In December 1983, the Deputy Secretary of Defense established the Defense Financial and Investment Review (DFAIR). The DFAIR is the first DoD study chartered to review the interrelationship of pricing, financing, and markup (profit) policies and to make recommendations to provide for appropriate integration of the policies. The study reviewed contract pricing, financing, and profit (markup) policies to determine if they resulted in effective and efficient spending of public funds and maintaining the viability of the defense industrial base and made recommendations for improvements in its 1984 report.

Summary of the 1984 Defense Financial and Investment Review (DFAIR) Report:

Methodology:

The review was confined to examining the results of the application of those policies by Government personnel, along with a review of defense contractor financial results achieved in performing contracts that are negotiated based on those policies. Data were examined from both Government and private sources, including questionnaires and financial data collection instruments specifically designed to elicit information bearing on the policies being studied.

Financial data covering the years 1975-1983 were collected and analyzed by the DFAIR and compared with similar data collected during the 1970-1974 period for the Profit '76 study. Comparisons were also made with the financial results of durable goods manufacturers and with the commercial work performed by defense contractor segments.

Conclusions:

In general, the DFAIR analysis concludes that current contract pricing, financing, and markup policies are balanced economically, are protecting the interests of the taxpayer, and are enabling U.S. industry to achieve an equitable return for its involvement in defense business. Analysis of industry financial and investment trends indicates that the goals of many of the previous policy changes are being realized, although there are a number of refinements and improvements which need to be made.

1. **Equity of DoD Financing Policies**
   - In comparison to an analysis of contractor working capital costs resulting from DoD financing policies since 1954, the recent policy of progress payments of 90% for large business and 95% for small business was equitable for the years covered by the study. With short-term interest rates around 10% and projected to decline, progress payment rates should be set at 85 and 90% for large and small business respectively.
   - Current markup policy does not explicitly take into account the cost of working capital.
   - Time to payment is a significant variable insofar as contractors' cost of working capital is concerned.

2. **Profitability of Defense Contracts**
    - Economic profits of defense work were very similar to those of comparable durable goods manufacturers for the years 1970-1979. For the period 1980-1983, average defense profitability decreased slightly from the previous 10-year period while that of durable goods manufacturers deteriorated dramatically. Defense industries were able to maintain their profitability primarily becaues of the increase in defense outlays and the decline in inflation.

    - Profitability of defense contracts has been consistently lower than the levels believed to have been negotiated by Government contracting officers.
    - FMS profits are greater than they are on DoD work while profits on DoD subcontracts are slightly less than on DoD prime contract work.
    - CAS 414 "Cost of Money" has not caused a significant increase in profits.
    - DoD's Weighted Guidelines markup policy is being followed by contracting officers, but it is in need of improvement.

3. **Capital Investment and Efficiency Improvements**
    - Significant capital investments have been made by defense contractors.
    - The rate of change in capital investment has been driven by factors other than DoD markup policy.
    - Current markup policy is indifferent to productivity of capital investments.
    - Markup policy, in and of itself, is insufficient to bring about productivity-enhancing improvements. Other methods are required.

4. **Other Subjects**
    - Shipbuilding contract pricing, financing and markup policies need re-examination.
    - FMS contract pricing, financing and markup policies need to be adjusted to approximate more closely DoD contract policy.
    - The nature and health of the subcontractor industrial base is not well understood.

Recommendations:

1. **Contract Financing Policy**
    - The report proposed various changes to progress payment rates.
    - Interest expense should remain unallowable, and progress payment rates should be reset in the future based on changes in interest rates.

2. **Markup (Profit) Policy.** The overall policy should be simplified and better integrated with financing policy and length of contract performance. A policy framework should be developed to achieve the following objectives:
    - Increase emphasis on investment and decrease emphasis on cost in the markup policy and narrow the range of factors.
    - Markup policy should yield results which are, on average, 0.5% to 1.0% of current allowable costs lower than for the 1981-83 period.

- The current special factors should be rescinded, but a special factor for FMS risk should be established.
- The markup on facilities capital employed should be based on productivity and risk of assets.
- Provide an explicit, but simple, method to calculate a cost of working capital markup amount.

3. **Other Pricing and Allowable Cost Issues.**
   - Milestone or interim acceptance payments should be permitted on large dollar contracts where there are more than three years from contract start to first delivery.
   - Milestones or interim acceptances should be: Scheduled to commence not earlier than six months after contract start; based on clearly identifiable events whose completion can be verified and whose costs can be reasonably estimated; and should occur not more frequently than monthly and preferably on a quarterly basis.
   - Economic price adjustment clauses should be used on all large dollar contracts whose period of performance is three years or longer.
   - Cost of money should continue to be treated as an allowable cost.

4. **Capital Investment and Productivity Improvements**
   - Efforts to motivate contractors to acquire productivity-enhancing capital and to make other productivity changes should be pursued on an extra-contractual, plant-wide basis.

5. **Shipbuilding**
   - The Navy should re-examine its current shipbuilding pricing, financing, and markup policies with the objective of making them conform to the above recommendations.

6. **Subcontractors**
   - DoD should better define critical needs from the subcontracting base and provide productivity-enhancing incentives directly with critical subcontractors and/or assure that prime contractors are doing so.

7. **Feedback and Future Monitoring System**
   - The negotiated markup reporting system (DD Form 1499) needs to be strengthened.
   - Actual results being achieved under DoD contracts also need to be reported on a periodic basis.