



DEPARTMENT OF DEFENSE

AUDIT REPORT

ADEQUACY AND IMPLEMENTATION OF
DOD PROFIT POLICY

No. 91-025

December 28, 1990

*Office of the
Inspector General*





INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

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MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (PRODUCTION AND LOGISTICS)
ASSISTANT SECRETARY OF THE ARMY (FINANCIAL MANAGEMENT)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT)
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Report on the Audit of the Adequacy and Implementation of DoD Profit Policy (Report No. 91-025)

This is our final report on the Audit of the Adequacy and Implementation of DoD Profit Policy for your information and use. Comments on a draft of this report were considered in preparing the final report. We made the audit from November 1988 through June 1989. The specific objectives of the audit were to evaluate the adequacy of the DoD Profit Policy-Final Rule and to determine whether additional changes were required to make it more effective. The audit also evaluated whether DoD contracting officers were fully complying with pertinent provisions of the Policy and properly documenting their profit decisions. In addition, we evaluated the effectiveness of DoD internal control policies, procedures, and practices applicable to the preparation, supervisory review, and reporting of profit objectives. The audit included a statistical review of contracting officers' profit decisions reported to DoD's management information system from October 1987 through September 1988. These FY 1988 reported profit decisions totaled \$16.9 billion at the negotiated total price level, of which \$1.8 billion (10.7 percent) represented negotiated profit amounts.

The audit showed that the DoD Profit Policy-Final Rule was generally adequate and that additional changes were not required to make it more effective. However, DoD contracting officers were not adequately documenting their profit decisions, as required by Defense Federal Acquisition Regulation Supplement (DFARS) 215.903(e)(S-70) and General Accounting Office documentation standards. These standards require that internal control systems, including management policies and procedures, be fully and clearly documented. The audit also identified internal control weaknesses in training, supervisory reviews, and reporting of DD Forms 1547, "Record of Weighted Guidelines Application." The results of the audit are summarized in the

following paragraph, and the details, audit recommendations, management comments, and audit response to management comments are contained in Part II of this report.

We found that DoD contracting officers did not adequately document the profit objectives in price negotiation memorandums, did not use correct data to compute profit objectives, and did not correctly prepare DD Forms 1547. As a result, DoD could not effectively evaluate the Profit Policy-Final Rule or realistically determine whether its goal of a 0.5- to 1-percent reduction in overall negotiated profit objectives was being achieved. We recommended that the Assistant Secretary of Defense (Production and Logistics) require that acquisition offices of the Military Departments establish adequate training procedures to ensure that the DD Forms 1547 are correctly prepared and fully documented and that specific internal controls be established to ensure that contracting officers perform adequate supervisory reviews of completed DD Forms 1547 before conclusion of the negotiation process. We also recommended that the Assistant Secretary perform an annual analysis of profit objectives contained on DD Forms 1547 to determine if DoD's goal of a 0.5- to 1-percent reduction in overall negotiated profit objectives is being achieved and to determine if changes to the profit policy are required (page 5).

The audit identified internal control weaknesses as defined by Public Law 97-255, Office of Management and Budget Circular A-123, and DoD Directive 5010.38. Controls were not established or effective to ensure that DoD contracting officers were adequately trained on documenting DD Forms 1547 and were adequately performing supervisory reviews of the completed DD Forms 1547 to identify mathematical and other errors before conclusion of the negotiation process. Recommendation 1., if implemented, will correct these internal control weaknesses. We could not determine the monetary benefits to be realized by implementing Recommendation 1. because our review covered only contracting officer profit objectives and not negotiated profit amounts.

On April 12, 1990, a draft of this report was provided to the addressees. We received comments from the Office of the Assistant Secretary of Defense (Production and Logistics) (Appendix E); the Office of the Assistant Secretary of the Navy (Research, Development and Acquisition) (Appendix F); and the Office of the Assistant Secretary of the Air Force (Financial Management and Comptroller) (Appendix G). The comments are summarized in Part II of the report. The finding and recommendations were directed only to the Assistant Secretary of Defense (Production and Logistics), and because his management comments summarize Air Force and Navy comments, the following paragraphs will address only the Assistant Secretary's comments.

The Assistant Secretary disagreed that DoD contracting officers did not adequately document the profit objectives in

price negotiation memorandums, and did not correctly prepare DD Forms 1547, "Record of Weighted Guidelines Application." For the reasons cited in Part II of the report, we believe contracting officers did not properly document profit objectives and prepare DD Forms 1547. The Assistant Secretary also disagreed with a statement in the background section of Part I of the draft report that related to a primary objective of the interim Profit Policy. We have revised the background to better reflect the objective of the Profit Policy.

The Assistant Secretary nonconcurred with the draft report Recommendations 1.a. and 1.b. to direct the Defense Acquisition Regulatory (DAR) Council to revise the DoD Profit Policy in the DFARS to specify the documentation required to fully support the profit analysis performed and to revise a formula related to developing certain profit objectives. Based on analyses of the Assistant Secretary's comments, we have deleted that portion of the draft report finding and related Recommendations 1.a. and 1.b. from the final report.

The Assistant Secretary concurred in part with the draft report Recommendation 2. (renumbered Recommendation 1.). This recommendation requires that acquisition offices of the Military Departments establish adequate training procedures to ensure that DD Forms 1547 are correctly prepared and establish specific internal controls to ensure that contracting officers perform adequate supervisory reviews of prepared DD Forms 1547 before conclusion of the negotiation process. We agree that the Assistant Secretary's use of computer software programs, if properly developed and tested, meets the intent of our recommendation related to establishing internal controls. However, we could not determine whether the Assistant Secretary concurred with that part of the recommendation that relates to establishing training procedures. Therefore, we ask that he comment on the training issue in response to the final report. For the final report we have added a new Recommendation 2. that relates to performing annual analyses of the automated data from the DD Forms 1547 to determine if DoD is achieving a reduction in the percentage of the overall profit objective and to determine if any other changes are needed in the profit policy. We request comments on the new recommendation.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. In order to comply with this Directive, we request that the Assistant Secretary of Defense (Production and Logistics) provide us with final comments on the unresolved issues in this report within 60 days of the date of this report. These comments should indicate either concurrence or nonconcurrence with the results of the review and each of the recommendations. If you concur, please describe the actions taken or planned, completion dates of actions already taken, and estimated dates of completion of planned actions. We also ask that your comments indicate concurrence and nonconcurrence with the internal control weaknesses identified above. If

appropriate, please describe alternative actions proposed to achieve the desired improvements. If you nonconcur, please state the specific reasons for the positions taken. This report does not claim any monetary benefits.

We appreciate the courtesies and cooperation extended to the audit staff. Audit team members are listed in Appendix J. Please contact Mr. Richard Jolliffe, Program Director, at (703) 614-6260 (AUTOVON 224-6260) or Mr. Tim Staehling, Project Manager, at (703) 614-6248 (AUTOVON 224-6248) if you have any questions on this audit. Copies of this report are being provided to the activities listed in Appendix K.



Edward R. Jones
Deputy Assistant Inspector General
for Auditing

Enclosure

cc:

Secretary of the Army
Secretary of the Navy
Secretary of the Air Force
Director, Defense Acquisition Regulatory Council

REPORT ON THE AUDIT OF THE ADEQUACY
AND IMPLEMENTATION OF DOD PROFIT POLICY

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Prepared by:
Contract Management Directorate
Project No. 9CC-0018

REPORT ON THE AUDIT OF
THE ADEQUACY AND IMPLEMENTATION OF DOD PROFIT POLICY

PART I INTRODUCTION

Background

In October 1986, DoD established an interim profit policy. One of the primary objectives of the interim profit policy was to reduce by 0.5 to 1 percent the overall profit negotiated on Defense contracts. This reduction was required because of an unintended increase in profit objectives that resulted from a 1980 change to the profit policy. DoD's examination of actual profits received on Defense contracts from 1980 to 1983 revealed that Defense contractors' returns on assets were greater than manufacturers' returns on assets for comparable durable goods. DoD believed that a reduction in negotiated profit objectives would have a corresponding downward effect on reducing actual profits received on Defense contracts.

The DoD Profit Policy-Final Rule was issued in August 1987 and resulted in several changes to the Defense Federal Acquisition Regulation Supplement (DFARS). DFARS, subpart 215.9, "Profit," prescribes policies and procedures that DoD contracting officers shall use in developing a prenegotiation profit or fee objective on negotiated Defense contracts. DFARS, subpart 215.902 states that the Weighted Guidelines Method, as described in DFARS, section 215.970, is DoD's structured approach for performing a profit analysis on negotiated contractual pricing actions. This subpart also describes how the contracting officers shall use the Weighted Guidelines Method, or an alternate approach, for any negotiated contract action that requires cost analyses. Furthermore, this section states that practices producing an arbitrary profit objective or accomplishing a profit analysis on an after-the-fact basis are unacceptable.

The DD Form 1547, "Record of Weighted Guidelines Application" (see Appendix A), which assists the contracting officer in establishing a profit objective under the Weighted Guidelines Method, also serves as the principal source document for reporting profit statistics to the DoD management information system. The Weighted Guidelines Method, as contained in the Profit Policy-Final Rule, considers the contractor's degree of performance risk in producing the goods or services being acquired, the contract and incentive arrangements, and the nature and extent of facilities capital that the contractor will employ.

DFARS 215.903(e)(S-70), "Contracting Officer Responsibilities," requires contracting officers to fully document the profit analysis performed in the price negotiation memorandum of both the interim and final profit policies, published in October 1986 and August 1987, respectively. This requirement changed earlier DFARS requirements. While the earlier 1980 DoD Profit Policy did not contain the documentation requirement, it provided specific

steps that contracting officers should perform in the profit analysis. It also required contracting officers to develop a profit objective only after a thorough review of proposed contract work; to review all available information on the contractor including capability reports, audit data, preaward survey reports and financial statements; and to analyze the contractor's cost estimate and comparison with the Government estimate or projection of costs.

DFARS 230.7001, "Policy," states that DoD policy recognizes facilities capital employed as an element in establishing the price of certain negotiated Defense contracts when such contracts are priced on the basis of cost analyses. Facilities capital employed primarily includes buildings and equipment purchased by contractors to be used under Defense contracts. This inclusion is intended to reward contractor investments, motivate increased productivity and reduce costs through the use of modern manufacturing technology, and generate other efficiencies in the performance of Defense contracts. Cost Accounting Standard 414, "Cost of Money as an Element of the Cost of Facilities Capital," establishes criteria for the measurement and allocation of the cost of capital committed to facilities, as an element of contract cost for historical cost determination purposes.

Objectives and Scope

Our announced audit objectives were to:

- evaluate the adequacy of the DoD Profit Policy-Final Rule, effective August 1987, and determine whether any additional changes were needed to increase its effectiveness,

- evaluate whether DoD contracting officers were fully implementing the profit policy and adequately documenting their profit decisions, and

- evaluate the effectiveness of DoD internal control policies, procedures, and practices applicable to preparation, supervisory review, and reporting of profit objectives.

Using a combination of random statistical and judgmental sampling techniques, we selected for review 150 DD Forms 1547 amounting to \$2.3 billion from the 1,101 forms totaling \$16.9 billion in DoD's management information system for FY 1988. Details of the audit universe and sample selection are in Appendix B. We visited the 18 contracting and acquisition locations identified in Appendix C. Of the 150 forms selected, only 147 were actually reviewed because 2 of the forms did not require the use of profit factors and the third form used the old profit weighted guidelines method. The Defense Logistics Agency (DLA) was excluded from our audit universe because DLA contract actions were primarily competitive and small in dollar size. Also, DLA is not subject to the DFARS reporting requirements for completing DD Forms 1547. At each contracting activity, we reviewed profit

data that contracting officers included in price negotiation memorandums to determine why weights and values were assigned to the profit factor items on the DD Form 1547. We compared the rationale in the price negotiation memorandums with criteria in DFARS 15.970-1 to evaluate why contracting officers were not complying with the DFARS requirements. We also reviewed contract negotiation files, including price negotiation memorandums, Government pricing and technical reports, and Defense Contract Audit Agency audit reports dated 1987 and 1988.

To achieve the audit objectives we used DoD's automated system that contained information from DD Forms 1547. We only assessed the accuracy of the data in the automated system from DD Forms 1547. We did not perform tests to determine whether all DD Form 1547's were included in DoD's system. However, our review concluded that the data were sufficiently reliable to be used in meeting the audit objectives.

This performance audit was made from November 1988 through June 1989 in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD. Accordingly, we included such tests of internal controls as were considered necessary. The principal activities visited or contacted during the audit are listed in Appendix I.

Internal Controls

We reviewed the program documentation and implementation of the internal controls and techniques related to the adequacy and implementation of the DoD Profit Policy-Final Rule by analyzing the preparation of DD Forms 1547 and DoD management approval. Specific internal controls assessed included those related to training, supervisory review, and reporting of prepared DD Form 1547's. Government internal control reviews at the acquisition offices were also analyzed during the audit. The identified internal control weaknesses related to a lack of adequate documentation, training, and supervisory reviews of completed DD Forms 1547. These weaknesses are discussed in Part II of the report.

Prior Audit Coverage

The General Accounting Office (GAO) issued the following reports that discussed or referred to DoD's Profit Policy.

GAO Report Number NSIAD 86-55 (OSD Case Number 6723), "Cost Accounting Standard 414: Its Relationship to DoD Profit Policy," dated March 14, 1986, reported that since the issuance of Cost Accounting Standard 414 in 1976, average profits on DoD contracts increased because of later DoD flawed policy revisions. DoD disagreed and responded that increased profit levels were caused

by increased contractor capital investment. The DoD, Assistant Inspector General for Analysis and Followup closed this case as a result of a DoD nonconcurrency.

GAO Report Number NSIAD 87-50 (OSD Case Number 7073), "Assessment of the Study of Defense Contractor Profitability," dated December 23, 1986, reported on the results of the Defense Financial and Investment Review and showed that Defense contractor profitability was higher than comparable manufacturers of durable goods from 1970 to 1983. The report also discussed the potential effect of DoD's interim profit policy and recommended that Congress consider establishing a Profitability Reporting Program. DoD nonconcurred with GAO's recommendations and the DoD, Assistant Inspector General for Analysis and Followup closed this case because OSD nonconcurred with the recommendation.

GAO Report Number NSIAD 87-195 (OSD Case Number 7417), "Selected Review of Defense Contractor Profitability," dated September 2, 1987, followed up on GAO/NSIAD 87-50 and found that DoD's interim profit policy may come close to reducing profit objectives by 1 percent. However, GAO found that a 1-percent reduction in profit objectives would not be enough to achieve DoD's goal of approaching comparability with manufacturers of durable goods. There were no specific recommendations.

GAO Report Number NSIAD 87-175 (OSD Case Number 7177), "A Proposal for a Program to Study the Profitability of Government Contractors," dated September 17, 1987, reported that the Government should develop a systematic method of measuring the effect of its profit policies and proposed draft legislation for Congress to consider in establishing such a method. The DoD nonconcurred with GAO's recommendations and the case was closed.

GAO Report Number NSIAD 89-121 (OSD Case Number 7994), "Effect of Changes in Procurement and Tax Policy on the Defense Industry," dated May 17, 1989, reported that an industry study, MAC Group (a facility based international general management consulting firm) Report, which concluded that recent changes in procurement and tax policy are squeezing Defense contractors' profits, cannot be validated concerning the overall Defense industry. GAO commented that there was a strong need for a profitability reporting program for Defense contractors and noted that DoD disagreed with the need for such a program. Responding to the GAO report, the MAC group stood by its findings and conclusions and accepted only 1 of GAO's 24 criticisms. There were no specific recommendations.

PART II - FINDING AND RECOMMENDATIONS

Development of Profit Objectives

FINDING

DoD contracting officers did not adequately document profit objectives and did not correctly prepare DD Forms 1547, "Record of Weighted Guidelines Application," used to develop profit objectives. These conditions existed because of inadequate training procedures for the documentation and development of DD Form 1547 profit objectives and because of inadequate supervisory reviews. As a result, DoD could not effectively evaluate the Profit Policy-Final Rule or realistically determine whether its goal of a 0.5- to 1-percent reduction in overall negotiated profit objectives was being achieved.

DISCUSSION OF DETAILS

Background. DFARS, subpart 215.9, "Profit," requires that DoD contracting officers use a DD Form 1547, "Record of Weighted Guidelines Application," to develop a profit objective on negotiated defense contracts. The contracting officer develops a profit objective by assigning weights and values to profit factors listed on the form. These profit factors include performance risks (technical, management, and cost control); contract risks; an adjustment for the contractor's investment in working capital; and contractor capital facilities employed (buildings and equipment). For each profit factor, the DFARS establishes a normal value and a designated range of values that the contracting officer may assign to each profit factor. A normal value is the expected profit assignment under average conditions when compared to all goods and services that DoD acquired. DFARS 215.970-1, "Procedures for Establishing a Profit Objective," presents a detailed discussion on when contracting officers may assign higher or lower than normal values, depending on the particular conditions of each case.

Documentation of Profit Objectives. For the 147 statistically selected DD Forms 1547 in our audit, we reviewed a total of 1,236 DoD contracting officer assigned profit factor weights and values. Our review showed that contracting officers assigned normal profit values for 510 of the 1,236 profit factors. OSD maintains that documentation is not required for assigned normal profit values; therefore, we excluded the 510 normal values from our sample results summarized in Appendix D. Of the remaining 726 individual profit factors on the DD Forms 1547, we found that 71 percent were not fully documented by the contracting officer in the price negotiation memorandum. There were many forms prepared with inadequate rationale, or rationale that supported a higher or lower weight or value than assigned. Further, contracting officers did not adequately document weights assigned to components of the performance risk factors.

The General Accounting Office publication, "Standards for Internal Controls in the Federal Government," states that internal control systems, including management policies and procedures, should be clearly documented. This requirement comes from the need to achieve proper conduct of Government business and to achieve the policies' objectives. In our review, there was no indication of how the contracting officers arrived at their conclusions for 71 percent of the profit factors needing documentation or if the contracting officers performed any analyses. Without an adequate profit analysis documented in the price negotiation memorandum, contracting officers could not support their conclusions on contractor performance, contract-type risk, or the contractor facilities capital employed.

There were cases of limited documentation supporting the rationale provided for assigned weights and values for the DD Form 1547 profit factors. The review showed that the primary reason for the lack of support was that the Army, Navy, and Air Force Commands provided inadequate guidance and training. The commands issued policies and procedures that did not adequately address preparation of supporting rationale for the assigned weights and values. Also, the commands provided inadequate training in the area of preparing the documentation supporting the rationale for the contracting officer's decision. This may have resulted in the incorrect use of profit objectives to negotiate contract prices and inaccurate statistics provided to the DoD management information system.

Preparation of Profit Forms. The audit showed that contracting officers assigned research and development and services contractors a value for facilities capital employed. This occurred even though the contractors had already been assigned an alternate higher normal value for contractor performance risk factors. The DoD Profit Policy does not allow for the assignment of a higher normal value for performance risk factors and a value for facilities capital employed. Additionally, we found weights and values assigned to some contracts were higher or lower than supported by the cited rationale. For example, the assignment of a normal or average value to the technical performance risk factor with the rationale that proposed efforts do not require highly skilled personnel or that they are relatively routine would indicate that assignment of a lower than normal value was the proper choice.

Our review of the 147 DD Forms 1547 and discussions with contracting officers disclosed a total of 18 mathematical errors (12 percent) and 19 coding errors (13 percent). These errors were found after negotiations with the contractor and after the forms were forwarded for inclusion in the DoD management information system. The audit showed that several forms had been returned to contracting officers after the negotiation process for correction of mathematical and coding errors. One of the reasons for the errors was inadequate training in the preparation of the forms. The Military commands conducted training sessions

covering preparation of the forms after DoD's current Profit Policy became effective, in August 1987. However, since that time, as new contracting officers and pricing analysts were hired, the commands have provided no formal training. In many instances, contracting and procurement offices have not given any training to new employees.

Internal Controls. Incorrect profit objectives were used because supervisors did not adequately review DD Forms 1547 before entering into contract negotiations. DFARS, subpart 215.970-2, "Instructions for Completing DD Form 1547," states that "It is essential that this form be prepared accurately." After preparation of the DD Form 1547, it was incorporated as an exhibit to the pre-Price Negotiation Memorandum. Although the price negotiation memorandum was usually reviewed, the profit objective was only reviewed as a line item and not in detail. Because no detailed reviews were made of the actual form, mathematical and coding errors went undetected causing inaccuracies in the profit objective used during contract negotiations.

Adequate internal controls were not established to ensure that the DD Form 1547 would be properly reviewed prior to negotiations with the contractor. DFARS, subpart 204.673-2 discusses the requirement for internal controls and states that the contracting officer is responsible for correction of any errors detected by the system's auditing processes. As mentioned above, several forms were returned to contracting officers for correction of mathematical and coding errors after negotiations. An adequate supervisory review performed before negotiations would have resulted in correct profit objectives for negotiations with contractors. In addition, a more accurate form would have been forwarded to the DoD management information system for use in compiling statistics for Congress and the public. Our review also found that prepared forms were not always forwarded to the designated Military office within 30 calendar days after the date of contract award.

DoD's Profit Goal. A major goal of the DoD profit policy was to reduce by 0.5 to 1 percent overall profit negotiated on Defense contracts. This was based on an assumption that a reduction in negotiated profit objectives would have a corresponding effect on reducing actual profits received on Defense contracts. DoD officials did not provide any evidence during the audit to confirm that DoD was achieving its goal of a 0.5- to 1-percent reduction in overall negotiated profit objectives. DoD currently collects all the information on profit in an automated data base. There is a need for analyses of the data to determine if DoD is achieving the goal of reducing profit or if any change is needed in the profit policy.

RECOMMENDATIONS FOR CORRECTIVE ACTION

We recommend that the Assistant Secretary of Defense (Production and Logistics):

1. Require that acquisition offices of the Military Departments establish adequate training procedures to ensure that DD Forms 1547 are correctly prepared and documented, and establish specific internal controls to ensure that contracting officers perform adequate supervisory reviews of prepared DD Forms 1547 prior to conclusion of the negotiation process. Examples of specific internal controls would include use of computer generated programs that contain test check or error traps and maintenance of supervisory check-off matrix schedules for review of DD Forms 1547 prior to conclusion of the negotiation process.

2. Perform an annual analysis of profit objectives contained on DD Forms 1547 submitted by the Military Departments to determine if DoD's goal (of a 0.5- to 1-percent reduction in overall negotiated profit objectives) is being achieved. This annual analysis should include an in-depth comparison of prior year (beginning in FY 1989) and current year reported profit objectives adjusted for any significant changes to the profit policy. Also, trend analyses of profit objective data should be periodically performed to determine the adequacy and applicability of the current profit policy.

MANAGEMENT COMMENTS

The Assistant Secretary of Defense (Production and Logistics) nonconcurrented with our draft report finding that DoD contracting officers did not adequately document the profit analyses in price negotiation memorandums, did not use correct data to compute profit objectives, and did not correctly prepare DD Forms 1547, "Record of Weighted Guidelines Application." The Assistant Secretary stated that the DFARS policy is sufficiently detailed to enable contracting officers to develop appropriate profit objectives and attributed the errors to significant differences between the new policy and the previous policy. The Assistant Secretary also disagreed with the audit conclusion that contract prices were not properly negotiated and added that it would be impossible to determine whether the 1-percent reduction in profit objectives was achieved without comparing profit objectives and data base characteristics for fiscal year 1988 to similar data for years prior to implementing the new profit policy. The Assistant Secretary disagreed with the contention that the DFARS requires documentation of the use of normal values since the Assistant Secretary and the Services had agreed that the use of normal values need not be documented by contracting officers. The Assistant Secretary also disagreed with the reported draft report sample results that showed an overall error rate of 62.27

percent on the reviewed DD Forms 1547. The Assistant Secretary recommended that the sample results be deleted from the final report because they were misleading.

The Assistant Secretary nonconcurred with the draft report Recommendation 1.a. (recommendation deleted from final report) that the Assistant Secretary of Defense (Production and Logistics) direct the Defense Acquisition Regulatory (DAR) Council to revise the DoD Profit Policy in Subpart 215.9 of the DFARS to specify the documentation required to fully support the profit analysis performed. The Assistant Secretary stated that additional documentation is not necessary as the concept of "normal values" was established to represent the expected profit assignment where average conditions exist.

The Assistant Secretary also nonconcurred with the draft report Recommendation 1.b. (recommendation deleted from final report) that the Assistant Secretary direct the DAR Council to revise the DoD Profit Policy in Subpart 215.9 of the DFARS to modify the formula in DFARS, subpart 215.970-1(b)(4) to show that the portion of contract costs financed by contractors is not always used to calculate the working capital adjustment. The Assistant Secretary responded that the formula is set forth in the DFARS for illustrative purposes only and that the text immediately following the formula provides the suggested guidance. Also, the Assistant Secretary commented that only two errors were found that were caused by the contracting officers relying on the formula instead of reading the related text material. The Assistant Secretary commented that it was counter productive to include redundancies in the DFARS while at the same time attempting to streamline the regulations and eliminate detailed or duplicative language.

The Assistant Secretary concurred in part with Recommendation 2. in the draft report (renumbered Recommendation 1.) and stated that the Army, Navy, and Air Force have already developed or plan to develop software programs that will ensure that resulting profit objectives are mathematically accurate and consistent with the profit policy.

AUDIT RESPONSE TO MANAGEMENT COMMENTS

We disagree with the Assistant Secretary that DoD contracting officers adequately documented and correctly prepared DD Form 1547's. Although our review included analyses of DD Forms 1547 prepared and submitted during the first year of the new profit policy, we believe that the significant changes between the new policy and the previous policy warranted additional attention by DoD and the Military Departments. These officials should have emphasized immediate in-depth training for the contracting officers subsequent to the issuance of the new policy in August 1987. The Assistant Secretary also disagreed with our conclusion that contract prices were not properly

negotiated. However, our review noted specific instances of higher-than-warranted negotiated profit rates based on incorrect profit rate objectives.

We agree with the Assistant Secretary that it would be impossible to determine whether the 1-percent reduction in profit objectives was achieved without comparing profit objectives and data base characteristics for several years; however, our report only stated that we believe that it will be very difficult for DoD to demonstrate that it is achieving its goal of a 0.5- to 1-percent reduction in overall negotiated profit objectives.

We agree with the Assistant Secretary's contention that the DFARS does not specifically require documentation of assigned normal profit values. However, DFARS, subpart 215.903(e)(S-70) requires contracting officers to fully document the profit analysis performed in the price negotiation memorandum. The Assistant Secretary also stated that because documentation of assigned normal profit values was not required, the draft report sample results showing an overall error rate of 62.27 percent was misleading. Based on the Assistant Secretary's comments, we have revised Appendix D in the final report to reflect the Assistant Secretary's position on the documentation of assigned normal profit values. However, after excluding the normal value errors from our sample results, we found that the error rate on the remaining profit factors was 71 percent (512/726 profit factors).

After considering the Assistant Secretary's comments related to Recommendation 1.b. of the draft report, we have deleted this recommendation because of the small number of errors and the logic of the Assistant Secretary's comments.

We agree with the Assistant Secretary's partial concurrence with Recommendation 2. (renumbered Recommendation 1.), but believe that a DoD-wide uniform software program for the preparation and review of DD Forms 1547 should be developed for use by all of the Military Departments. It is important that the selected software program be properly formatted and tested as our review showed that the existing programs were not properly formatted for input into DoD's management information system and contained certain defects. We could not determine if the Assistant Secretary agreed with the part of the recommendation related to training; therefore, we request his comments on this area.

**SAMPLE OF DD
FORM 1547**

RECORD OF WEIGHTED GUIDELINES APPLICATION						REPORT CONTROL SYMBOL DD-P&LQ11751		
1 REPORT NO		2 BASIC PROCUREMENT INSTRUMENT IDENTIFICATION NO			3 SPNN		4 DATE OF ACTION	
		a PURCHASING OFFICE	b FY	c TYPE PROC INST CODE	d PRISM		a YEAR	b MONTH
5 CONTRACTING OFFICE CODE				ITEM	COST CATEGORY		OBJECTIVE	
6 NAME OF CONTRACTOR				13	MATERIAL			
				14	SUBCONTRACTS			
7 DUNS NUMBER		8 FEDERAL SUPPLY CODE		15	DIRECT LABOR			
				16	INDIRECT EXPENSES			
9 DOD CLAIMANT PROGRAM		10 CONTRACT TYPE CODE		17	OTHER DIRECT CHARGES			
				18	SUBTOTAL COSTS (13 thru 17)			
11 TYPE EFFORT		12 USE CODE		19	GENERAL AND ADMINISTRATIVE			
				20	TOTAL COSTS (18 + 19)			
WEIGHTED GUIDELINES PROFIT FACTORS								
ITEM	CONTRACTOR RISK FACTORS		ASSIGNED WEIGHTING	ASSIGNED VALUE	BASE (ITEM 18)	PROFIT OBJECTIVE		
21	TECHNICAL		%					
22	MANAGEMENT		%					
23	COST CONTROL		%					
24	PERFORMANCE RISK (COMPOSITE)							
25	CONTRACT TYPE RISK							
26	WORKING CAPITAL		COSTS FINANCED	LENGTH FACTOR	INTEREST RATE			
					%			
	CONTRACTOR FACILITIES CAPITAL EMPLOYED			ASSIGNED VALUE	AMOUNT EMPLOYED			
27	LAND							
28	BUILDINGS							
29	EQUIPMENT							
30	TOTAL PROFIT OBJECTIVE							
NEGOTIATION SUMMARY								
				PROPOSED	OBJECTIVE	NEGOTIATED		
31	TOTAL COSTS							
32	FACILITIES CAPITAL COST OF MONEY (DD Form 1867)							
33	PROFIT							
34	TOTAL PRICE (Line 31 + 32 + 33)							
35	MARKUP RATE (Line 32 + 33 divided by 31)			%	%	%		
CONTRACTING OFFICER APPROVAL								
36 TYPED/PRINTED NAME OF CONTRACTING OFFICER (Last, First, Middle Initial)			37 SIGNATURE OF CONTRACTING OFFICER			38 TELEPHONE NO	39 DATE SUBMITTED (YYMMDD)	
OPTIONAL USE								
96	97		98		99			

DD Form 1547, AUG 87

Previous editions are obsolete

SAMPLE METHODOLOGY

Sampling Objectives. The sampling objectives were two-fold:

- to estimate the extent of contracting officers' compliance with Defense Federal Acquisition Regulation Supplement criteria on DoD's Profit Policy-Final Rule and their use of the Weighted Guidelines Method in developing profit objectives, and

- to evaluate various attributes of the internal control techniques, policies, procedures, and practices followed by contracting officers to assess their effectiveness in developing, reviewing, and reporting profit objectives on DD Forms 1547, "Record of Weighted Guidelines Application."

Universe and Sample Size. The audit universe consisted of 1,101 Army, Navy, and Air Force DD Forms 1547 reported to DoD's management information system during FY 1988. The universe was broken down by office code, number of contracts within each office code, and total office code contract dollar values for each of the Military Departments. As shown below, the universe was further divided into five strata based on the office code total and the contract dollar size.

<u>Strata Size</u>	<u>Number</u>		<u>Dollars (000)</u>	
	<u>Universe</u>	<u>Sample</u>	<u>Universe</u>	<u>Sample</u>
Over \$1 Billion	164	30	\$11,940,336	\$1,660,703
\$100 Million - \$999,999,999	608	68	4,036,264	514,685
\$10 Million - \$99,999,999	261	32	834,275	136,701
\$1 Million - \$9,999,999	58	20	94,426	22,159
\$500,000 - \$999,999	10	0	6,364	0
Total	<u>1,101</u>	<u>150</u>	<u>\$16,911,665</u>	<u>\$2,334,248</u>

The actual sample size consisted of only 147 DD Forms 1547 as 3 contracts were excluded from the original sample selection of 150. Two of the three contracts did not contain detailed profit values and weights, the other contract could not be located, and a replacement contract was not available.

Desired Reliability: 90 percent

Desired Precision: 5 percent for attributes
12.5-15.0 percent for dollar amounts

Sampling Techniques Selected. The sample selection techniques were structured to permit sampling for both attributes and variables. Sampling for attributes involves qualitative characteristics while sampling for variables relates to quantitative characteristics such as dollar projections.

LISTING OF SAMPLED CONTRACTS

<u>Contractor</u>	<u>Contract Number</u>	<u>Modification Number</u>	<u>Contract Amount</u>
Hughes, EDD	N00164-88-C-0114		\$ 2,765,376
Econo Broadcast Service	N00164-88-R-0002		2,871,000
Grumman Aerospace	N00164-88-D-0046		15,262,837
Total-NWSC *			<u>\$ 20,899,213</u>
Magnavox Corporation	N60530-88-C-0329		\$ 1,518,342
Tracor	N60530-88-D-0054		935,700
Computer Science Corporation	N60530-88-D-0051		1,767,034
Conax Florida Corporation	N60530-86-C-0015	P00022	2,918,330
Total-NWC *			<u>\$ 7,139,406</u>
Electromagnetic Sciences	N00104-88-C-2439		\$ 770,137
Gould Incorporated	N00104-88-C-4520		1,181,515
Pneu Devices Incorporated	N00104-88-C-2801		945,000
Varian Associates	N00104-88-C-4533		594,270
Crafts Company Incorporated	N00104-88-C-0140		1,051,980
Plessey Microwave Materials	N00104-88-C-3980		626,826
Total-NSPCC *			<u>\$ 5,169,728</u>
VVR Incorporated	N62470-85-C-3059	P00001	\$ 982,981
Whitman, Required and Assoc.	N62470-87-C-8998		594,107
Total-NAVFAC-ENGR *			<u>\$ 1,577,088</u>
General Electric/RCA	N00039-88-C-0068		\$ 53,190,000
General Electric/RCA	N00039-87-C-0071	PZ0006	2,545,000
General Electric/RCA	N00039-87-C-0071	PZ0006	70,493,000
Unisys Corporation	N00039-88-C-0100		1,595,116
Mandex	N00039-88-C-0012		2,113,192
ESL Incorporated	N00039-88-C-0146		10,339,630
General Electric/RCA	N00039-88-C-0068		2,358,485
RCA Aerospace	N00039-87-C-0373	P00005	504,711
RCA Aerospace	N00039-87-C-0373	P00005	840,000
RCA Aerospace	N00039-87-C-0373	P00005	620,927
RCA Aerospace	N00039-87-C-0373	P00004	1,174,266
Litton Data Systems	N00039-87-C-0330	P00006	3,764,169
Simplex Wire and Cable	N00039-88-C-0117		48,000,000
AT&T Technologies	N00039-88-C-0134		21,780,000
Total-SPAWARS *			<u>\$ 219,318,496</u>
General Electric	N00019-87-C-0185	PZ0002	\$ 10,560,244
General Electric	N00019-87-C-0253		841,771
Lucas Aerospace Industries	N00019-87-C-0353		10,023,071
McDonnell Douglas	N00019-87-C-0103		134,175,000
Precision Echo, Incorporated	N00019-88-C-0022		6,137,500
McDonnell Douglas	N00019-86-C-0302	P00028	346,128,330

* See Location key at end of Appendix.

LISTING OF SAMPLED CONTRACTS (Continued)

<u>Contractor</u>	<u>Contract Number</u>	<u>Modification Number</u>	<u>Contract Amount</u>
Cubic Corp	N00019-87-C-0065	P00001	\$ 1,739,500
McDonnell Douglas	N00019-88-C-0089	P00007	1,825,000
McDonnell Douglas	N00019-88-C-0029		6,389,547
General Electric	N00019-87-C-0253		3,768,144
Grumman Aerospace	N00019-87-C-0017	P00002	3,750,735
Grumman Aerospace	N00019-87-C-0017	P00002	21,048,044
Texas Instruments	N00019-85-C-0102	7	1,250,000
EDO Corporation	N00019-87-C-0230	PZ0001	22,422,659
Unisys Corporation	N00019-88-C-0165		4,900,000
Grumman Aerospace	N00019-85-C-0475	P00021	2,235,507
Grumman Aerospace	N00019-85-C-0475	P00022	7,003,853
Allison Gas Turbine	N00019-84-G-0220	3	2,450,000
Elbit Computers, Ltd.	N00019-88-C-0099		990,000
Honeywell Incorporated	N00019-87-G-0089	1	2,887,012
Total-NAVAIR *			<u>\$ 590,525,917</u>
Sikorsky Aircraft Division	DAAJ09-88-C-0004		\$ 48,564,561
Sikorsky Aircraft Division	DAAJ09-88-C-A003		983,181,377
BFM Romec Corporation	DAAJ09-88-C-0789		584,630
Boeing Helicopter	DAAJ09-88-G-A005	0370	2,552,000
Boeing Helicopter	DAAJ09-88-G-A005	0384	752,847
Boeing Helicopter	DAAJ09-85-G-A017	87R2090	595,421
Link-Belt Construction	DAAJ09-88-R-1325		2,121,736
United Technologies	DAAJ09-85-G-A023	0839	5,434,315
Boeing Company	DAAJ09-85-C-A005		819,000
Avco Corporation	DAAJ09-88-C-1169		25,570,686
Total-AVSCOM *			<u>\$1,070,176,573</u>
Magnavox Corporation	DAAL01-88-C-0829		\$ 1,223,152
Stanford Communications	DAAL01-88-C-0830		618,058
Texas Instruments	DAAL01-88-C-0831		653,029
Vitronics	DAAL01-88-C-0846		659,415
T.H. Wallace	DAAL01-88-C-0036		845,266
Total-LABCOM-A *			<u>\$ 3,998,920</u>
Rohm and Haas Company	DAMD17-88-C-8038		\$ 2,309,822
Electromagnetic Tech	DAMD17-85-C-5083	P80016	637,674
Herner V. Co. Incorporated	DAMD17-85-C-5340	P80009	812,004
SRA Technologies	DAMD17-86-C-6185	P80008	2,105,391
SRI International	DAMD17-88-C-8001		508,764
Bionetics Research Inc.	DAMD17-88-C-8037		1,393,264
Mitre Corporation	DAMD17-86-C-6145		8,058,744
Salk Institute	DAMD17-88-C-8082		32,332,561
Total-Ft. Detrick *			<u>\$ 48,158,224</u>
ESL Incorporated	DAAL02-85-C-0122		\$ 1,376,006
Berkeley Research Assoc.	DAAL02-87-R-9381		1,943,356

* See Location Key at end of Appendix.

LISTING OF SAMPLED CONTRACTS (Continued)

<u>Contractor</u>	<u>Contract No.</u>	<u>Modification Number</u>	<u>Contract Amount</u>
Booz, Allen and Hamilton	DAAL02-87-R-9419		\$ 1,013,087
Digital Fantasies LTD	DAAL02-86-C-0002	P00005	2,457,713
RCA Corporation	DAAL02-87-C-0028	PZ0002	20,440,000
RCA Corporation	DAAL02-87-C-0028	PZ0002	3,020,000
Total-LABCOM-M *			<u>\$ 30,250,162</u>
Band Lavis and Assoc., Inc.	DAAK70-88-C-0012		\$531,325
Sun Power Incorporated	DAAK70-84-C-0107	P00013	782,827
Chamberlain Mfg. Corporation	DAAK70-87-R-0036		682,579
Total-R & D Command *			<u>\$ 1,996,731</u>
Ford Aerospace	DAAH01-88-C-0113		\$ 1,991,885
Martin Marietta	DAAH01-88-C-0015		1,675,888
Science and Technology	DAAH01-88-C-0293		1,349,861
Computer Sciences	DAAH01-88-C-0186		1,744,568
Beech Aircraft	DAAH01-86-C-0019	P00027	1,808,673
Honeywell Incorporated	DAAH01-87-C-0596		3,822,290
Raytheon Company	DAAH01-88-C-0323		6,549,719
Total-Missile Command *			<u>\$ 18,942,884</u>
AM General Division	DAAE07-88-C-R002		\$ 1,187,209
GTE Products Corporation	DAAE07-88-C-A017		1,047,578
AVCO Corporation	DAAE07-84-G-A006	0043	1,770,121
Emerson Electric	DAAE07-88-C-R055		3,758,925
General Dynamics	DAAE07-88-C-R023		821,530
Man Truck and Bus Corporation	DAAE07-88-C-R022		1,040,865
FMC Corporation	DAAE07-86-C-A047	0034	4,371,604
Caterpillar Incorporated	DAAE07-85-C-J098	P00005	9,703,200
Caterpillar Incorporated	DAAE07-83-C-H260	P00068	1,381,654
Total-TACOM *			<u>\$ 25,082,686</u>
VSE Corporation	F08635-86-C-0001	P00035	\$ 578,989
Hughes Aircraft	F08635-88-C-0093		1,327,159
Raytheon Company	F08635-87-C-0065	P00006	9,100,000
TRW Incorporated	F08635-87-C-0061	P00008	558,039
Magnavox Corporation	F08635-88-C-0021		970,000
Dyna East Corporation	F08635-88-C-0141		512,050
Total-Munitions Sys. Div. *			<u>\$ 13,046,237</u>
General Electric	F34601-88-G-6603	24	\$954,263
General Electric	F34601-88-G-6603	128	745,292
General Electric	F34601-88-G-6603	76	654,462
Sundstrand Corporation	F34601-88-C-2450		1,759,260
Boeing Corporation	F34601-87-C-3379	PZ0003	1,375,000
Boeing Corporation	F34601-85-C-3243	P00029	723,200
Boeing Corporation	F34601-85-C-0802	P00021	3,435,225

* See Location Key at end of Appendix.

LISTING OF SAMPLED CONTRACTS (Continued)

<u>Contractor</u>	<u>Contract No.</u>	<u>Modification Number</u>	<u>Contract Amount</u>
General Electric	F34601-88-G-6603	15	\$ 677,585
General Electric	F34601-88-G-6603	80	2,310,750
General Electric	F34601-88-G-6603	88	2,371,960
Sundstrand Corporation	F34601-86-G-0254	480	1,252,788
Sundstrand Corporation	F34601-86-G-0254	677	527,966
E-Systems Corporation	F34601-83-C-3056	P00089	5,886,402
J.T. Slocomb Company	F34601-88-C-1176		539,299
Sundstrand Corporation	F34601-86-G-0254	507	637,351
Total-OCALC *			<u>\$ 23,850,803</u>
IBM Federal Systems	F04690-86-C-0004	P00055	\$ 16,354,343
Ford Aerospace	F04690-86-C-0001	P00067	1,922,648
Ford Aerospace	F04690-86-C-0001	P00064	900,547
Total-SSD *			<u>\$ 19,177,538</u>
Federal Electric	F04703-86-C-0618	P00115	\$ 1,793,896
Federal Electric	F04703-86-C-0618	P00108	1,562,872
Federal Electric	F04703-86-C-0618	P00129	1,878,906
Federal Electric	F04703-86-C-0618	P00118	674,048
Frontier Engineering	F04703-88-C-0822		845,000
Commun. and Power Engineers	F04703-87-C-0545	P00008	692,530
Total-WSMC *			<u>7,447,252</u>
Raymond Engineering Inc.	F09603-88-C-2903		\$ 7,104,960
E-Systems Incorporated	F09603-87-C-4552		517,658
McDonnell Douglas	F09603-87-C-2262	PZ0005	24,242,471
Allied Signal	F09603-87-G-0085	0085	583,842
Sanders Associates Inc.	F09603-88-C-2252		560,133
Westinghouse Electric	F09603-87-G-0824	0014	960,004
Westinghouse Electric	F09603-88-C-1950		98,869,000
Westinghouse Electric	F09603-87-C-4723	P00003	1,252,047
Allied Corporation	F09603-84-G-1372	0071	3,365,000
Litton	F09603-87-G-4667		1,500,000
Loral Systems	F09603-87-G-1355	0005	606,154
Rockwell International	F09603-88-D-0088	P00003	1,152,447
Cross Systems	F09603-84-C-1543	P00011	4,780,000
E-Systems Incorporated	F09603-87-G-0664	0005	1,286,772
Israel Military Industries	F09603-87-C-0535	PZ0002	608,400
Lockheed Aeronautical	F09603-87-G-0741	P00003	48,424,992
Bell Helicopter	F09603-88-C-2943		2,929,003
Rockwell International	F09603-88-C-2991		748,489
Fairchild Weston Systems	F09603-87-G-0084	0010	3,277,116
General Services Engn.	F09603-88-C-2826		6,541,202
Total-W/R ALC *			<u>\$ 209,309,690</u>
Total-All Locations			<u>\$2,316,067,548</u>

* See Location Key at end of Appendix.

Location Key:

NWSC = Naval Weapons Support Center, Crane IN
NWC = Naval Weapons Center, China Lake, CA
NSPCC = Navy Ships Parts Control Center, Mechanicsburg, PA
NAVFAC-ENGR = Naval Facilities Engineering Command, Norfolk, VA
SPAWARS = Space and Naval Warfare Systems Command, Arlington, VA
NAVAIR = Naval Air Systems Command, Arlington, VA
AVSCOM = Army Aviation Systems Command, St. Louis, MO
LABCOM-A = Army Lab Command, Adelphi, MD
Fort. Detrick = Medical R & D Command, Frederick, MD
LABCOM-M = Army Lab Command, Ft. Monmouth, NJ
R & D Command = Mobility Equipment R & D Command, Ft. Belvoir, VA
Missile Command = Army Missiles Command, Redstone Arsenal, AL
TACOM = Army Tank Automotive Command, Warren, MI
Munitions Sys. Div. = Munitions Systems Division, Eglin Air Force
Base, FL
OCALC = Oklahoma City Air Logistics Center, Tinker Air Force Base, OK
SSD = Air Force Space Division, Los Angeles, CA
WSMC = Western Space & Missile Center, Vandenberg, Air Force Base, CA
W/R ALC = Warner Robins Air Logistics Center, Robins Air Force Base, GA

SUMMARY OF SAMPLE RESULTS

<u>DD Form 1547 Profit Category</u>	<u>Total Reviewed Profit Factors</u>	<u>Less Normal Assigned Values</u>	<u>Remaining Profit Factors</u>	<u>Observed Errors</u>	<u>Percentage Error Rate</u>
	<u>1/</u>	<u>2/</u>			
Technical					
-Weight	147		147	111	76
-Value	147	82	65	30	46
Management					
-Weight	147		147	112	76
-Value	147	86	61	34	56
Cost Control					
-Weight	147		147	110	75
-Value	147	89	58	40	69
Contract Type Risk	147	92	55	41	75
Buildings	101	83	18	15	83
Equipment	<u>106</u>	<u>78</u>	<u>28</u>	<u>19</u>	68
Sub Totals	1,236	510 <u>2/</u>	726	512	71
Math	147		147	18	12
Bases	147		147	19	13
Working Capital	<u>84</u>	---	<u>84</u>	<u>32</u>	38
Grand Total	<u>1,614</u>	<u>510</u>	<u>1104</u>	<u>581</u>	53

1/ The actual sample size consisted of 147 DD Forms 1547 as explained in Appendix B.

2/ Contracting officer assigned normal profit values were excluded from our total of reviewed profit factors as OSD maintains that documentation is not required when normal values are assigned.



ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D C 20301-8000

PRODUCTION AND
LOGISTICS

June 8, 1990

(P) CPF

MEMORANDUM FOR DEPARTMENT OF DEFENSE INSPECTOR GENERAL

SUBJECT: Draft Report on the Audit of the Adequacy and
Implementation of DoD Profit Policy
(Project No. 9CC-0018)

This is in response to your April 12, 1990, request for comments on the subject draft audit report. Our detailed comments on the report findings and recommendations are attached.

In general, we do not agree that changes to the profit policy are required. Your review included an examination of 147 actions negotiated during the first year the new policy was in effect. Since the new policy is significantly different from the previous policy, some errors are to be expected. However, to classify the failure to document the use of normal values as an error is incorrect. The profit policy does not require contracting officers to document normal values, and we do not believe such documentation is necessary or would make the policy more effective. Furthermore, Appendices D and E are misleading in this regard and should be deleted from the report.

We consider the additional language proposed for inclusion in the Defense Federal Acquisition Regulation Supplement (DFARS) to be duplicative and unnecessary, particularly in light of our current efforts to streamline the DFARS and relieve contracting officers of unnecessary administrative burdens. We consider it to be an inefficient use of resources to require contracting officers to document every weight and value entered on the DD Form 1547.

David J. Berteau
David J. Berteau
Principal Deputy

Attachment

ASSISTANT SECRETARY OF DEFENSE (PRODUCTION AND LOGISTICS)
(ASD(P&L)) COMMENTS ON DRAFT DODIG REPORT ON THE AUDIT OF
THE ADEQUACY AND IMPLEMENTATION OF DOD PROFIT POLICY

PART I - INTRODUCTION

ASD(P&L) COMMENT: The background statement indicates that a primary objective of the interim profit policy issued in October 1986 was to reduce profit negotiated on contracts by 1 percent based on an analysis which revealed that defense contractors' return on assets were greater than durable goods manufacturers' returns. This statement is not correct. A primary objective was to reduce profit objectives by .5 to 1 percent because of an unintended increase in profit objectives which resulted from a 1980 change to the profit policy.

PART II - FINDING

The IG found that contracting officers did not adequately document profit analyses, did not use correct data to compute profit objectives, and did not correctly prepare DD Forms 1547 in part because the DFARS lacked sufficient guidance. The IG concluded that, as a result, contract prices were not properly negotiated, profit objectives were incorrect, and DoD could not effectively evaluate the new profit policy or determine if a 1 percent reduction in profit objectives was being achieved.

We do not concur with this finding. We believe the DFARS policy is sufficiently detailed to enable contracting officers to develop appropriate profit objectives. While it is unfortunate that mathematical errors were discovered by the IG, the review was performed during the first year the policy was implemented and some errors are certain to occur because of the significant differences between the new policy and the previous policy.

We also disagree with the IG's conclusion that contract prices were not properly negotiated. The IG examined profit objectives only; as stated elsewhere in the report, it would be difficult to conclusively state that inflated profit objectives resulted in inflated negotiated profits. Additionally, it would be impossible to determine whether the 1 percent reduction in profit objectives was achieved without comparing profit objectives and data base characteristics for fiscal year 1988 to similar data for years prior to the implementation of the new profit policy.

The IG also found that contracting officers did not adequately document weights or explain why normal values were assigned because of inadequate guidance in the DFARS. This lack of documentation was classified as an error on the part of contracting officers.

We disagree with the IG's contention that the DFARS requires documentation of the use of normal values. In developing the policy, ASD(P&L) and the Services established the concept of

ATTACHMENT

"normal values" to represent the expected profit assignment where average conditions exist, and agreed that the use of normal values need not be documented by contracting officers. We see no need for such documentation at this time.

We also disagree with the summary of sample results included at Appendices D and E. The IG characterizes the lack of documentation for normal values as "errors" and thus concludes that there was an overall error rate of 62.27 percent on the forms reviewed. We strongly disagree with this analysis and recommend the appendices be deleted from the final report because they are misleading.

Final Report
Page No. _____

RECOMMENDATIONS

RECOMMENDATION 1.A.: We recommend that the ASD(P&L) direct the Defense Acquisition Regulatory (DAR) Council to revise the DoD Profit Policy in Subpart 215.9 of the DFARS to specify the documentation required to fully support the profit analysis performed. This clarification should require contracting officers to describe the work performed and document why weights and values were assigned. A marked-up version of DFARS 215.9 covering specific areas is included as Appendix F to assist your office in recommending revisions to the DFARS.

Deleted

ASD(P&L) RESPONSE: Nonconcur. We do not agree that additional documentation is necessary. The concept of "normal values" was established to represent the expected profit assignment where average conditions exist and we see no need for any documentation.

RECOMMENDATION 1.B.: We recommend that the ASD(P&L) direct the DAR Council to revise the DoD Profit Policy in Subpart 215.9 of the DFARS to modify the formula in DFARS Subpart 215.970-1(b)(4) to show that the portion of contract costs financed by contractors is not always used to calculate the working capital adjustment.

Deleted

ASD(P&L) RESPONSE: Nonconcur. The formula is set forth in the DFARS for illustrative purposes only. The text which immediately follows the formula already provides the guidance suggested by the IG. Errors were found in only 2 cases, and those errors were attributed to contracting officers relying on the formula instead of reading the related text material. In our opinion, it is counterproductive to include redundancies in the DFARS at the same time we are attempting to streamline the regulations and eliminate overly detailed or duplicative language.

RECOMMENDATION 2.: We recommend that the ASD(P&L) direct the DAR Council to revise the DoD Profit Policy in Subpart 215.9 of the DFARS to require that acquisition offices of the Military Departments establish adequate training procedures to ensure that DD Forms 1547 are correctly prepared and establish specific internal controls to ensure that contracting officers perform adequate supervisory reviews of prepared DD Forms 1547 prior to conclusion of the negotiation process. Examples of specific internal controls would include use of computer generated programs containing test check/error traps and maintenance of supervisory

Renumbered

check-off matrix schedules for review of DD Forms 1547 prior to conclusion of the negotiation process.

ASD(P&L) RESPONSE: Concur in part. The Navy has developed software for contracting officer use in developing profit objectives. The software performs edit checks of all data fields and will not permit insertion of an incorrect entry. This tool is currently in use throughout the Navy. The Air Force has developed a similar software tool and is distributing it within the Air Force. The Army is examining available software and will shortly decide which software to make available to its activities.

We believe the use of these software programs will ensure that resulting profit objectives are mathematically accurate and consistent with the policy.



DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(Research, Development and Acquisition)
WASHINGTON, D C. 20350-1000

15 JUN 1990

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING
ATTN: ACTING DIRECTOR, CONTRACT MANAGEMENT

Subj: DRAFT REPORT ON THE AUDIT OF ADEQUACY AND IMPLEMENTATION
OF DOD PROFIT POLICY (PROJECT NO. 9CC - 0018)

This memorandum provides the comments you asked for in your April 12, 1990 request.

We do not agree that your recommended changes to profit policy are appropriate. The minor errors found do not indicate any significant weaknesses in either the policy or its implementation. Specific comments follow.

Part II - Finding and Recommendations

Findings:

We do not agree that DFARS 215.903 provides inadequate guidance on method or documentation.

DFARS 215.903 clearly states the weighted guidelines method. It contains no ambiguities. It is not surprising that minor errors were discovered in the first year the policy was implemented.

We do not agree that normal values or performance risk weights must be documented or that failure to document them is an error. The policy deliberately does not require this documentation. It is not accurate to state that an action is an error because it does not comply with a policy that does not exist (but that you recommend).

We do not agree that contract prices were not properly negotiated. You examined profit objectives only. You did not examine negotiated profit or negotiated cost. Both must be considered in any discussion of the appropriateness of a sole source negotiated price.

Recommendations:

We do not agree that additional documentation is necessary. Normal values and performance risk weights are adequately described in DFARS.

We do not agree that the formula in DFARS 215.970-1(b)(4)

should be revised. The policy is clear. The few errors found do not indicate a need to reiterate the formula.

We agree that computer programs are appropriate internal control devices to monitor profit policy. The Navy uses computer programs (with functions that prevent errors) extensively. We also monitor actual results and take relevant control actions.



E. G. CAMMACK
Procurement Policy



DEPARTMENT OF THE AIR FORCE
WASHINGTON DC 20330-1000

OFFICE OF THE ASSISTANT SECRETARY

JUN 11 1990

Final Report
Page No.

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING
OFFICE OF THE INSPECTOR GENERAL
DEPARTMENT OF DEFENSE

SUBJECT: DOD/IG Draft Report on the Audit of the Adequacy and
Implementation of DOD Profit Policy (Project 9CC-0018) -
INFORMATION MEMORANDUM

This is in reply to your memorandum for Assistant Secretary of the Air Force (Financial Management and Comptroller) requesting comments on the findings and recommendations made in subject report.

Recommendation 1 concerns revising DOD Profit Policy in DFARS 215.9. We do not believe that the proposed wording changes are necessary. In response to Recommendation 1(a), DFARS 215.903(S-70) currently states that "The contracting officer's price negotiation memorandum shall fully document the profit analysis performed..." The auditors contention that the files they reviewed were inadequately documented can be attributed to two problems. The first lies, not in the fact that the guidance is unclear, but in the fact that contracting officers failed to fully document the files as required by the current DFARS. The second problem is the auditors interpretation of what is required in the documentation. As stated on page 14 of the draft audit report, the "Military Department officials interpreted DFARS Subpart 215.970...to mean that no explanation is needed when normal values are assigned." The report goes on to state that "training officials stated that no rationale was necessary when contracting staff assigned normal values." Both of these statements are true. When the profit policy was written, examples were given of when higher or lower than normal values were warranted in performing a profit analysis. The intention was that little or no justification would be required when the procurement fell within the range of normal and a normal value was assigned. The designation of this as a "normal value" was intended to define a standard which only required explanation when there was a deviation from the standard.

Deleted

With regard to recommendation 1(b), the wording which the auditors recommend adding to the formula in DFARS Subpart 215.970-1(b)(4) is superfluous. Immediately following the formula are subparagraphs which explain each element of the formula. The paragraph entitled "Portion Financed by Contractor" already contains the wording recommended by the auditors.

Deleted

Recommendation 2 requires that the Military Departments establish adequate training procedures to ensure DD Form 1547s are correctly prepared. We concur that additional training in this area is necessary and the Air Force has already taken major steps to improve the reliability of the forms. All Air Force contracting activities are now required to utilize a computer program (WGL Version 1.0) to prepare and report DD Form 1547 profit objectives. This program contains a variety of edit checks which ensure that profit objectives are not only computed properly, but that the forms contain reliable data for reporting purposes. Air Force offices recently started using this program. The program is responsible for increasing our acceptance rate from 69% to 85% in just two months. Once the previously rejected forms (not prepared using the program) are recycled, we anticipate a near 100% acceptance rate by the end of the fiscal year. WGL Version 1.0 contains extensive help screens and a detailed manual which should satisfy the training deficiency identified in the report. We understand DLA has adopted the program for their activities. A copy of the software and manual have also been provided to the Army and the Navy for their evaluation and use.

Renumbered



IRA L. KEMP
Associate Deputy Assistant Secretary
(Contracting)
Assistant Secretary (Acquisition)

**SUMMARY OF POTENTIAL MONETARY AND OTHER
BENEFITS RESULTING FROM AUDIT**

<u>Recommendation Reference</u>	<u>Description of Benefit</u>	<u>Amount and Type of Benefit</u>
1.	Preparation of correct and properly documented DD Forms 1547. Contracting officer adequate supervisory reviews of prepared DD Forms 1547 prior to conclusion of the negotiation process - Internal control.	Monetary benefits not determinable.
2.	Annual analysis and comparison of profit objectives contained on DD Forms 1547 to determine if the current profit policy is adequate and applicable-compliance with regulations or laws.	Monetary benefits not determinable.

Note: Monetary benefits related to the above audit recommendations were not determinable because the audit review covered only contracting officer objectives and not negotiated profit amounts.

ACTIVITIES VISITED OR CONTACTED

Office of the Secretary of Defense

Assistant Secretary of Defense (Production and Logistics),
Washington, DC

Department of the Army

Assistant Secretary of the Army (Financial Management),
Washington, DC

U.S. Army Armament Command, Rock Island, IL

U.S. Army Tank Automotive Command, Warren, MI

U.S. Army Aviation Systems Command, St. Louis, MO

U.S. Army Missile Command, Redstone Arsenal, AL

U.S. Army Lab Command, Ft. Monmouth, NJ

U.S. Army Medical R&D Command, Ft. Detrick, Frederick, MD

U.S. Army Lab Command, Adelphi, MD

U.S. Army Mobility Equipment R&D Command, Ft. Belvoir, VA

Department of the Navy

Assistant Secretary of the Navy (Financial Management),
Washington, DC

Assistant Secretary of the Navy (Shipbuilding and Logistics),
Washington, DC

Naval Weapons Support Center, Crane, IN

Naval Weapons Center, China Lake, CA

Naval Ships Parts Control Center, Mechanicsburg, PA

Naval Sea Systems Command, Washington, DC

Naval Air Systems Command, Washington, DC

Space and Naval Warfare Systems Command, Washington, DC

Atlantic Division Naval Facilities Engineering Command,
Norfolk, VA

Department of the Air Force

Assistant Secretary of the Air Force, (Financial Management and
Comptroller), Washington, DC

Aeronautical Systems Division, Wright-Patterson Air Force Base,
OH

Munitions Systems Division, Eglin Air Force Base, FL

Warner-Robins Air Logistics Center, Robins Air Force Base, GA

Oklahoma City Air Logistics Center, Tinker Air Force Base, OK

Air Force Space Division, Los Angeles, CA

Western Space and Missile Center, Vandenberg Air Force Base, CA

Defense Agencies

Headquarters, Defense Contract Audit Agency, Alexandria, VA
Headquarters, Defense Logistics Agency, Alexandria, VA
Defense Personnel and Support Center, Clothing and Textiles,
Philadelphia, PA
Defense Personnel and Support Center, Subsistence,
Philadelphia, PA

Other

U.S. General Accounting Office, Washington, DC

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Director, Defense Acquisition Regulatory Council

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Auditor General, U.S. Army Audit Agency

Department of the Navy

Secretary of the Navy
Assistant Secretary of the Navy (Financial Management)
Comptroller of the Navy
Director, Naval Audit Service

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Secretary of the Air Force
Assistant Secretary of the Air Force (Financial Management and
Comptroller)
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Senate Committee on Armed Forces
Senate Committee on Governmental Affairs
Senate Ranking Minority Member, Committee on Armed Services
House Committee on Appropriations
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House Committee on Armed Services
House Committee on Government Operations
House Subcommittee on Legislation and National Security,
Committee on Government Operations