RENEGOTIATION STANDARDS AND PRACTICES

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[As this article goes to press, there is pending before Congress the Revenue Bill of 1943 containing provisions for amending the existing Renegotiation Act. This Bill has passed the House of Representatives, has been amended in certain significant aspects by the Senate Finance Committee, but has not yet been introduced on the Senate floor. In view of the discussion contained in the concluding article of this symposium and of the uncertainty of the adoption of the various items constituting the amendment proposals, the writer has decided not to comment on any particular portion of the Bill as it now stands.]

Since April, 1942, thousands of manufacturers have undergone examinations by and conferred with government representatives pursuant to the requirements of the Renegotiation Act (Sec. 403 of the Sixth Supplemental National Defense Appropriation Act, 1942, approved April 28, 1942, as amended).¹ This Act authorizes the renegotiation of contracts not exempt therefrom under its terms, to eliminate excessive profits from production under contracts with the War Department, the Navy Department, the Treasury Department, the Maritime Commission, War Shipping Administration, Defense Plant Corporation, Metals Reserve Company, Defense Supplies Corporation, and Rubber Reserve Company, respectively. Within those agencies Price Adjustment Boards, as well as Regional Boards or "Sections" in some agencies, have been set up to carry out the provisions of the Act. The term "Board" or "Section" when used in this article refers to one of the departmental price adjustment boards or their regional organizations, as the case may be.²

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¹ 56 STAT. 245, 41 U. S. C. A. note prec. §1 (Supp. 1942). The original Act was contained in Pub. L. No. 528, 77th Cong., 2d Sess. (April 28, 1942), §403. It has been amended by: Pub. L. No. 753, 77th Cong., 2d Sess. (Oct. 21, 1942); Pub. L. No. 108, 78th Cong., 1st Sess. (July 1, 1943); Pub. L. No. 149, 78th Cong., 1st Sess. (July 14, 1943).

² For full discussion of the administrative machinery and organization for handling renegotiation in the various agencies, see, in this symposium, Boyd, *Administrative Machinery and Procedures for Renegotiation*, *infra* p. 309.

In September, 1943, by joint action of the interested agencies, a "Joint Price Adjustment Board" was created to which were delegated certain over-all coordinative functions, including the formulation of policies, principles and interpretations binding upon all the interested agencies.

The Boards early adopted the principle of renegotiation upon the basis of contractor operations for a fiscal period, rather than to consider each contract specifically, except with respect to cost-plus-fixed-fee contracts. They further agreed that for any fiscal year a contractor would be subject to renegotiation only once, and then by the Board or the Department most heavily interested in his production, whether from prime or subcontracts. On this basis, of the companies³ subject to renegotiation approximately 65% are cases for the War Department Price Adjustment Board, 20% for the Navy Department Board, with the remaining 15% distributed among the other four boards.

NATURE OF RENEGOTIATION

The accumulation, analysis and discussion of a contractor's financial and operating data are the three elements of renegotiation. To many people negotiation is a high sounding word for a process of trading, a "dicker," which is expected to result in a compromise; the seller tries to get for the object of sale more than he is willing to accept, the buyer offers a price which is less than he is willing to pay; each moves gradually from his original position until agreement on a price agreeable to both, as a basis for sale, is reached. Although a negotiation may degenerate into a "dicker" or "horsetrade," fundamentally it is an orderly procedure which involves discussions between buyer and seller to evaluate correctly, from an analysis of all determinable factors, the object of sale, with a view to setting a

³ This brings up the question of affiliated companies. When two or more companies constitute an "affiliated group," as defined by Section 141(d) of the Internal Revenue Code, they will ordinarily be renegotiated on a consolidated basis. This section reads in part as follows:

"(d) Definition of 'Affiliated Group.' As used in this section, an 'affiliated group' means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

"(1) Stock possessing at least 95 per centum of the voting power of all classes of stock and at least 95 per centum of each class of the non-voting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

"(2) The common parent corporation owns directly stock possessing at least 95 per centum of the voting power of all classes of stock and at least 95 per centum of each class of the non-voting stock of at least one of the other includible corporations.

"As used in this subsection, the term 'stock' does not include non-voting stock which is limited and preferred as to dividends."

Under such circumstances all companies in the group will usually be assigned to the same Board or Section for consolidated treatment. When two or more companies do not meet the terms of the above definitions, but are nevertheless so related, both with respect to stock ownership and management control, that they customarily report their earnings and financial condition on a consolidated basis, they may be renegotiated on a consolidated basis, also. In any event, all companies that are related through common ownership, through a parent-subsidiary affiliation or through common management are usually assigned to the same group for renegotiation, in order that the factors inherent in their relationship may be properly evaluated. There have been a few outstanding exceptions, where the business of a subsidiary is so different from that of its parent that consolidation is not deemed proper, in which case they have been assigned to different departments.

price agreeable to the buyer, that will fairly compensate the seller for his services in producing the item.

The exigencies of the war necessitated the substitution of negotiation for normal competitive procedures in the procurement of practically everything required for its prosecution. The unanticipated profits from war production at prices negotiated in good faith but in ignorance of costs obtainable with respect to articles never before manufactured and from others produced in theretofore unheard-of quantities, compelled the passage of the "Renegotiation Act," whereby the negotiation could be completed through renegotiation, and as the result of a discussion of all the determinable factors involved therein, based on an analysis of known facts, accumulated through experience in war production, the war goods could be delivered, properly priced. While the scope of renegotiation, as originally contemplated, may have undergone changes in practice, nevertheless, without such a procedure many contractors would realize profits so excessive as to create conditions in our economy, the far reaching disastrous effects of which would endanger the very things for which this nation is fighting.

The question is sometimes raised as to whether the work of the Price Adjustment Boards is not similar to that of commissions responsible for fixing or approving public utility rates. To be sure, the function of each involves the pricing of the output to leave a fair and reasonable profit. At that point, however, the similarity ends. The determination of fair public utility rates, under prevailing legal theories, centers around the company's rate base, which involves valuation of certain assets in terms of original cost, cost of reproduction, etc. Public utility commissions are expected to see that the rates they allow provide a fair return to investors as well as fair service charges to customers, but their concern is for a long range rather than a short range result. The Price Adjustment Boards, on the other hand, are concerned with the problems of production of a large variety of types of business operating under abnormal conditions. The relation of a company's profits to its gross assets and to its net worth are only a few of the factors which the Price Adjustment Boards must consider. Short term factors are more important in war production than long term factors. Furthermore, even if capital were the major factor in determining fair war profits, to secure adequate appraisals of contractors' assets in order to place their respective capitals on a comparable basis, would be, at least under current conditions, an impossible task. The Boards seek to determine a fair compensation to a contractor for the war production job that he has done in the light of the problems with which he has been faced in its performance, and after an analysis of the contractors' financial data of a type that is usually found to be of assistance to procurement officers in setting prices for future orders. Too many important war production jobs worthy of substantial compensation are done by companies having very little capital, to limit them to profits determined on a basis comparable to that followed in fixing the rates of utilities. The incentives to full war production call for a compensation for out-

standing immediate contributions and not particularly for encouragement to long term investment as is the case in fixing rates for utility services.

INITIAL STEPS AND REQUIRED DATA

The procedure of renegotiation with respect to a specific contractor therefore begins with a search for facts regarding his operations, costs, financial condition, performance and a variety of other factors which bear on the prices of his war products and the profits from his war business. The responsibility for obtaining and analyzing the financial data lies with a cost analyst identified with the Board or Section to which the contractor is assigned. The cost analyst is not expected to audit the contractor's accounts. He usually finds it necessary, however, to spend a day or two at the contractor's plant in order to explain what data are required and how they shall be obtained and presented. It is helpful if he can go through the plant, obtain impressions of how it operates, the types of equipment used, the types of employees required, the nature of the products manufactured and so on. In this initial discussion with the contractor and in the survey of the plant, the negotiator or general analyst charged with the case may accompany him.

While the forms in which they are submitted are not uniform, all the Boards seek substantially the same types of information and data from the contractors assigned to them.

These include the results of operations for the latest closed fiscal year, separated as to renegotiable and non-renegotiable business as defined under the Act, and itemized with respect to sales, costs, expenses and profit applicable to *fixed price* business, shown in detail or supplemented by schedules of cost of sales, selling and advertising expenses, general and administrative expenses and other applicable income and deductions. Analysis of depreciation charges included (whether or not specified) in any of the above items or schedules, with respect to their normality, acceleration and relation to idle plant, is requested, as well as information relative to such miscellany as amortization of emergency facilities, executive salaries, the approximate cost of work subcontracted and a segregation of renegotiable sales between prime and sub-contracts. The net fees earned under cost-plus-fixed-fee contracts, applicable, respectively, to both renegotiable and non-renegotiable business, are not to be confused with income from fixed price business, though included in a contractor's income statement. The costs and billings applicable to cost-plus-a-fixed-fee contracts are wanted, but may be shown in a separate schedule.

In addition, in anticipation of this first renegotiation, a contractor is generally asked to furnish his renegotiating Board with a comparative operating statement, in columnar arrangement, for the six years immediately preceding the year under review, comparable as to titles with the corresponding statement for such year.

Statistical data related to the financial figures, an explanation of the methods employed to obtain the segregation of renegotiable and non-renegotiable business,

and comments relative to a variety of matters of significance to a Board in its determination of a contractor's excessive profits, are also requested.

EXEMPTIONS AND DETERMINATION OF RENEGOTIABLE BUSINESS

The determination of the amount of a contractor's renegotiable business and the costs and expenses applicable thereto, is his most difficult task in the fact finding procedures of renegotiation. The difficulty is less formidable where the contractor has directly contracted with the Government than in those transactions with respect to which the contractor is a "sub-contractor" within the renegotiation statute, as that term is currently interpreted administratively. As in "prime contracts," the main question in determination of renegotiable business is whether the contract, although with one of the governmental agencies included in the Act,⁴ is nevertheless exempt by the specific statutory exemption provisions and the administrative practice under the discretionary exemptions. The Act, as Mr. Kenney points out in his article in this symposium, contains a number of exemptions.⁵ The following five types of business may be said to be exempted directly or indirectly by the Act: (1) all contracts which are not with one of the renegotiating departments, or sub-contracts thereunder; (2) contracts completed and fully paid for prior to April 28, 1942; (3) contracts or sub-contracts for the product of a mine, oil or gas well, or other mineral or natural deposit, or timber, which has not been processed, refined or treated beyond the first form or state suitable for industrial use; (4) intra-federal Government contracts; (5) contracts of Renegotiating Departments with extra-federal Governments or agencies thereof.

In addition, the Act authorizes the Secretary of a Department, in his discretion, to exempt certain types of contracts.⁶ As to his *prime* contracts, a contractor should have little difficulty in determining what part of his sales during any fiscal year are

⁴ Contracts with government Departments and agencies not named in the Act (except War Shipping Administration) and subcontracts thereunder, or transactions in products the end use of which is not related to a prime contract with one of such Departments, are not subject to renegotiation. Thus, contracts with the Post Office Department for mail boxes would not be subject to renegotiation, and the companies that furnished the steel and the locks for such boxes would be exempt from renegotiation with respect to such sales. Contracts with War Shipping Administration and subcontracts thereunder are subject to renegotiation due to the transfer of certain responsibilities to it by the President under the First War Powers Act, from the Maritime Commission.

Although all contracts with the Treasury Department appear to be within the purview of the Act, unless of a type otherwise specifically exempt, the Treasury Department Price Adjustment Board has taken the position that it will renegotiate only those contracts which it considers to be strictly war contracts such as purchases for Lend-Lease, of strategic and critical materials, or suppliers for refugee relief under the Red Cross program, etc.

Accordingly, contracts of the Procurement Division of the Treasury Department under its General Schedule of Supply Contracts are not subject to renegotiation unless of such war time nature. However, purchase orders issued by any other Department named in the Renegotiation Act, under the General Schedule, are subject to renegotiation.

⁵ Because a discussion of renegotiation standards and practices inevitably involves a consideration of the exemptions, the writer deems it advisable to comment briefly upon certain aspects of exemption at the risk of a slight duplication with some of the material in Kenney, *Coverage and Exemptions*, *supra* pp. 263 ff. This article, however, does not purport to present an over-all discussion of exemptions, and for a general discussion of the subject, the reader is referred to Mr. Kenney's article.

⁶ See, in this symposium, Kenney, *Coverage and Exemptions*, *supra* p. 263, at 272 ff.

under those contracts and of segregating the sales under non-renegotiable prime contracts from those under renegotiable prime contracts.

With respect to sub-contracts, however, the determination of the renegotiable business may be far from simple. This results from the application of the statutory term "sub-contract," as administratively interpreted, to the complexity of the distributive processes of industry, and the difficulty of tracing products into the crucial end product subject to renegotiation. A sub-contractor—a manufacturer of, or dealer in products sold to other manufacturers—may have to apply several tests to determine what proportion of his sales are war business. Under the interpretation which the agencies have adopted, the *general* test for determining a renegotiable "sub-contract" lies in this question: Will the price of the product sold become a part of the cost of something to be delivered to a department named in the Act? In the statute, "sub-contract" is defined to include "any purchase order or agreement to perform all or any part of the work, or to make or furnish any article required for the performance of any other contract or sub-contract."⁷ This has been administratively interpreted to include: the sale, furnishing or installation of machinery, equipment, or materials used in the processing of an end product, or of an article incorporated therein; the sale, furnishing or installation of machinery used in processing of other machinery to be used in the processing of an end product or of an article incorporated therein; the sale, furnishing or installation of component parts (including materials and ingredients) of, or sub-assemblies for, such machinery, equipment, and materials, and the performance of services⁸ directly required for the performance of such contracts or sub-contracts.

Under the foregoing interpretation sales of end products and of everything which in any way contributes directly to the actual production of an end product—or one of its components—purchased by a renegotiating Department, except items used for general plant maintenance (including safety equipment and clothing, and fuel and equipment to produce light, heat and power), and for general office maintenance (including office machinery and supplies), are renegotiable. Thus, sales of steel ingots, which are processed into rods, which are drawn into wire, from which are made screws used in the manufacture of a machine tool which is used in the manufacture of a part of a motor which is installed in a truck sold to the Army, are subject to renegotiation. Likewise the sales of each processor or manufacturer in the chain, insofar as they contribute to the completion of such truck, are subject to renegotiation. But it is not likely that all of the screws produced from the steel ingot figured in war production. Some of them undoubtedly reached retail hardware stores through regular channels of distribution, and were sold to individual consumers who used them for innumerable purposes far removed

⁷ For a discussion dealing with the present administrative interpretation of "sub-contracts," in the light of historical antecedents of the statutory definition, see, in this symposium, Kenney, *Coverage and Exemptions*, *supra* pp. 263 ff.

⁸ For the extension of the Renegotiation Act to contract brokers, see, in this symposium, Kenney, *Coverage and Exemptions*, *supra* p. 263, at 268.

from war production. The determination of the renegotiable business of the screw manufacturer and of all preceding manufacturers in the chain of screw production thus presents a difficult problem.

All sales of such products as specific parts for an airplane, a tank, a jeep, a gun, a gun mount, or any one of hundreds of items which now have only war uses, are war business. Sales to customers known to be engaged solely in war production can quickly be identified. A scrutiny of priority ratings, CMP allotment numbers (which are entered on the certification on a purchase order, in accordance with CMP regulation No. 1 or No. 3), and other designations which some Divisions of the War Production Board require manufacturers to enter on their purchase orders for certain types of materials, will reveal something as to the probable end use of the articles delivered thereunder. It would be unfair to a contractor, however, for a negotiator or analyst to assume that because a company's product was given a high priority rating or CMP allocation, its end use was necessarily such as to make all its business renegotiable. High ratings have been given to materials and products required by hospitals and schools. Containers and materials used in their manufacture receive high ratings when they are to be used in connection with foods, but contracts for such foods purchased by the Department of Agriculture for Lend Lease, and hence their containers, are not subject to renegotiation.

Producers whose sales are made exclusively through regular trade channels may have to resort to percentages to estimate what amount is renegotiable. Thus, if it is reliably determined that 75 per cent of a particular article had a war end use in 1942, an individual producer might be permitted to allocate 75 per cent of his 1942 sales of that article not fully paid for prior to April 28, 1942 as renegotiable, but it must be understood that this is not a common practice. A more nearly accurate estimate of renegotiable business may usually be obtained through circularizing representative customers as a basis for obtaining percentages of renegotiable business which may then be applied to all customers of the same type. Trade association reports have been used to suggest the extent to which specific industries are engaged in war production and thereby indicate the renegotiable proportion of an individual manufacturer's output which they absorb. Such reports need to be used with caution, however, for not only have many trade associations been somewhat optimistic in their estimates of the extent to which their members have contributed to the war effort, but the proportion of war end business of one manufacturer varies greatly from that of another.

A careful analysis of deliveries for one or two months may provide a clue to the proper segregation of a company's business into renegotiable and non-renegotiable components. Where the records give no clear indication of the probable end use of a company's output, many analysts have found that the most reliable estimates of the volume of its renegotiable business can be secured from the sales department rather than from the accounting department. Many concerns now ask their salesmen and servicemen who are in direct touch with their customers

and with the industries which use their products, to report regarding the extent to which they go into war production. Frequently a combination of several procedures may be required to obtain a satisfactory segregation of a contractor's renegotiable and non-renegotiable business. The Boards do not recommend procedures that involve an enormous amount of work in order to obtain a meticulously accurate segregation, nor do they approve of the use of pure unsupported guesswork, which is fully as likely to work to the disadvantage of the contractor as to that of the government. The application of a practicable procedure which does not involve an undue amount of the contractor's time and effort is usually acceptable to the Boards and a contractor will make a mistake in undertaking the job before consulting with the renegotiation agency to which his case is assigned. Usually he will find that a practical solution that will not work any hardship on him can be agreed upon. Trade association reports sometimes suggest the extent to which industries may be engaged in war production and thereby indicate the renegotiable proportion of an individual manufacturer's output which is absorbed by such industries. A careful analysis of deliveries for one or two months may provide a clue to the proper segregation of a company's business into renegotiable and non-renegotiable components.

Exemption of War Business Paid for Before April 28, 1942. For some companies segregation involves the elimination of sales of products specifically exempt under the Act. Such exemptions include all sales under contracts, payment for which had been completed by April 28, 1942. Companies whose business is chiefly on the basis of purchase orders, rather than identified with more formal contracts, are likely to find that the total of their outstanding customers' accounts at April 28, 1942 will be subject to the same analysis for renegotiability as their subsequent sales. The entire volume of sales under a contract for a specified number of units, each of which is to be paid for upon delivery, is subsequent to renegotiation unless all payments finally due under the contract were paid for before April 28, 1942. The Boards have agreed, however, that if a contractor completely fulfilled his part of the contract and the balance unpaid at April 28, 1942, was relatively insignificant and was withheld because of disagreement as to the amount, or for some similar reason, they would waive the technicality of the law and look upon it as non-renegotiable. Such a waiver is not based upon the amount alone. All of the circumstances surrounding the delay in payment are scrutinized by a Board to be sure that it can justify its treatment of the contract.

Exemption of Sales of Products of Mines, etc. Of the mandatory statutory exemptions the only other one of direct interest to private contractors relates to contracts and subcontracts "for the product of a mine, oil or gas well, or other mineral or natural deposit, or timber, which has not been processed, refined or treated beyond the first form or state suitable for industrial use."

This provision of the Act was introduced for the purpose of encouraging the production of certain depletable materials the exhaustion of this country's supply

of which was uncomfortably near, but which are the basic sources of critical and strategic materials. To provide this encouragement the exemption was couched in terms that were broad enough to include contracts for a number of the products of mineral and natural deposits for the production of which no such encouragement was necessary.

The Price Adjustment Boards interpret this provision to include only wasting assets or materials normally subject to depletion. Such materials as water, sea water and air, and derivatives therefrom, and gums and vegetable juices derived from living or vegetable products are not deemed to be wasting assets, and contracts and subcontracts for such items are therefore subject to renegotiation. Thus, while contracts for the sale of timber are exempt, those for the sale of turpentine or other resins extracted from the living trees are not exempt from renegotiation.

In determining whether a contract for a particular product, clearly related to the types specified by the Act as exempt, is itself exempt, the Boards apply the principle of the dispersal point, that is, the point at which the product is used in substantial quantities by the ultimate consumer, or by industries other than the industry of origin. The industry of origin may be merely the industry of actual extraction or severance, such as mining or timber falling, or it may include processing, refining or treatment, applied to the extracted or severed product, of a character necessary to make it usable, either to the ultimate consumer or to industries which use it in the manufacture of other products. Thus, coal mining companies are completely exempt from renegotiation, for though they may put the direct product in the mine through a series of manufacturing operations, such as crushing, screening, grading, washing, etc., one or more of them is necessary to make the coal suitable for consumer or industrial use. Aluminum production through the ingot stage has been exempted, although it is recognized that bauxite, the original mineral or natural deposit from which aluminum is ultimately produced, is also used in the manufacture of fire bricks, artificial abrasives and mineral oil refining, as well as in the production of alumina, which, though principally used as the direct source of aluminum ingots, is also used as an abrasive, a fixing agent in dyeing and for other industrial purposes. Since approximately eighty-five per cent of the bauxite extracted in the United States is processed into aluminum ingots, the Boards took the position that as a practical administrative matter little was to be gained by fixing the dispersal point closer to the mining stage. A contract for the analytical processing of a product into one or more of the chemical elements or compounds present in it in the state in which they are normally found, is also exempt. Contracts not only for the mining, therefore, but also for the smelting of ore are exempt from renegotiation.

In general, contracts for products which are the result of a combination of substantial quantities of two or more materials are subject to renegotiation. A problem arises where the same product is obtainable from different procedures, one of which would meet the test of exemption, while the other would not. Salt, for

example, is one of the exempt products when it is produced by the common method of mining or extracting it from deposits, but when it is obtained from sea water by the distillation process, it becomes subject to the interpretation that contracts for products derived from water, sea water and air are not exempt. Similarly, cement is exempt when it is produced from quarried rock with relatively simple processing to prepare it for industrial uses but when it is manufactured by combining several materials, each of which has industrial uses independent of its participation as a component of cement, it is not considered to be within the purview of the Act with respect to exemption.

Every product, a contract for which is exempted from renegotiation under this paragraph of the Act is presumed to have a readily determinable market price. Companies so integrated that they extract the raw material, process it, and from the processed raw material fabricate or further process the items which they sell, are permitted to include, as a cost of the latter, the exempted raw materials used therein at such an amount as, in the opinion of the Price Adjustment Board, fairly represents a properly applicable allowance. In determining this amount due consideration is given to the established sale or market price where there is a representative market for the product in the first form or state suitable for industrial use, and to such other factors as may be necessary to reflect the purpose and intent of the exemption accorded under the Act. In general, it is the purpose and intent of this provision to allow to the contractor engaged in an integrated process of the type described, an item of cost substantially equivalent to that granted by the statute to others who sell an exempted product, namely what it could have realized if it had sold the exempt product at the intermediate stage.

Discretionary Exemptions. With respect to some contracts of the types which the Secretary of a Department may, in his discretion, exempt from renegotiation, the Secretaries of the War Department and the Navy Department have issued regulations, which if not substantially duplicated by other Departments with Price Adjustment Boards, have been concurred in by most of them. These regulations exempt from renegotiation, on the ground that profits thereunder can be determined with reasonable certainty when the contract price is established, contracts and subcontracts (1) for the purchase or lease of any interest in real property, (2) for any of a long list of perishable fresh or frozen uncanned foods, (3) for the furnishing of commodities and services by public utilities and common carriers at published rates fixed, approved or subject to regulation by a public regulatory body, and (4) for commodities, the minimum price for the sale of which has been fixed by a public regulatory body.

Exemption of Contracts Affecting Real Estate. It should be observed that the first provision of this regulation, which deals with transactions in real property, exempts from renegotiation contracts and subcontracts for the purchase or lease of any interest in *existing* real property, but does not relieve from renegotiation contracts to sell, furnish or install machinery, equipment, materials or other personal

property which would otherwise be renegotiable, merely because such property is to be installed in a building or become so affixed to it as to make it thereafter a part of the real estate. Nor does it exempt from renegotiation contracts and subcontracts thereunder for the construction of a building or other improvements to real property, to which the Government will take title. On the other hand, similar contracts for the construction and equipment of buildings to which the Government will not take title, even though such improvements are covered by Certificates of Necessity, are not subject to renegotiation. It is necessary therefore to look beyond the superficial character of a contractor's operations to determine whether or not they should be included in his renegotiable business. Thus, whether A sells a war plant site to the Government or to the B Company, the transaction is excluded from renegotiation. If A then builds thereon a building, and otherwise improves the real estate, equips the building with machinery and other facilities, all for the account of the Government which is to take title to it, he is subject to renegotiation with respect thereto. If he does the same thing for the B Company, which will receive title to the property upon its completion, neither he nor any of his subcontractors is subject to renegotiation with respect to that part of the contract and subcontracts pertinent to the construction or to the furnishing or installation of equipment which is not to be used in processing a renegotiable article but they will be subject to renegotiation on the furnishing and installation of machinery and equipment which is to be so used even though such property is to be affixed to the real estate in such a way as to become real estate for some other purpose.

Exemption of Contracts for Perishable Goods. Perishable fresh or frozen uncanned foods have been exempted from renegotiation by the Secretaries under the authority granted by the Statute. Many such commodities are purchased by supply officers at forts, camps, ports, and bases from nearby sources of supply, and very often do not exceed \$100,000 from any one person in a single year. To a large extent the actual costs to the vendor and hence the amount of his profits are difficult to obtain. Many purchases of perishables are made on a day to day or week to week basis, at the best prices available and it is recognized that, in general, competition is likely to play a larger part in the establishment of their prices than is the case with other products. Undoubtedly, the administrative task involved in renegotiation of perishables also encouraged the Secretaries to make this exemption.

Exemption Affecting Companies Subject to Public Regulation. The third and fourth classes of commodities and services, sales of which the Secretaries have used their discretionary power under the Act to exempt from renegotiation, are those provided by common carriers and public utilities. While many companies in these fields are either prime or subcontractors, yet with legal rates or minimums established by state and federal commissions it may be assumed that they are subject to adequate controls. Since the Renegotiation Act is a pricing act, any attempt on the part of the Price Adjustment Boards to modify prices (other than applied ceiling prices), fixed or approved by other government bodies, would involve considerable administrative difficulty as well as unnecessary duplication.

Sales to Post Exchanges, etc. Because sales to Army Post Exchanges and to Navy Service Stores have been treated by the Boards as non-renegotiable, it has been thought by some that they were subject to a special exemption. The real reason for their elimination from renegotiable business, however, is the fact that the purchases of these organizations are not made by the War Department nor by the Navy Department. Their working capital is supplied by officers of the Army and Navy, respectively, and the proceeds from their operation do not revert to the Government in any way. Sales of goods to be resold to enlisted personnel and their families through Army commissaries and Navy stores are subject to renegotiation (except with respect to perishables specifically exempt), since such sales are made directly to the War and Navy Departments.

RENEGOTIABILITY OF PATENT LICENSES

Public Law 768, 77th Congress, approved October 31, 1942, authorizes the head of a government Department or agency which has ordered the manufacture of a product which is based on an invention, patented or unpatented, with license from its owner which provides for the payment of royalties believed by him to be excessive, to "fix and specify such rates or amounts of royalties, if any, as he shall determine are fair and just, taking into account the conditions of war time production." This statute further provides: "Nothing herein contained shall be deemed to preclude the applicability of Section 403 of Public Law 428, 77th Congress (the Renegotiation Act) as the same may be heretofore or hereafter amended so far as the same may be applicable."

It has been ruled that patent licenses for processes or inventions required in performing contracts with the Departments and subcontracts thereunder, are subcontracts, and unless specifically exempted, subject to renegotiation. There are numerous instances of individuals and corporations that have granted the use of their inventions and processes, license free, to the Government for purposes of war production. In other cases, because to do so would deprive an organization of its entire wherewithal to carry on further research, or because of existing license contracts which cannot be changed, or because of other conditions, the need for renegotiation is important. In many such cases the war-time income from royalties based on license agreements originally negotiated in anticipation of peacetime production, has been so far in excess of the fondest dreams of the patent holders, that the excessiveness of profits involved therein is easily established. Even rates fixed under Public Law 768 may not prevent excessive profits from patent royalties. In one case a company that complained that rates so fixed were too low, realized from patent royalties during the first six months thereafter several times what it had ever realized in a full fiscal year prior thereto.

COSTS AND EXPENSES APPLICABLE TO RENEGOTIABLE BUSINESS

Since the Renegotiation Act was designed to eliminate excessive profits on renegotiable business only, it is necessary to ascertain the amount of costs and ex-

penses properly applicable to such business as distinct from those chargeable to non-renegotiable sales. While the cost analyst is not expected to make the examination required to accomplish this, he is expected to consult and advise with the contractor relative to the methods used in obtaining the amounts of costs and expenses charged to each category, and to satisfy himself that such methods are sound and are based upon full consideration of the relationship of the expenditures to the types of sales to which they have been applied. If the contractor's cost system is comprehensive and of a type thoroughly suitable to his business, it may be assumed that the costs of specific products will be reasonably accurate. If his wartime products are identical with those of his peacetime operations, costs applicable to renegotiable business will basically bear the same proportion to those applicable to non-renegotiable sales. Where no adequate cost system is in operation a careful analysis of expenditures must be made, either by the contractor or his auditor or by a representative of the Price Adjustment Board, as circumstances dictate.

Relation of Allowable Costs to Income Tax Deductions

The basic allocation of costs and expenses is likely to require adjustment for special items. In general, a "Secretary shall recognize the properly applicable exclusions and deductions of the character which the contractor or subcontractor is allowed under Chapter 1 and Chapter 2E of the Internal Revenue Code" (Sec. 403(c)(3)). Specifically, "the Secretaries of the respective Departments shall not make any allowance for any salaries, bonuses, or other compensation paid by a contractor to its officers or employees in excess of a reasonable amount, nor shall they make allowance for any excessive reserves set up by the contractor or for any cost incurred by the contractor which are excessive or unreasonable" (Sec. 403(d)).

With respect to the first of the two foregoing provisions of the Act, the Boards emphasize the significance of the phrase "applicable exclusions and deductions . . . of the character allowed under Chapter 1 and Chapter 2E of the Internal Revenue Code." Although such Code provisions guide the Boards in their allowance of expenditures as charges against renegotiable income, they do not feel bound to use in all cases, the amounts the Bureau of Internal Revenue may accept. In the matter of depreciation, for example, a Board may accept a contractor's computation of accelerated depreciation resulting from war production, even though a portion of it may ultimately be disallowed for tax purposes by the Bureau of Internal Revenue. In the treatment of amortization of facilities acquired under Certificates of Necessity, the Boards treat as an operating expense whatever portion of the charges seems to represent normal depreciation, and deduct the balance from profits to arrive at the amount of profit from which excessive profits are to be eliminated. Both the Bureau of Internal Revenue and the Price Adjustment Boards recognize amortization as a deduction in full, but treat the amount differently. The Board's treatment is for the purpose of obtaining from companies which are

allowed amortization of facilities profit figures that are comparable with those not so favored.

The Boards may allow against renegotiable sales, salaries and other compensation in amounts greater than those which the Bureau of Internal Revenue subsequently approves as a deduction for income tax purposes.

Because they are charged with recognizing the same types of costs and expenses as are permitted for federal tax purposes, consideration must be given to the returns that have been filed by the contractor and to the reports of Internal Revenue Agents based on their examinations of the records upon which such returns were based. If, however, the Boards were to delay their decisions until the Bureau of Internal Revenue could complete its audit of every contractor subject to renegotiation, in order to be sure that they allowed expenses in the same amounts as the Bureau of Internal Revenue, the real purpose of the Renegotiation Act would never be realized. It must be remembered that this Act was designed, not to secure more taxes, but to eliminate excessive profits from war contracts and, as part of the same procedure to aid in securing lower prices on future contracts. For these purposes, and particularly the latter, speed in accomplishing the task is of the highest importance.

Excessive Compensation

The Secretaries, and through them the Boards, are charged specifically with the disallowance of excessive costs resulting from unreasonably high payments of compensation (whether in the form of salaries, bonuses, commissions or a combination of them) to officers and employees, from unreasonable provisions against future contingencies or commitments, and from any other expenditure. Some companies, whose sales as the result of the war have catapulted astronomically, have increased the compensation paid to key men to fantastic amounts that are in no way justified even by the increased responsibility which increased business has placed upon them. In other instances wages of workers have been raised beyond the amounts earned through regularly approved overtime rates, as the results of bonuses and "incentive payments," to figures out of all proportion to any conceivable valuation of their services. Whether or not such payments are excessive under the various circumstances of their payment, it is the job of the Boards to determine. To assist them in arriving at a fair decisions the cost analyst must obtain from the contractors the facts and an explanation of them.

In general, in considering the reasonableness of compensation to officers and higher paid employees, attention is paid to the nature of the work, extent of responsibility, experience and effectiveness of the individual, increases in compensation since January 1, 1941, and amounts paid to persons similarly employed in other companies of the same industry. There is no attempt to be picayunish in this survey; the judgment of the management in fixing its employees' compensation is given great weight. Wage restrictions under Executive Orders and under Reg-

ulations issued by the Director of Economic Stabilization, are recognized as a basis for determining whether or not in given instances payments to employees are excessive. A certificate from the contractor relative to his compliance with such regulations is acceptable to the Boards. In partnerships, where partners are not allowed specific "salaries," amounts considered reasonable in view of the size and character of the business are allowed to all active partners before arriving at the profit the excessiveness of which is to be determined.

Taxes

While federal income and excess profits taxes are not allowed as costs or expenses in the determination of profits, all other federal taxes and excises and all taxes to states and other taxing jurisdictions, paid or accrued in accordance with legal formulas, are allowed as costs either to be apportioned or applied specifically against renegotiable business, as the circumstances justify. Real estate and other property taxes, for example, are usually charged only against the production obtained from the use of the properties subject to such taxes. Social security taxes are related to the labor costs of renegotiable and non-renegotiable production, respectively, on the basis of payments made on account of the actual labor employed in each type. Where the cost procedures so include such items in overhead that actual reapplication is difficult, the cost analyst is expected to be sure that the method of apportioning such overhead between renegotiable and non-renegotiable production does substantial justice to the costs of each kind.

State income taxes and franchise taxes based upon income, are allowed as expenses apportionable to renegotiable business, but since the amount of such taxes may be subject to adjustment as the result of renegotiation, it is generally agreed with a contractor that whatever tax refund he may obtain from a state, when such refund is based on a recalculation of the taxes as the result of renegotiation, will be turned over to the Treasury Department as excessive profits.

Employee Pension Funds

When a contractor has established a pension or retirement fund, to which it makes regular contributions, for the benefit of employees, the portion of the contribution pertinent to employees engaged in war production will be allowed as a cost against renegotiable business, provided the expenditures by the contractor are of a type generally approved by the Bureau of Internal Revenue as proper deductions for tax purposes. When such funds have been established for many years no question of their legitimacy as costs is likely to arise. If a plan provides for annuity or pension credits for services rendered in prior years, the amount allowable as an item of cost against renegotiable business will not be permitted to exceed the amount contributed on account of current services plus 10% of the total amount required to provide in full for such past service credits.

Provisions for Contingencies

Similar examinations are made with respect to credits to reserves of various kinds. It may be entirely proper for a contractor to provide for possible expenditures to meet guarantees with respect to his product. Whether the amount of his provision is excessive must be determined in the light of his past experience under such or similar guarantees, the terms of the contracts which contain them, the costs involved, etc. Provisions for accelerated depreciation are allowable costs but only to the extent that the conditions under which the company is operating justifies them. These are matters of both fact and opinion, but a Board's judgment with reference to the propriety of the amount allowable, for example, for accelerated depreciation can be sound only to the degree that adequate factual data are available. So the cost analysts must develop them—the types of equipment affected, their probable useful life, the conditions of operation, effect of abnormal hours of plant operation, abuse by unskilled operators, adequacy of maintenance, etc.

Provisions for postwar conversion, and other provisions for contingencies cannot be allowed as costs chargeable against war business. They are not of the character allowed under Chapter 1 and Chapter 2E of the Internal Revenue Code, nor are they proper deductions under any acceptable method of determining profits. The expenditures for which such reserves are set up may ultimately be proper deductions for tax purposes when they are made, but the impossibility in most instances of determining either the propriety of their amount, in relation to the ultimate use of the funds to which they relate, or their relation to current war production, denies them the right to recognition as a legitimate and allowable cost applicable to present war business.

Treatment of Non-Manufacturing Expenses

The propriety of an allocation of the costs of sales, and resultant gross operating profit, is usually determined in connection with an examination of the cost methods used. While individual items of cost, even when the basis of allocation is sound, are not to be neglected, because excessive costs are often found among them, each item of non-manufacturing costs and expenses is subject to scrutiny for excessive items, the most common of which are abnormally high salaries and bonuses. While interest expense may frequently be apportioned to renegotiable and non-renegotiable business on the basis of sales, this is not necessarily equitable. Interest on a mortgage on property used exclusively for non-war production should not, except under most unusual circumstances, be charged against war production. On the other hand, interest on a V-loan may, under most conditions, be treated in full as an expense applicable to renegotiable business. In every case the facts must be determined and the decision based on the circumstances.

Occasionally a company may have buildings and equipment for which it has no immediate use, for either war or non-war purposes. Unless they are idle purely

because of conversion to war, the expense of guarding, protecting and maintaining such facilities is not a proper charge against renegotiable income.

Selling expenses, including advertising, require particular inquiry. The accounts of many companies still show substantial amounts for sales salaries, salesmen's expenses, commission, etc., even though the persons to whom the amounts charged under such categories are paid, no longer do sales work but act as service engineers, expeditors, inspectors, etc. To the extent that their services are related to war business, reasonable compensation paid to such persons is applicable thereto. Long standing arrangements whereby salesmen, agents, dealers and distributors receive commissions based on deliveries of certain products within specified territories, cannot be set aside over night, unless a manufacturer is willing to abandon any hope of retaining or recapturing his regular markets after the war. The existence of unexpired agency contracts in many cases adds to his difficulty of eliminating or reducing selling expenses during the war. In the case of many subcontractors commissions paid in accordance with a long established practice are completely justifiable, not only from the viewpoint of the contractors, but from that of the Government as well, for the recipients have rendered valuable service in spreading the job of war production among a larger number of manufacturers than would otherwise have been possible, and have followed up the contracts after they have been obtained. In other cases individuals have been the beneficiaries of commission arrangements to an extent so great as to leave no doubt that the compensation paid was far greater than the service rendered could possibly have been worth.

Commissions or compensation contingent upon obtaining contracts directly from the Government are frowned upon by the Boards, on the theory that during war time any manufacturer who is able to produce something that the Government needs in carrying on the war, needs no agent to get a contract. While the theory is sound, it has fallen down many times in practice, for many contractors have spent days and weeks in Washington unsuccessfully trying to get contracts, only to be swamped with them shortly after turning the job over to a broker. Payments under brokerage contracts entered into prior to the beginning of the first year covered by renegotiation are generally allowed as a charge against renegotiable sales. As mentioned in an earlier paragraph, however, the broker will be subject to renegotiation.

On the other hand, the expense of maintaining a Washington office, or even a Washington representative, provided he is not rewarded on a contingent basis for his services in securing prime contracts, is recognized as a legitimate deduction. Again, while each case must be considered on its merits, the expenditures need to be scrutinized carefully, and any portion of them deemed to be illegitimate charges against war business must be transferred to the non-war section of the statement.

Advertising expenses, to be allowable deductions in computing the profit on war business, must be reasonable both in amount and in their relation to the advertiser's business activities. Consideration is given to both institutional and product

advertising. In general, straight product advertising, designed to publicize the merits of a contractor's specific products, is chargeable only against his non-renegotiable business, unless it relates to products which he as a subcontractor is providing for war purposes. The cost of institutional advertising may be partially or wholly allowed as a cost against war business, depending upon the relative change in the character of the contractor's business as the result of his conversion to war production. It is not expected that the total amount of a contractor's budget for such advertising during the war period will exceed that of his prewar days. If, in spite of his conversion to war production there has been no diminution of his non-renegotiable business, the entire amount of his expenditure for institutional advertising will be charged against such sales. If, on the other hand, his conversion to war production has left him with no non-renegotiable business, its reasonable cost will be allowed as a deduction in computing his profit on war business. If, as the result of conversion, his non-renegotiable business has suffered, he will be permitted to transfer a portion of the cost of his institutional advertising to renegotiable sales not less than the corresponding ratio during the prewar period. If the total amount of institutional advertising cost is substantially in excess of the corresponding prewar expenditures, some of the excess is likely to be disallowed as an expense against renegotiable business.

The treatment of taxes and pensions funds, both of which may involve expenditures of a non-manufacturing character, have been discussed in an earlier paragraph.

No major expenditure of a contractor is overlooked in an effort to allocate properly to renegotiable and non-renegotiable business, respectively, his costs and expenses. The cost analyst reviews the segregations prepared by the contractor, and in his report to the negotiator or general analyst recommends such changes as seem to him to be in order.

Effect of Disallowances

The fact that items of cost which a Board believes to be excessive are disallowed with reference to renegotiable business merely means that the portion of such costs or expenses, which under acceptable allocations would be charged against renegotiable sales are, upon disallowance, applied to non-renegotiable business. This has the effect of increasing the amount of profit on renegotiable business with an offsetting decrease in that on non-renegotiable business.

FACTUAL REPORTS AND DISCUSSIONS WITH CONTRACTOR

Based on (1) the information supplied by the contractor, (a) in response to the Assignment Office's request for data, (b) in response to the request for financial data and other information on the part of the Price Adjustment Board or Section to which the contractor was assigned for renegotiation, (c) in conversations with him and his employees, and (2) facts and opinions obtained from such other sources as the procurement officers, who are familiar with his operations, the Bu-

reau of Internal Revenue, etc., the analyst or negotiator prepares a report which succinctly embodies all the essential facts upon the basis of which the members of the Board or renegotiating group can familiarize themselves with the case before engaging in final discussions with the contractor. In addition to a summary of the significant financial data, including an income statement for the year under renegotiation, analyzed with respect to renegotiable and non-renegotiable business, income statements for the prewar period, and a balance sheet at the end of the renegotiable year, this report contains evidence of the character of the contractor's contribution to the war program, the difficulties under which he has had to operate, the special advantages he has had, etc., together with suggestions of matters to be developed more fully with the contractor during the renegotiation discussions.

The renegotiation proceedings with respect to a contractor reach a climax in the discussion which the renegotiating group holds with the contractor after they have thoroughly analyzed and digested the factual reports relative to his case. The members of this group reach no conclusions regarding the amount of excessive profits the contractor has accumulated, until they have heard the contractor explain what he has done to earn the profits reported. A discussion of his revelations, coordinated with the factual data obtained by the cost analyst and the negotiator or general analyst, results in a proposal to the contractor that he refund a stated amount of excessive profits, or an acknowledgment that his operations for the period under review have yielded no excessive profits.

Contractors sometimes contend that a Price Adjustment Board determines what amount of profit it will allow a manufacturer, and will not thereafter budge from that conclusion, with the result that the contractor is compelled to accept the Board's judgment as final, or submit to a unilateral determination by the "Secretary" of the Department or Agency responsible for the renegotiation. There is some justification for the feeling of many contractors that a Board's proposal relative to the amount of profit it will agree to as excessive in a particular case is final. But this does not mean that there is anything arbitrary about the manner of its determination, nor that the process by which the amount of a proposed refund or adjustment is fixed is not negotiation. From the commencement of the renegotiation with respect to a contractor, his representatives work with representatives of the government, not only in the accumulation and analysis of financial data, but in discussion of their significance and of the intangible factors involved in the contractor's operations and accomplishments, all with a view to a mutual understanding of the problems involved and, based thereon, a determination of a fair compensation for the job done. When all of the factors disclosed have been carefully weighed and considered by a Board's members in the light of their information regarding comparable operations of and settlements with other contractors and in view of their own independence of personal financial bias in the case it is natural that the Board should feel that it can and does make its first proposal a fair and reasonable one which it should not change unless new evidence can be presented

to justify another conclusion. If the contractor really believes that the Board's proposal is not fair and reasonable, he can refuse to accept and let the matter be referred to the Under-Secretary (or his counterpart if the renegotiating Board is in neither the War nor Navy Departments) for a unilateral determination from which he may appeal to the courts.

STANDARDS OF RENEGOTIATION

It cannot be denied, however, that the Price Adjustment Boards have an advantage in their dealings with contractors, in consequence of which they have felt keenly their responsibility to develop standards and procedures, involving a thorough study, by a group of qualified men, of all the factors pertinent to the problem, which would result in proposals of settlements that would be recognized by all concerned as fair and reasonable.

The application of standards to the problems of renegotiation should not be confused with the use of a rigid formula whereby a profit to be allowed a contractor may be computed. The Boards have considered many suggested formulae designed to determine the amount of a contractor's excessive profits from war production, but have found none that is universally applicable. Each company is an individual problem; no two are alike. A fair rate of profit, based on the sales of a paper manufacturer, would be entirely inadequate for a manufacturer of tanks or complicated precision instruments. Even within the same industry a company with a new modern plant, fitted out with new machinery, arranged with a view to the most economical production, and all provided by the government, is not entitled to the same rate of profit as one that produces the same articles in an old plant, perhaps not designed in accordance with the latest ideas for the most efficient production, but all provided by the contractor without government aid. The concern that makes its patents available license-free to other war contractors is entitled to a different consideration than the one that does not. The company, that lends its personnel to teach other manufacturers production methods, even at the risk of thereby creating post-war competitors, is deserving of recognition which should not be accorded to the concern that does not do so. The contractor who constantly improves manufacturing processes and procedures which reduce unit costs, and passes the benefits on to the government in price reductions, is more worthy of a generous rate of profit than the one who does little to reduce costs or who does not reduce prices as his costs go down but, instead, maintains a margin of profit so wide that it virtually eliminates risk. The varieties and degrees of difference between the operations of contractors are such that no formula for the determination of excessive profits is likely to be devised which will replace the combined judgment of a group of men, qualified by years of business and professional training and experience, to evaluate the performance of a contractor as a basis for determining the amount of excessive profits he has accumulated.

A standard is a basis of comparison. A performance standard may be either an

ideal of attainment or a normal accomplishment. It is in this latter sense that the Price Adjustment Boards use the term in scrutinizing a contractor's profits and accomplishments.

One of the standards which the Boards use in determining excessive profits is the prewar experience of the contractor. For this purpose the four-year period ended with the close of the contractor's 1939 fiscal year is generally taken as a basic period, the average results of which are likely to be approximately normal. If a contractor is not to be permitted to make excessive profits from war business, it is natural and proper to learn what he was accustomed to earn under peacetime conditions, when volumes, prices, expenses and profits were governed largely by competitive conditions, which tended to weed out the inefficient and high-cost producers and to strengthen the efficient low-cost manufacturer.

The 1936-1939 period was selected because it was felt to be long enough to provide a reliable picture of a concern's habitual operative progress, recent enough to reflect the operating ability and experience of its present management, sufficiently pre-war to be relatively unaffected by the war, but short enough to permit of the easy accumulation of the pertinent data. Furthermore, it was felt that it was generally a fairly representative period, since it includes two moderately good years (1936 and 1939), one very good year (1937) and the "recession year" (1938). Moreover, it was the period legally recognized as a basis for computing the excess profits credit, under the Second Revenue Act of 1940 and its successors.

Although a contractor's profits during a renegotiable period are compared with those he earned during this pre-war period, it should not be assumed that the war profit he may retain (before federal income and excess profits taxes) is limited either in amount or as a ratio to sales, net worth, or any other figure, to his average, maximum or minimum pre-war profit. When the pre-war activities of a company or the results of its operations were such that to use them as a basis for comparison with profits on war business would be eminently unfair, they have been completely disregarded or certain years eliminated. In some instances a company's business is more cyclical in character than that of most companies, with the result that a period of four years is inadequate to suggest accurately its profit history or expectations. In such cases, too, the selected period of four years is rejected as a basis for obtaining normal profits, and if possible, a longer period, including the years 1936-1939, will be considered for that purpose. Other companies are engaged in types of war production so different from their normal peacetime operations, either wholly or partially, that a comparison of profits from one with those from the other would be unjustifiable. In any given instance, then, a concern's pre-war record provides a standard by which the excessiveness of its war profits may in some measure, be gauged, only to the extent that such record is indicative of normal operating results during the pre-war period. Under any circumstances it must be recognized that this is only one of many factors to be considered in a particular case.

Another standard used by the Boards is the pre-war experience of an industry.

In many instances an indication of a reasonable profit on war business can be gained by comparing the results of an individual company during the renegotiable period with those of the industry as a whole, or of a group of representative companies in the industry, during the pre-war period. This is particularly useful when the contractor has no pre-war record, or an abnormal one, or has undergone a reorganization or a change in management. It is also helpful in determining how close to normal the pre-war experience of an individual contractor may be.

In the manufacture of many war articles there is no adequate pre-war experience to provide a comparative basis for measuring excessiveness of war profits. In such cases pre-war results, whether on a company or on an industry basis provide only general information regarding the types of profits companies engaged in the employment of similar skills have been accustomed to make and as to the relative standing of a company in competitive operations. The factors which a Board considers in determining whether or not a contractor's operations during the years 1936 to 1939 inclusive were abnormal, are similar to those of which the Bureau of Internal Revenue takes cognizance in connection with a taxpayer's application for excess profits tax relief pursuant to the provisions of Section 722 of the Internal Revenue Code. Accordingly, a contractor who has taken steps to secure such tax relief may find it desirable to submit a copy of his Section 722 application to his renegotiation Board rather than to prepare a statement especially for it, as evidence of his belief that his operations during the years 1936 to 1939 were not normal.

Profits for a period are commonly measured in relation to sales, to costs, to net worth (either at the beginning of the period or the average for the period), or to total assets (either at the beginning of the period or the average for the period). Without neglecting the other ratios, the Price Adjustment Boards have, in general, used sales as a basis for the measurement of profits on war business. Probably the major reason for this is the fact that business men commonly express profits as a ratio of sales whenever they are discussing pricing policies but it is also partly due to the fact that when companies are engaged in both war and civilian production it is frequently difficult to divide profits in terms of their relation to the invested capital or total assets employed in each phase of the business. The inequities involved in relating profits to assets and net worth because of the difficulty of making comparable evaluations of the bases among different companies has also been of some significance in this connection.

War production has yielded ample evidence of what business men have long known, that increased production provides opportunities for increasing profits at a rate more rapid than that of the increase in volume of sales. Increases in profits may result from increases in prices, increases of volume or decreases in unit costs, and when all three factors work together may reach unbelievable heights. The demands of the war have supplied many producers with volumes impossible under normal conditions. To counteract this factor alone lower unit prices would prob-

ably be justified, even assuming unit costs remained unchanged. But with increased volume reductions in unit costs were almost inevitable. Fixed overhead spread over a larger number of units of production yields a smaller amount to be applied to each unit. Streamlining production, made possible by orders for very large quantities of the same item, yields direct operating economies. The elimination or reduction of selling and advertising expenses further reduces the unit cost of every item of war production. Such reductions in unit costs facilitate the turnover of capital. On the other hand, economies made possible from increased volume have been to some extent offset by increased wage rates, the use of untrained employees, the cost of training workers, high labor turnover, greater inspection costs, increased cost of plant protection, greater wear and tear on machinery and equipment, etc.

To determine, therefore, on the basis of a mathematical formula, how much of a contractor's profits on war business is the result of his normal business ability, how much is due to the increase in volume for which the war alone is responsible, how much is the net result of direct economies and savings from the wider spread of fixed overhead, how much is to be credited to extra efforts inspired by his patriotic desire to go the limit for his country, is well nigh impossible.

Another standard of comparison—one very difficult to fix, because it is based on personal judgment gained from wide experience—must therefore be used by the Price Adjustment Boards in appraising the excessiveness of a contractor's profits. This standard is the accomplishment of industry as a whole under conditions of wartime production. How does the A company's job compare, not only with that of the B company, which is engaged in similar business, but with what it should be capable of doing, in the light of what industry as whole has done?

AN ILLUSTRATIVE APPLICATION OF STANDARDS

An illustration may indicate the manner in which the Boards attempt to apply these standards.

Company P has had a very successful career for more than a quarter of a century as a manufacturer of a small variety of electrical specialties, in the field of which, in spite of numerous competitors, it has long been dominant, due to its extremely efficient management, its pioneering in the development of uses for its products, its training of personnel in their operation, and its influence in persuading the industry to standardize on a few styles and sizes. Except in the development of methods and equipment for the manufacture of its output it has made no outstanding contribution with respect to the products themselves. All are standard in the industry and are related to no important existing patents. Since the demands of war had no effect on the character of its product, it had no conversion problem other than a slight expansion in the form of additional equipment (which was acquired without Certificates of Necessity) and will have no reconversion problem, as such, although for some of its products there will be for several years a heavy reduction in postwar demand.

The P Company's sales during the pre-war years 1936 to 1939 inclusive averaged less than \$10,000,000 a year, with the total for the low volume year about two-thirds of that of the high volume year. In 1940 the company began to feel the effect of preparations for national defense, for in that year its sales were 20 per cent greater than those of its best preceding year and nearly 50 per cent greater than its average for the period from 1936 to 1939, inclusive. Its sales for 1941 were nearly double those for 1940, and in 1942 mounted further to a total, before renegotiation, of nearly four times its average 1936-1939 record. Profits before taxes hovered fairly consistently around 25 per cent of sales during the six years prior to the war. Based on net worth at the beginning of the year these profits ranged from a low of slightly less than 25% to a high of more than 50%, with an average of nearly 40%.

During 1942 the company's non-renegotiable business, about equally divided between commercial sales and war business, payment for which was received before April 28, 1942, was computed to be about 35 per cent of its total business (before renegotiation), about 90 per cent of its total sales in 1940 and more than 30 per cent greater than its average annual volume during the 1936 to 1939 period. After adjustment of costs and expenses, to apply against non-renegotiable business items not related to renegotiable business, the ratio of its profit before taxes on its renegotiable business was approximately 27.5 per cent, about one-half of one per cent greater than the corresponding ratio on its non-renegotiable business. On both classes of business, therefore, its rate of profit on sales was greater than the average for the six years prior to the war, and its volumes for each class was also greater, which clearly indicated that all of the renegotiable business was over and above what the company might reasonably have expected, except for the war.

In considering what would represent a fair profit to this contractor on his renegotiable business the renegotiating group recognized that the company was the lowest cost producer in its field; that it had for years consistently operated to reduce prices, though not specifically as the result of war production; that it has been largely responsible throughout its history for the development of new uses for its products, with the result that they are essential and critical tools of war production, the use of which has reduced the cost by untold millions of dollars; that it has been instrumental in speeding up the production of its own plant and of its competitors, through cooperation with the latter in improving their manufacturing methods and procedures, with the result that the government has been saved many millions of dollars in plant costs and an undeterminable number of hours of delay in the completion of war products; that its products have always been satisfactory; that its deliveries have always been according to schedule; that it required no financing by the government; and that altogether it has made an important contribution to the war effort. On the other hand, the renegotiating group also recognized that the company had no problem of plant conversion to engage in war business, its war products being identical with those of its peacetime operations; that its genius is reflected primarily in production rather than invention of epochal devices; that

it will have no problem of postwar reconversion; that its postwar reduction in business will not be comparable with that to be suffered by many industries; that its investment in new facilities for war production is relatively small and of standard character; that it has retained its peacetime contacts by preferring subcontracts to prime contracts; that it was not wholly cooperative with government procurement agencies in connection with such few prime contracts as it accepted; and that its profit before taxes on non-renegotiable business was greater than its total corresponding profit for any year prior to 1941.

This net result on renegotiable business, combined with its return on non-renegotiable business which entitled it to a profit on renegotiable business which represented a reward for its outstanding contribution and performance in connection with the war effort, but which must also be related to the degree of its sacrifice in comparison with other types of industry and to the development of inventions of immeasurable significance. As a result of this conclusion it was recommended that the company refund an amount which would leave it a profit on renegotiable business alone, before federal income and excess profits taxes, as follows:

- (1) in amount, more than its average annual profit before taxes during the 1936 to 1939 period.
- (2) as a rate on adjusted sales (renegotiable sales, reduced by the amount of the refund), more than half the highest rate on its sales for any year since 1935.
- (3) as a rate on adjusted sales approximately one-third greater than that allowed any renegotiated company in a comparable business.

The net result of these considerations was the conclusion that the P Company renegotiable business which was entirely unaffected by renegotiation, leaves the company with a return before taxes of approximately twice as much as it made in its best year prior to 1940 and a net return after taxes and all other charges of about 20 per cent on its net worth. While the resultant return after taxes is less in amount than the company enjoyed during a few of its prewar years and less in rate than it was during any of those years, it must be recognized that the tax rate for 1942 is much higher than it was during the earlier period so that all taxpayers must pay substantially larger proportions of their incomes to the government in taxes.

CONSIDERATION OF EFFICIENCY

Contractors are particularly concerned about the Boards' recognition of their efficiency in war production. Many feel that through renegotiation they are penalized for increasing efficiency and lowering unit costs, and that those companies with high costs and relatively low profits fare better than those that strain every nerve to improve production, lower unit costs and pass on to the government the benefits resulting from their efforts. In some instances, highly efficient low cost producers may have suffered, through renegotiation, in comparison with others engaged in similar types of production. If this be so, it is contrary both to the desires and the general practices of the Boards, for particular consideration is given

in every case to evidence of efficient and cost reducing operations, in order to compensate the efficient manufacturer more generously than the less efficient. It does not follow that the efficient producer, merely because of his efficiency, may not have accumulated excessive profits. The opportunity for the demonstration of his efficiency may have been provided by the war. Under conditions of his normal production the opportunities for such notable cost reductions may not have existed.

An example of one who received full recognition of his efficiency is a small manufacturer, whose war product is identical with his peacetime product, and whose 1942 volume, more than half of which was on war contracts, was not substantially greater than his peacetime volume. The profits on his total business in 1942 were at a rate of 60 per cent greater than he had earned during the prewar period. This increase in profit ratio was due, almost entirely, to the installation in 1942 of equipment he had wanted to buy for several years, but which he was unable to do without (as he felt) over-extending himself, financially. In this case the war program received the benefit of improved manufacturing methods, which the manufacturer, because of conservative business habits, had denied himself for several years. With such equipment for his prewar operations his unit costs would have been lower and his consequent profit ratios higher during the years of his base period. In renegotiation he received the benefit of the increased efficiency of his 1942 operation, in comparison with that of the prewar period, by the allowance as normal of the profit he would have made during the earlier years had he had the reduced unit costs which the improved equipment permitted him to develop.

Admittedly one of a Board's most difficult tasks is to determine the relative production efficiency of the various contractors with whom it deals, and the extent to which a manufacturer's success in reducing costs is the result of his own ingenuity as opposed to the application of factors not subject to his control. Through analyses of capital turnover, labor hours per unit of output, nature and extent of government assistance, and a variety of other factors, with special emphasis on economy in the use of facilities, manpower and raw materials, the Boards attempt to obtain the facts upon the basis of which they can justly reward the supercompetent for outstanding efficiency in production and treat with comparable justice all other producers, on the basis of their respective records.

THE SIGNIFICANCE OF SUBCONTRACTING

Another factor to which the Boards attach considerable weight is the degree to which a contractor's operations are integrated. A manufacturer who depends only on the facilities and labor in his own plant to convert raw material into finished war products is generally entitled to a higher rate of profit on sales than one whose operations consist primarily of assembling parts accumulated from a number of other manufacturers because he has more capital invested and adds more value in the process of manufacture. The price of every item furnished by a subcontractor includes a profit which becomes a part of the cost of the final product. Unless the

subcontractor can supply his parts for less than the contractor can produce them in his own plant, the ultimate costs of the latter's product will be greater than it otherwise would be. On the other hand, since from a national viewpoint every plant and facility in the country has been needed, either for direct war or essential civilian production, it must be recognized that without the extensive subcontracting that has been such a vital factor in our development of war matériel, this country could never have become the arsenal of democracy that it is. The cost of some products may have been greater, but the speed with which they were obtained justified the increased cost. Accordingly, under some circumstances subcontracting is a definitely favorable factor for which the contractor is entitled to special rewards. For example, one company, through the utilization of a large number of small subcontractors on more than 95 per cent of its production, turned out over \$25,000,000 of critical ordnance items before any plant was equipped to produce them on anything like an integrated basis. The importance, significance and necessity of such subcontracting is not overlooked.

When a contractor sells a product on a fixed price basis, and it develops that he buys all the parts, so that his contribution is primarily that of assembling them, in determining whether he has made excessive profits consideration must be given to the relative value of his participation in the final product. If the purchased parts are standard and easily obtainable, he may not be entitled to a very substantial compensation for his assembly job but, even though the purchased parts are all standard and easily obtainable, if the assembly job is intricate and requires a high degree of technical skill, the reward for his services should be correspondingly greater. Furthermore, subcontractors do not always supply standard parts; they are not always in sound financial condition; they may not use reliable accounting procedures. In such cases, even though the contractor's contribution to the final product may appear to be only an assembly job, actually it may include furnishing his subcontractors with engineering aid, production specifications, financial help, inspection service, accounting and auditing and a variety of other benefits essential to total production. In other words, the contractor's contribution may be one of management fully as much as one of assembling the parts manufactured by subcontractors and he would, accordingly, be entitled to greater profits.

A contractor cannot be accorded fair treatment in evaluating the excessiveness of his profits unless full consideration is given to the nature and amount of subcontracting involved in his production and the character of his relationship to his subcontractors.

CONTRACTOR'S RISKS

Closely related to the matter of subcontracting, though by no means solely involved in it, is the problem of a contractor's risks. Profit is generally considered to be compensation for the use of capital, and the greater the risk involved the higher is the rate of return which owners of capital demand for its use. In war time it is

necessary to allow profits as compensation for a fine production job even though there may have been no capital at risk but, in considering what are reasonable and what are excessive profits, the Price Adjustment Boards must be concerned, to a considerable extent, with the evaluation of a contractor's risks in connection with his war production.

In the early days of preparation for war some of the risks which now seem unimportant were very real. Increases in material costs and increases in labor rates, for example, while possibilities not now completely non-existent, were then of vital concern to every manufacturer. The danger of production stoppages as the results of delays in the delivery of materials and parts is an ever present risk, but more serious for some companies than for others. Many contractors have observed their costs rising because of the inexperience of a large part of their employees, a condition which has necessitated specific job training, and has resulted in slower production, more spoilage and a larger number of rejects than would normally be expected. The difficulties involved in stabilizing labor conditions has caused a high labor turnover in many industries. The employment of women in industries unaccustomed to them, while providing a solution for some problems, has created others.

Some manufacturers are subject to uninsurable risks because of the nature of their production; some are required to provide product guarantees, the cost of meeting which, under present conditions, is largely a matter of speculation. One company at its own expense has sent repairmen by plane to drop on ships in mid-ocean to make the equipment which it installed function properly.

Of particular concern to many contractors is the risk of cancellation of their orders, or of a modification of their production programs which reduces the utilization of their facilities. Contractors whose product is largely produced by subcontractors and whose facilities are in great measure government-owned or acquired under certificate of necessity, ordinarily have less at stake, relatively, than highly integrated manufacturers and those that have received no financial assistance of any kind from the government.

While provisions for post-war rehabilitation cannot be allowed as costs in the determination of profits from renegotiable business, recognition of post-war risks cannot be denied. A contractor whose post-war business is going to be extremely lean because he has flooded industrial plants with equipment needed for war production but which will need no replacement for many years and is adequate for peace-time operations, is deserving of much consideration by reason of that fact in arriving at a fair rate of profit on his war sales. A manufacturer who was dominant in his field before the war and who has sacrificed his regular business in order to do a war job for which his plant and organization were peculiarly fitted, and has assisted in the development of other contractors in the same field, has taken a serious risk with respect to his post-war future, for he has lost a large part of his prewar market for what was formerly his principal product and has created (or

assisted the government to create) a great many competitors in the field in which at one time he had his own way.

Contractors are well aware of the risks they have taken; many, of course, are inclined to exaggerate or over-emphasize them. The Price Adjustment Boards encourage the contractors to present their views clearly on this as on other factors and they take full cognizance of them and evaluate them in profit terms as accurately as possible.

COST-PLUS-FIXED-FEE CONTRACTS

Because most of the risks incident to the performance of fixed-price contracts are not applicable, at least in the same measure, to cost-plus-fixed-fee contracts, the latter are not included in the usual overall renegotiation of a company's fixed price business, but are given separate consideration. Furthermore, when such contracts relate to large physical units, such as ships or construction projects, to consider them on a fiscal year basis is likely to yield inequitable results, since the real profit from such jobs cannot be determined until the contracts are completed. For this reason ship and construction contracts are often renegotiated on a completed contract basis depending upon conditions in the individual case.

In general, the same types of factors are weighed as in the renegotiation of fixed-price contracts. Greater attention is paid, however, to the comparability of a contractor's performance to that of others currently or recently engaged in similar operations than to his prewar experience. Changes in factors governing production subsequent to the signing of the contract may justify a modification of the fee. Thus, in one instance a contract for a small number of units of a particular product specified a fixed fee per unit based on production conditions suitable for the originally contemplated quantity. The subsequent need for a great many units, which were ordered on the same basis as the first quantity, enabled the contractor to change his production methods so radically that the fee per unit yielded a profit, which as a percentage of actual cost was at several times the rate applied to the estimated cost contemplated in fixing the fee originally.

Disallowances of costs must be treated as deductions from the fee in renegotiation proceedings. There are times when, depending upon the nature of the disallowances, a loss or an inadequate profit on cost-plus-a-fixed-fee business will be taken into consideration in fixing the amount of profit to be allowed on fixed price business so as to allow a larger amount than would otherwise have been considered proper.

Fixed fees directly related to production in government-owned plants are fundamentally compensation for management, and may easily become very exorbitant as production mounts beyond the limits anticipated when the contracts were negotiated.

EVALUATION OF CONTRACTOR'S PERFORMANCE

From the foregoing it is evident that in renegotiating the war business of a contractor on an overall basis a Board relates its performance to its prewar experi-

ence, to the general prewar experience of the industry with which it is identified, the experience of other contractors now engaged in similar kinds of production and the significance of the contractor's production to the war program as a whole. By balancing the favorable factors against the unfavorable factors, with due consideration for the risks involved, it tries to arrive at a fair evaluation of the amount of profit to which the contractor is entitled for the job done. In reporting to him the amount of refund the renegotiating group feels it is proper he shall return, its chairman generally enumerates the factors to which special consideration has been given. The complaint is frequently made that the renegotiating Boards do not indicate how much weight they give to each of such factors, and make it impossible for a contractor either to verify the amount of the proposed refund, assuming he accepts the basis of its determination, or to oppose intelligently the determination of the Board with reference to the amount of weight allowed certain factors. To the contractor, the refund recommendation appears to be the result of an arbitrary determination. It cannot be denied that the Boards do not attach specific numerical weights to specific factors which influence their judgment in the final determination. Nor, if they did, is it likely there would be agreement among the several members as to what weight should be applied to each of the factors. In one proceedings the five Board members took a secret ballot and were unanimous in their recommendation of an amount to be refunded by the contractor. Discussion subsequent to the announcement of the results of the ballot revealed that each voter had reached his conclusion in pursuit of a train of thought quite different from that of the others. In other words, each member of the renegotiating group weighted differently the various factors considered, yet arrived at the same net result as all the others. Business men are daily confronted with analogous situations, wherein they are required to evaluate pieces of property or jobs done. They reach conclusions which they themselves would have difficulty in analyzing mathematically, but the soundness of which is admitted by their associates. In buying a factory site, for example, such factors as nearness to raw materials, nature of transportation facilities, with respect to suitability for incoming freight and shipments to customers, availability and character of labor supply, types and amount of taxes, attitude of the community toward industrial plants—these and many other factors must be considered in determining a fair price to be paid. But it is doubtful if any business man attempts to place a value on each factor in arriving at the amount he is willing to offer for such property. His experienced judgment enables him to reach a conclusion which balances one factor against another without identifying the exact degree of importance he attaches to each.

PROFITS AFTER RENEGOTIATION

Whatever the final conclusion with respect to an amount of refund, the resultant profit can be expressed as a percentage of sales. Since the Renegotiation Act has been designated as a pricing act, any refund made by a contractor is in effect a

rebate of price, made because, in the light of the facts developed through renegotiation, not known when the contracts involved were originally placed, the prices named in such contracts were too high. Had they been lower, sales as well as profits would have been less. The refund resulting from renegotiation operates to reduce the sales of renegotiable business as reported before renegotiation, and the profits based thereon. The ratio of profits after renegotiation, insofar as they are related to sales, must therefore be computed with reference to sales after renegotiation.

If, for example, a company's renegotiable business was reported as \$10,000,000 on which the profit before federal income and excess taxes⁹ was \$2,500,000—or 25 per cent of such sales, and as the result of renegotiation it refunded \$1,500,000 (also before taxes), its sales after renegotiation would be \$8,500,000 and the final profit after renegotiation and before taxes, would be \$1,000,000 or 11.76 per cent of "adjusted sales," that is, original renegotiable sales, reduced by the amount of the refund.

EXECUTION OF RENEGOTIATION AGREEMENT

Most contractors are interested in knowing what will happen if they refuse to accept the refund proposal of a Board. Since renegotiation presumes a mutual understanding, discussions usually terminate in execution of a bilateral agreement relative to the total amount of refund and the manner in which it shall be applied to specific prime contracts, with further reference to price reductions applicable to future billings under such contracts and prices to be changed under subcontracts. If the representatives of the contractor are not empowered to enter into such an agreement at the time of their meeting with a renegotiating group, the agreement is not completed until their principals have had an opportunity to pass upon the proposal and have signified their willingness to accept it. It is, however, their privilege to reject it. If the renegotiation group is a Price Adjustment Section in one of the War Department Services or a regional board of the Navy Department, appeal may be made to the top Board of the Department involved, for a reconsideration of the case. If there is still no meeting of the minds, the case is referred to the Under-Secretary for a unilateral determination of the amount of excessive profits involved. The amount of excessive profits found by a unilateral determination may be collected by withholding amounts due the contractor or, in the case of a subcontractor, by ordering prime contractors who are his customers to withhold payments for the account of the government. The contractor then has the right of suit for recovery in the Federal Courts. If there are no funds that can be withheld or collected through the contractor's customers the government has recourse to the courts for collection.

⁹ For a discussion of the relation of renegotiation to federal income taxes, see, in this symposium, Watts, *Renegotiation and Federal Taxation*, *infra* p. 341; also, on the controversy before-taxes vs. after-taxes, see the last article in this symposium by Jules Abels on The 1943 Revenue Bill's Renegotiation Proposals.

PUBLICATION OF RESULTS OF RENEGOTIATION

Nearly every contractor who appears before a Price Adjustment Board would like to know how the settlement proposed to him compares with that offered his neighbor or competitor. Because the matters revealed to a Board are given in confidence, it is not at liberty to discuss with contractors the affairs of other contractors. A contractor sometimes thinks a Board has accorded him unfair treatment, because he has heard of companies that seemed to have fared better than he. On one occasion a contractor brought to a meeting with his renegotiating board a list of a dozen contractors which, it had been publicly reported, had been renegotiated with results therein indicated. Seven of the twelve had, at that time, not yet met with a price adjustment board!

Many persons on the government side of the table would welcome the right to reveal the facts underlying the settlements proposed to contractors, and the bases upon which they were developed. They believe that a contractor would have a different attitude toward a proposal made him, if he could compare it in detail with those made to some of his competitors. Until, either by law or by common consent of contractors, Price Adjustment Boards are permitted to release the facts underlying settlements with each contractor renegotiated, secrecy with respect to the facts of specific renegotiations must prevail.¹⁰

EXCESSIVE PROFITS AND INADEQUATE WORKING CAPITAL

"How am I ever going to pay this amount?" is a question often asked by contractors who have received a proposal by a Price Adjustment Board. "You tell me I have made excessive profits, but where are they? Three years ago I had a current ratio of 5 to 1; now I am doing five times as much business as I did in 1939, and my current ratio is 1.1 to 1. With all my war business I'm worse off than I was before the war."

The problems of currently financing a rapidly expanding volume of production are not to be taken lightly. Even when collections for goods delivered are received promptly, the need for meeting payrolls, paying for materials, parts, subassemblies and supplies on time, in order not to lose discounts, providing for taxes and other expenditures, when their total increases at a faster rate than the receipts from deliv-

¹⁰ An erroneous impression has perhaps prevailed concerning secrecy and disclosure of renegotiation results. The restrictions on the disclosure of the results of a particular renegotiation proceeding is, for the most part, limited to government representatives. The manufacturer whose contracts have been renegotiated is under no obligation to keep silent with respect to the settlement made with him, except that for military security purposes, he may not disclose information concerning individual contracts with respect to which he is otherwise already restricted. For the same reason, in some cases it may be improper for him to disclose the gross amount of renegotiable business done. A contractor who compares his own settlements with published results of earnings after renegotiation should be sure, however, that the latter relate solely to the allowed return on renegotiable business and do not include the results from operations which are beyond the scope of the Price Adjustment Boards. A company, for example, which was allowed a profit before taxes of ten per cent on adjusted renegotiable sales representing approximately one-half of its volume, and had a profit before taxes of thirty per cent on the other half of its sales not subject to renegotiation, will show a total net profit after renegotiation, expressed as a percentage of sales, much greater than that of a company allowed a profit of twelve per cent of adjusted renegotiable sales which represented one hundred per cent of its business.

eries, requires constant attention and application of great ingenuity and extreme vigilance to keep a reasonable bank balance. When in addition, a company uses its own funds to provide additional facilities, its financial condition may become really uncomfortable. The Boards approve of the efforts of contractors to finance their war production without borrowing, either from private or government sources. Nevertheless, they recognize that the manner of utilizing the funds acquired through the realization of profits is a matter quite apart from the amount of the profits realized. Excessive profits are profits which should never have been received. To the extent that they have been received a contractor is, in effect, borrowing from the government without interest. In private operations, to expand his plant to handle contracts from which he expects to make a profit he would expect to use his credit, if his own funds were insufficient for the purpose. The same point of view should prevail in his dealings with the government, particularly when the government is so willing to assist him, through its V-loan provisions, and in other ways, to obtain the funds required to finance his war production. The Boards are glad to render whatever aid they can to help a hard pressed contractor to obtain the credit necessary to enable him to carry out his contracts and to refund excessive profits but they do not believe that the contractor who has been inadequately financed and is therefore in serious financial difficulty should be allowed to make and keep excessive profits which he would not be allowed to have if he had been adequately financed. Whether he can pay it back and when are questions quite apart from the one as to whether he has made excessive profits.

CONCLUSION

The Renegotiation Act is a war-time measure which is being administered by persons experienced in business and industry who have no desire to see it develop into a permanent part of the federal statutes. As long as the war lasts and the act stands, the recapture of excessive profits from war production will be an essential part of the task imposed upon the Price Adjustment Boards. The real success of the Act lies, however, in the utilization of the data supplied them by contractors to secure more reasonable prices on future contracts. That the Act is accomplishing this purpose both procurement officers and contractors are in a position to bear witness. It seems highly probable that refunds of excessive profits based on 1943 business will be required of a smaller number of contractors than was the case with respect to 1942 business. As for the war production of 1944, the problem of renegotiation should be greatly simplified. This does not mean that it will be unnecessary to require contractors to continue to furnish the Boards with financial data of the types heretofore requested, although much of the information needed in connection with their first renegotiations they will not have to supply for subsequent ones. It does mean that such data will reveal no excessive profits on war business in an increasing number of cases because procurement officers are so benefitting from the work of the Price Adjustment Boards that they are now able to secure prices on prime contracts and to bring about reductions in prices of subcontractors which are much less likely to yield excessive profits than those negotiated during the early days of the defense and subsequent war program.