressing profits is as a percentage of costs or a percentage of sales. You think of profit as 8 percent, 10 percent, or 12 percent of cost. Let's take a look at each of these factors which Colonel Thompson says are generally recognized and generally considered, and see how expressing profits as a percentage of cost works out.

First, let's take volume. As volume goes up, should the rate of profit on cost be reduced? I think so, normally. Why? Because of the fixed costs. I think it's fair enough to reduce the rate as the volume goes up.

But remember that another way of measuring profit is as a return on investment. You take how much the contractor has invested on this contract throughout the life of the contract and you measure his profit as a return on investment. Maybe 10 percent on cost yields a return of 8 percent on investment. Let's remember that as volume goes up, possibly the rate on cost should come down. But I think the rate on investment should go up rather than down, because the contractor is turning his investment over more times.

Another thing to look at, if you are talking volume in terms of pure sales dollars, is what is occasioning the increase in dollar volume. If you are actually turning out more engines, that's one thing. If you are merely using a different material, that's quite another. Let's say that you have a product on which you have been silver plating and you change to gold plating. That increases your sales dollars, but unless gold plating is a new technique, it really doesn't give any greater problems to the contractor and therefore probably would not justify a material change in the amount of profit. On the other hand, if he has been making a steel engine and he starts to make a titanium engine, he does get an increased dollar sales volume, but there, believe me, he gets a lot of increased problems, too.

As you get further down the scale, or maybe as the use of titanium becomes as well known and the art becomes as well advanced as the use of steel, it might be different. What I am trying to point out is that you should determine what has occasioned the increase in sales volume. If there are more problems, then maybe more profit is justified. If there aren't more problems, no more profit may be justified.

The next profit factor is the extent of subcontracting. Presumably the Colonel meant that the more the contractor subcontracts--percentage-wise, I presume, he means--the lower the rate of profit on costs should be. I certainly agree with that. I think normally the contractor's contribution on his own production effort is greater than the contribution he makes to subcontracting. But again, if you turn around and start measuring profit as a return on investment, you will find that he has a lower investment than before and that his return on investment should be increased if he subcontracts more, still agreeing that his return on cost should be decreased.

What about use of Government facilities? I think the obvious answer is that the more Government facilities are provided, probably the lower the rate of profit should be on costs. Right. But again when you start viewing profit as a return on investment, remember that the contractor's investment is lower when facilities are furnished, and therefore his rate of profit on investment will be greater when compared with another contractor who is furnishing his own facilities.

Also I think this should be considered. When a contractor furnishes his own facilities, he may be operating in an area with which he is thoroughly familiar. If he is, possibly his problems in making this particular product are not nearly as great as the problems a contractor is having when Government facilities are furnished. The latter almost surely indicates something foreign to the contractor's normal production.

I am trying, in looking at each one of these factors, to show that you can't cite generalities and say that it's all black or it's all white. You can't say, "The more facilities, the lower the rate of profit."

Risk is a very important factor in Government contracting and should be heavily weighed, I agree, in determining profit rates. But sometimes I wonder if we don't overrate that factor. For example, where the contractor has an assured buyer, the Government, for his products, then his risk is not as great as would be the risk if he did not have an assured buyer. This condition applies to a great deal of Government contracting. Consequently, I think we tend to overrate the element of risk in Government contracting, if we are thinking of risk of loss of money invested in Government inventories.

There is, however, another element of risk that is more important than the risk of loss of investment, and that's the risk of loss of reputation. I'm sure everyone of you has read from time to time where some particular contractor has fallen on his face in delivering a Government product. That contractor is hurt, and he's hurt seriously, in his commercial business when he performs in that manner and receives unfavorable publicity in the newspaper. On many of these complex products that are delivered to the Government, I think the risk of loss of reputation is greater, and is therefore a more important factor in determining profit rate, than is the risk of not getting back invested capital.

The greater the complexity of the product, the greater is the risk of not delivering satisfactorily. In that case, possibly the complexity of the product rather than the dollar investment is more important when considering risk in profit determination.

Finally, let's look at performance. What weight should we give to performance in arriving at a fair profit on a Government contract? You remember, there were four subheadings under "performance." The first was "design."

No one is going to question that a manufacturer who has design responsibility probably should get a higher profit than if he doesn't have any design responsibility. He certainly has more problems. But let's look at this factor: Let's see how many technical people he is recovering in his overhead. After all, design responsibility means adding engineers and maybe the cost of these design engineers is recovered in the price. If contractor A is loaded with engineers versus contractor B, who has less design responsibility but is producing more efficiently, maybe contractor B should get a higher rate of profit. I merely want to point out that you should look at how efficiently this extra operation that contractor A has is being performed before you immediately jump to the conclusion that A, who has more responsibility, should get a higher rate of profit.

Schedule was the second factor under performance. Certainly the schedule record, the record that the contractor has of delivering on schedule or not delivering on schedule, should be considered in arriving at the rate of profit he is allowed on his contract. But look at this: Consider the tightness of his schedule. One contractor may have never missed a schedule, but he may never have had a tight schedule. Another contractor may have missed several times; but if you look at the record, you may find that he's delivering the same product with a shorter lead time than the first contractor.

Also in comparing two companies on this matter of schedule, look at the complexity of the products. If it's a simple product, he may never miss a schedule. If it's a complex product, maybe missing a schedule is excusable. Maybe when the contractor finally delivered the product it turned out to be quite complex, and both sides now recognize it. The contractor's delivery time may actually represent very good performance, even though it didn't meet the original schedule.

Finally, look at the contractor's inventory position. Contractor A has a year's inventory in his system. Contractor B is operating with half a year. Certainly A should make schedule more easily than B. What I'm driving at again is that merely performance against a schedule, good performance on one contract versus relatively bad on another, doesn't necessarily mean that A is doing a better job on schedule than B. You must consider these other factors.

Quality? Yes, the contractor's quality is important, very important. But again who determines quality? Which organization within a manufacturer's plant is primarily responsible for good quality? The quality control or inspection organization. So before we jump to the conclusion that, "Boy, here's a very high quality on contractor A's part and so he gets a high profit as compared to B," let's see what the inspection ratios of A and B are. Maybe the buyer, the Government, is paying a very high price for that excellent quality. They may be paying for twice as many inspectors, in which case possibly the rate of profit should be lower, not because of quality alone, but because of the overall cost of the product.

Finally, take performance. By "performance" I think we mean cost performance. Before you look at contractors A and B and just look at the total costs and say that the one that has the lower cost should get the higher rate of profit, again you have to look at other factors. Be sure that you have a fair method of comparison. Usually you will find that in the procurement of complex products the standard of comparison is not such that you can look at the total costs of two contractors. Total costs won't mean a thing. There are too many differences. So it's necessary that you arrive at some sort of a standard that can be applied.

For example, in the airframe industry, I believe that the Air Force feels it has reached the point where it has some pretty good standards. But in the aircraft engine part of the industry, I think they agree--in fact I know they agree--that their standards are not as good as they are in the airframe industry. They haven't yet come up with standards that are good enough.

Another thing to be considered in looking at cost is the type of facilities furnished. One contractor may have inherited facilities from the last war. Another may get a lot of brandnew ones. Certainly the latter should have a lower cost.

The timeliness of the furnishing of facilities should also be considered. A contractor may have to go along for quite a while with makeshift methods. Obviously, his costs are going to be high until he gets the kind of facilities that both parties contemplated.

Separate collection for research and development is another factor. There are a number of others which should be considered in arriving at profit.

I believe that it's customary in a good talk to summarize what you have said, but I remember that last year a lot of additional points came out in the question period. Consequently, I'm going to stop right here instead of taking time to summarize. That will give us more time for questions, if there are any questions.

CAPTAIN STEIGELMAN: Mr. Guinn is ready for your questions.

QUESTION: Since most of us have been trying to get along without bonuses for several years, I admit that I am a greenhorn on the subject and probably will fall right into your trap. Nevertheless, I have always entertained a quaint idea that bonuses should come out of profits, inasmuch as they are essentially a reward for the efficient management which creates profits. Therefore, I can't quite reconcile that view with your idea that bonuses are a part of normal cost on Government contracts. Could you expand on that a little bit more?

MR. GUINN: I'd be glad to try.

I am quite familiar with the viewpoint that bonuses should come out of profits. I think possibly from the firm's standpoint, let us say, bonuses may be viewed as coming out of profits, particularly if they are computed with relation to profits. But I think the most significant point is the viewpoint of the employee--how the employee is viewing the bonus.

After all, the employer is a success or failure depending upon the caliber of his management people, who are usually the people who receive bonuses. As far as they are concerned, the bonus is a part of their compensation. Of course, you may have two or three employees who siphon off a large part of the profits as bonus. If you have that situation, I guess I would agree with you. But most bonus plans nowadays--I think I can generalize that way--cover hundreds of management people, and they do not normally vary widely with profit.

Certainly bonuses are related to profits. There's no question about that. But practically every year--every reasonable year, at any rate--there is some bonus paid, and the bonuses do not get ridiculously high when the profits are unusually high. They are held by one means or another within a level of maybe from 5 percent to 50 percent. There is a range which the employee is well aware of when he joins the company. He considers the bonus as a part of his basic remuneration for services rendered. He recognizes that it goes up and down somewhat as profits go up and down.

I think you must look at it as between two companies--A versus B. Everyone is fighting for being given fair and equitable treatment, and he means treatment consistent with the treatment that other fellows are getting. If company A has a bonus plan and company B does not, and you don't allow the bonuses of company A as a cost, I think you are putting A at a competitive disadvantage with B. I know you are not going to allow A a larger profit rate than you allow B merely because he pays some of his compensation in the form of bonuses. Contractor A has a very simple expedient to get around this. He merely discontinues the bonus plan and gives all of his people a raise that approximates the bonuses they were getting. This way he holds his employees. He would surely lose many of them if the bonus plan were liquidated without adjusting basic salaries.

Now, I oppose pushing contractors in the direction of eliminating the bonus and putting it into salary, because I don't think there's any question that a bonus is a better incentive than just a salary. We all know that. It's the same thing as commission in salesmanship. A commission is generally preferred over a straight base salary.

I recognize your argument that bonuses might properly be considered as part of profit. I don't think it is a fair argument, though, to consider them as a portion of profit, unless you adjust profit rates to reflect the fact that some of the compensation of executives is in profit. After all, employees are not owners. Employees are not stockholders. They are a commodity just the same as the material that the contractor buys. I cannot agree that, because they are allowed to share in a part of the profit, they are getting profit. They are getting, to me, remuneration for labor. Labor is a cost, whether it's the labor of the president or the labor of the screw machine operator.

QUESTION: If I understood your talk correctly, you indicated earlier that you are infavor of a single set of cost principles; and I believe I understood you correctly as being in favor of the draft that is currently being circulated. However, you did go on to take exception with individual items that are in that draft in a way that is contrary to the manner in which they are included. I know that at least one large trade association has bitterly attacked the draft that is being circulated and has opposed it in such a way that it may never come out in its present form. I wonder if you would clarify your views on a single set of cost principles. Possibly your industry is or you are in the minority on that.

MR. GUINN: Well, maybe I am. I don't know. But the only thing, I believe, that is contradictory here is that I think you have misinterpreted my feeling about having a single set of cost principles as also being one in favor of the cost principles that came out. I have a number of things that I disagree with in that single set of cost principles, as you have so effectively stated yourself. I am in favor of a set of principles. I am not in favor of the particular set they now have.

Now, let's face it. I am not so naive as to think they will ever have a set of principles that I will be in complete agreement with or that industry will be in complete agreement with. I favor having a single set of cost principles. I think that the single set of cost principles, though, should cover about two areas. First, it should generally bless the accounting system and practices of the contractor so long as they are in accordance with generally accepted accounting principles. I think there should be that overall blessing. That is not there presently, I believe.

Second, I think the set of cost principles should, when going beyond that, almost entirely limit itself to items to be disallowed. I am not going to agree with many of the disallowances, I am sure; but at least if I get into Government contracting, I will be forewarned that there are costs which I am not going to recover on this Government contract. Then I get back to the point I made in my talk. If the disallowance of these costs is going to reduce my profit enough so that I don't find Government contracting economically interesting to me, I'll stay out of it.

QUESTION: We had an interesting session recently on the controversial matter of renegotiation. Would you care to express your personal feeling about the philosophy and practice of price renegotiation?

MR. GUINN: Are you referring to renegotiation or redetermination?

STUDENT: Renegotiation following performance.

MR. GUINN: You are referring now to the separate renegotiation by the Renegotiation Board?

STUDENT: Yes.

MR. GUINN: Not by the services with which you have dealt?

STUDENT: That is correct.

MR. GUINN: I'll be honest with you. I don't particularly care to get over into that area. I don't know what would be served.

I have to concede this: I understand the arguments in favor of renegotiation. I think we certainly needed renegotiation in the last war. Possibly today it's desirable. But my only position on that would be one of trying to keep the applicability of renegotiation at a minimum, where it is necessary to avoid complete windfall profits that are not deserved.

There are restricted areas where it is impossible to avoid those windfall profits by any other method. In those areas I think it is fair to apply renegotiation. However, I believe that renegotiation has been applied further, more broadly, than I personally would have applied it had I had anything to say about it. Beyond that I am afraid I wouldn't care to comment.

QUESTION: In discussing reimbursement and the contractor's conception of it, is there any comment you would like to make on the penalty clauses which provide for reimbursement to the Government in case of performance failures? To me that seems to be an area in which we generally tend to lose, with the possible exception of construction contracts.

MR. GUINN: When you say you lose, do you mean that you don't collect where you had a legal right to?

STUDENT: We are seldom if ever able to complete a contract that doesn't have a penalty clause except on termination. Terminations are generally more expensive to us than the original cost, irrespective of the reason for the termination. Or, reversing that, failure to perform may produce a termination cost that is twice as much as the original contract. If there had been a penalty clause in the contract, we might have started the reverse procedure a little earlier in the game.

MR. GUINN: You are asking me how I feel about having penalty clauses in contracts?

STUDENT: I am asking you why it is difficult ever to get them in a contract?

MR. GUINN: On the latter I cannot express any opinion at all, because I haven't had any experience. I gather that in the negotiations we have had there hasn't been any attempt, let us say, to inject any penalty clauses other than probably the boiler plate, and I know you are not referring to that. So I am frank to say that I think I would be kidding you if I tried to give you any opinions on it, because I don't have any; and I think I will not. I have had no experience with them. That's a long way around to say "I don't know."

QUESTION: That question has come up in my mind before and I have wanted to ask other speakers about it on my last tour of duty. I wondered why the Bureau of Aeronautics didn't put penalty clauses in their contracts.

The impression I got was that it was because it would make the contract cost too much to put them in. Is that your opinion? That is not my question. I want to reserve my question. I just wanted to comment on what you had to say.

MR. GUINN: Are you saying that the contractor would insist on putting enough more in his price to cover the contingency of the penalty?

STUDENT: Yes.

MR. GUINN: So much more that it wouldn't balance out and be favorable to the Government?

STUDENT: Yes.

MR. GUINN: Well, I must confess that in our own pricing we don't have that one. But when we are asked to do something rather unusual, we are normal human beings. We want to get a pretty good allowance to cover a contingency that is very difficult to estimate.

QUESTION: In my last renegotiation experience I heard that the Government does not allow any contractor to anticipate wage increases that might be in the national picture at the time. In your price determination how do you take care of anticipated wage increases that might seriously increase your costs?

MR. GUINN: I will be honest with you. I have not run into that. We have our wage negotiation every three years; so we don't run into that very often. I was not aware--and this will come as a real shock to me two or three weeks from now if that is the case--that the services would not allow at least a reasonable estimate of what the wage increase might amount to.

STUDENT: I may be wrong.

MR. GUINN: That seems unreasonable to me. I can certainly understand why the Government generally doesn't like to allow for things that are nebulous, that may never happen at all. I can see a Government representative saying in such circumstances: "Well, this year you won't pay as much as you did last time." I could entertain the fairness of that sort of an approach. But I'm afraid it wouldn't seem at all proper to me for the Government to say: "Well, we won't give you anything."

QUESTION: Could you give us one or two examples of why company A is so darned anxious that company B doesn't get a look at its cost breakdown? In that situation how do you arrive at your fixed price on individual contracts?

MR. GUINN: Why company A is so anxious that company B doesn't get a look at its cost breakdown? I am just thinking a minute before answering that. I'll be honest with you. I have made several attempts to work through the Air Force, after having failed in working directly, to exchange information with other manufacturers of the same product we are manufacturing. I confess that I didn't have much success except with our licensor, Pratt & Whitney, with whom we have good relations. We do exchange information with them. But I didn't get anywhere with anyone else.

The reasoning I got from the other firms for refusing was along this line: "Well, we're so different that it won't be of much value to you to exchange information on the number of people in the inspection organization, yours versus mine, or the number of people in product engineering or accounting."

Personally, I do not agree with that. I recognize that there would be a number of areas where we would be so different that we would get nothing out of it. But I always have countered with this argument: "There will certainly be some areas where we will get some information of value." I felt--as a controller, anyway--and those of you who have had any experience with controllers will not be surprised at this--that I could do as other controllers do. In those cases where the other guy is better than your own people, you hold that up as a standard for your own people. Where the other guy is worse, you just don't mention that and you come up with another technique. So I felt real strongly that I would get some good budget performance standards in some cases.

Inasmuch as I do share that opinion, I can only state that (1) maybe they have had bitter experience in wasting time on attempting a comparison, and (2)--and this is probably the more fundamental reason--I guess when you start looking into cost, you will get not only into cost but you will get also into profit, and companies to the maximum extent possible just don't like to let the other fellow know how well they are doing. We are public firms to a large extent and we have an awful lot of public information, but there is still a lot of internal information that is not available to the public. You just don't like to let your competitor know how you are doing. Still, I kind of feel that by circumscribing or narrowly delineating the areas you look at, you can exchange some information without giving away the whole picture. So I don't agree with that viewpoint. I can't give you any further answer than I have given you.

QUESTION: You gave an example of a situation wherein a firm is in commercial business primarily and the Government steps in and awards a contract to the extent of some 25 percent of their total volume. You felt that the Government should share the prorata cost or the fixed overhead. At the same time, if the Government shared this fixed overhead on a cost-proration basis, would that not reduce the cost of the items sold commercially? If so, would you then reduce the price of those items which you sell on the commercial market as a result of the reduction by prorating the cost when the Government shares that cost?

MR. GUINN: Out of the goodness of our heart we would not. But we have an economic system that we all are pretty proud of and I think this might follow: If the Government came along with 25 percent of our business and started sharing the fixed overhead, and did thereby reduce the cost of the commercial, we might for pure profit and competitive reasons reduce our price to increase our volume. Soon we would have our old volume of commercial plus the 25 percent Government, and everybody would be better off. The share the Government was taking would be smaller, the price to consumers would be smaller, and the Government would have a good contractor rather than one that was very happy to have the Government come in and take his effort without paying for his fixed overhead.

This is like the law of supply and demand. We can talk very glibly about it, but it's very difficult to prove it in individual instances.

I agree with you that it looks as though there would be a complete windfall to the contractor if the Government should share those costs. But to carry that to ridiculous extremes, why should the Government be the one favored customer? If we are selling to the public at large and a new fellow comes in, a new customer that we never had before, and wants to give us some business which will amount to 25 percent of our business, why shouldn't he apply the same theory? He could just as well, from the pure cost standpoint, couldn't he?

Then you would get into what is sometimes referred to as the old mail-order-house deal. It seems to me it would be like the mail-order houses were in the thirties. They were going around buying from everybody on the basis of not paying for any of their fixed overhead. Soon a lot of those companies started to fail, because the only fellows carrying the fixed overhead were their old customers. They soon lost them, and the new customer--the mail-order house--was not paying the fixed overhead. Nobody was paying it, and they were out of business.

I can't prove my point. I completely agree with you. I would even be willing, if necessary, to negotiate down somewhat from a sharing of the total fixed overhead without changing my opinion that it should be the total. But I certainly won't buy the other end of the scale--that you shouldn't bear any because there wasn't any increase in the fixed overhead--because, invariably, when you take on a new product line, you do start diluting your management effort.

QUESTION: You said a couple of times that if the profits on Government business were brought down to a point where it would not be worth while, you would get out of it. Let us take your case where you built a plant in Chicago and have several thousand employees there. After you have made your investment, doesn't that put the Government in sort of a blackmail position? At what point do you say that it is no longer worth while and that you won't take Government business? Is it an economic point that determines whether you will stay in or not?

MR. GUINN: Oh, yes. We have been getting a profit out there since we have been there. We think it's quite a modest one, but the Air Force doesn't always agree with us. But if they cut that in half, I am sure we would get out of the business.

We have had a number of times since we got into that business out there when we wished we had those management people, who are over in Chicago, back in Detroit. We have siphoned off an awful lot of our management talent from Detroit to Chicago. But I will face it right now. We are not as concerned about having them there as we were a couple of years ago, and I doubt if we will be a year from now.

But--yes, sir! We can determine when that profit rate gets down to where we don't think it's worth the use of our talent over there and the exposure to loss of reputation. Remember, I made that point in my talk. We are constantly subject to that. We are not unique, but we are extremely aware of what would happen to the sale of Ford products if the reputation got out through all industry or through all commerce that Ford wasn't able to build a jet engine that would fly.

So, if we ever should get down to where the profit didn't seem worth while, we would get out.

I think I should make one significant point on your question. You mentioned our investment there. We don't have much investment except in people. That happens to be a completely Government-owned facility. So we can get out pretty easily.

Now, it would be different and getting out would not be as easy, and we probably wouldn't be inclined to get out as quickly, if we owned all those facilities. I think I should have answered your question under the circumstances which you probably thought existed. If those were all our facilities and if we had millions invested there, yes, sure; they've got us in a bit of position just as any customer has his supplier when a supplier devotes a lot of his investment to that particular customer's business. But that goes on every day in industry. People finally reach the point where they throw in the sponge if it isn't profitable. You just are not going to go on operating the rest of your life at no profit or a profit so low that it isn't worth while.

QUESTION: Sir, you have indicated that these cost operations and profit determinations are very complex, requiring the highest type of judgment and the most capable type of people. Now, wearing your hat as a taxpayer, are you satisfied with the quality of the Government personnel who are representing your interest in these negotiations?

MR. GUINN: I would be pleased to answer that. I'll be quite honest with you. I have been most favorably impressed with the people we have dealt with. And, believe me, that impression is not formed because I feel that they have been real generous with us and have thrown the Government's money away. Rather, I have been impressed with their capability, their astuteness, and their fairness--all of those--and their firmness, too. That should be a part of it also. There are a number of people there that I would be delighted to see working for Ford. And if someone else should ask me for my honest recommendation, I would give them a very high one, because I think they are doing a really good job.

And I confess to being a bit surprised. I got into this business in Chicago about two and a half years ago, and when I approached it, I'm afraid I did not expect to find many of the high-caliber people whom we have run into. As a taxpayer, I feel rather good about the people that are representing the Government in dealing with us, and I hope that equally capable people are representing the Government in dealing with all other contractors.

QUESTION: When the Government makes a contract with a subsidiary or a division of the Ford Motor Company, and part of the products called for in that contract are subcontracted by you to other subsidiaries of the Ford Motor Company, what is your reaction to the Government either eliminating completely any additional profit by your subsidiary over the profit made by the other subsidiary on the parts they furnish, or segregating that section out for a much reduced rate?

MR. GUINN: Well, that is exactly what happens. We don't get but one profit on the work done by our subsidiary or other division of our company. And since it is a noncommercial product, I don't take any real issue with that. I feel we are getting a fair shake. We are getting a profit on what our subsidiary, as you express it, does. We are also getting a profit on our own cost for handling our entire subcontracting program, including that one. So I feel that the company is getting the profit it deserves. I don't feel that we are being taken there. My personal opinion is that we don't need two profits there.

Now, I'll say this: If we were to buy a competitive, a standard, article or something that is sold in competition, I think my feeling would be that we ought to be allowed to put that into our Government contract at the normal sales price of that standard article. The profit rate on that might be 20 percent, where we are only making 7, 8, 10, or whatever we are making, on our own. I would argue pretty strongly that we should be allowed to keep the 20 percent there, since that is what we could sell it for generally. But on nonstandard articles, as far as I am concerned, all of us are part of the Ford Motor Company. The Government didn't contract with the several divisions. They contracted with the corporation.

QUESTION: I am not talking against the Ford Motor Company, but it seems to me that last year before the Hebert committee some cases came up that I think had some relation to your comment about our contracting people. One of them involved the $5 million that the Air Force was accused of not being right in not taking back. The other involved the 19-percent profit in our 1950 contract. It seems to me that we have been at a slight disadvantage in negotiating with these companies. It also seems to me that in many cases we were not as firm as we should have been. It is not the fact that Ford accepted the $5 million; it is the fact that we were not able to use that money.

MR. GUINN: You mean you as a service, since it goes back into the general Treasury?

STUDENT: Yes.

MR. GUINN: Sir, I am afraid that as a taxpayer, if I were worried about the $5 million, I would be more worried about the fact that it was there in the first place without worrying about which service got it back.

Companies generally, large companies particularly, which are concerned about their national reputation, are not interested in making excessive profits on Government business. They don't like these give-back things or anything else. Ideally, we like to negotiate a price which will yield a reasonable profit and will never occasion a refund. Nobody is ever happy about a refund. You get very little credit for that. You do, however, get more credit for refunding it voluntarily than for having it taken away from you.

CAPTAIN STEIGELMAN: Mr. Guinn, on behalf of the Commandant, the students, and the faculty I want to thank you for an interesting, informative, and frank discussion. We are certainly indebted to you. Thank you very much.

(21 July 1958--4, 100)B/en:mjs;ekh