



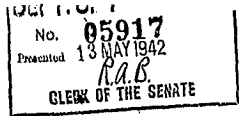
Jowrie
Governor-General.

Message No. 22.

A Proposed Law intituled:-

"Judiciary (Diplomatic Representation) Act 1942"
as finally passed by the Senate and the House of
Representatives of the Commonwealth, having been
presented to the Governor-General for the Royal
Assent, His Excellency has, in the name and on behalf
of His Majesty, assented to the said Law.

Government House,
C a n b e r r a,
8th May, 1942.



1940-41-42.

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA.

JOINT COMMITTEE ON WAR EXPENDITURE.

FOURTH PROGRESS REPORT.

“COST-PLUS” CONTRACT SYSTEM—ANNEXE
CONTRACTS.

7TH MAY, 1942.

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JOINT COMMITTEE ON WAR EXPENDITURE.

FOURTH PROGRESS REPORT.

COST-PLUS CONTRACT SYSTEM--ANNEXE CONTRACTS.

1. In its Second Progress Report the Joint Committee on War Expenditure reported that it was addressing itself to a survey of the system of "Cost-plus" contracts operating in connexion with the manufacture of Service requirements in Australia, and outlined generally the principles underlying the various types of contracts which may be classified under the heading of "Cost-plus". The report, further, indicated that some form of contract based on cost was unavoidable, and, in mentioning briefly the procedure followed by the Department of Munitions in the supervision of such contracts, emphasized the necessity for the greatest possible efficiency in the checking of costs.

2. The Committee's inquiries have proceeded along the lines indicated in the Second Progress Report, more particularly in connexion with an examination of the conditions applicable to Annexé contractors and the results of their operations. It is now desired to report on this phase of munitions production.

ANNEXE CONTRACTS.

ESTABLISHMENT OF ANNEXES.

3. Prior to the outbreak of war a Committee comprising officers from the various Defence Services was functioning under the name of the Principal Supply Officers' Committee, and certain of its operations were carried out in collaboration with the Advisory Panel on Industrial Organization. As far back as 1938 the Committee approached certain State Government Departments and industrial undertakings with the object of obtaining workshop space for the installation of equipment for the production of munitions. As a result of these negotiations facilities were provided either in existing factories or by the erection of new buildings. In the main, land and buildings were made available without cost to the Commonwealth, and tenancy was secured under a formal lease at a nominal rental for a period of ten years.

4. On the formation of the Department of Munitions in June, 1940, the scheme for the establishment of Annexes was greatly extended, and it became necessary for the Government, in the majority of cases, to provide the necessary funds for the provision of workshop space. This marked the commencement of a concentrated effort towards the production of munitions and armaments by industrial firms. The functions of the new Department had previously formed part of the operations of the Department of Supply and Development, the latter continuing to procure, through its Contracts Board, other requirements of the fighting forces, such as food, clothing, &c.

5. In accordance with section 8 of the *Supply and Development Act 1939*, an Advisory Accountancy Panel was set up in June, 1939, to assist the Government in its consideration of schemes of costing and profit control in connexion with the production of munitions. It continued to function until June, 1940, when the office of Director of Finance was created in the Department of Munitions. Mr. E. V. Nixon, C.M.G., Chartered Accountant of Melbourne, was appointed and still continues to hold this responsible office in an honorary capacity. Prior to this appointment, Mr. Nixon was Chairman of the Advisory Accountancy Panel.

CLASSIFICATION OF ANNEXE CONTRACTORS.

6. Annexes may be grouped under the following classifications:—

(a) *State Government Annexes*.—Considerable assistance has been rendered by the various State Governments by the establishment of Annexes at railway workshops for the production of munitions, armament and aircraft components. The Committee has not made any special investigation into this type of Annexé.

JOINT COMMITTEE ON WAR EXPENDITURE.

(Appointed 3rd July, 1911.)

Senator the Hon. A. J. McLACHLAN, Chairman.

† Senator T. C. ARTHUR.
* Senator W. P. ANBLEY.
* Senator R. E. CLOTHIER.
† Senator R. DARCEY.
† Senator C. A. LAMB.

A. O. BADMAN, Esquire, M.P.
† A. J. BECE, Esquire, M.C., M.P.
* W. P. CONELAN, Esquire, M.P.
W. A. JOLLY, Esquire, C.M.G., M.P.
H. V. JOHNSON, Esquire, M.P.
* G. LAWSON, Esquire, M.P.
W. V. McCALL, Esquire, M.P.
† C. A. A. MORGAN, Esquire, M.P.
D. MULLCAHY, Esquire, M.P.
Hon. T. PATERSON, M.P.

* Discharged from attendance 12th November, 1941.
† Appointed 12th November, 1941.
† Appointed 12th November, 1941; discharged from attendance 6th March, 1942.
† Discharged from attendance 6th May, 1942.

- (b) *Contractors providing Land and Buildings.*—This group comprises mainly those who were approached prior to the outbreak of war to co-operate with the Commonwealth to organize factories for the manufacture of munitions in case of emergency. In some cases a portion of the plant required was also made available by the contractor.
- (c) *Contractors providing Land for Building Sites.*—In this group the contractor made available land under lease to the Commonwealth for the erection thereon of buildings at the expense of the Commonwealth. It also includes some of the contractors classified in (b) above in cases where factory buildings have been erected in addition to those originally agreed to be provided free of cost to the Commonwealth.

ANNEXE BUILDINGS.

7. In the case of the earlier established Annexes it was usual for the contractor to erect the buildings at his own expense. With the big expansion of the munitions programme, however, the Commonwealth undertook, in most cases, to bear the cost of building construction, and provisions were included in agreements to grant contractors an option of purchase at the expiration of the contract.

8. A number of Annexes have been inspected by Members of the Committee. In some instances it has been noted that elaborate buildings of a non-movable nature have been erected and modelled on the style of the contractors' own buildings, or so located that they would be of little value to other than the particular firm concerned. This has, no doubt, been arranged with a view to their ultimate incorporation as part of the contractors' own establishments. The Committee is of opinion that, in some such cases, suitable buildings could have been erected at less expense to the Commonwealth. Buildings of a permanent and costly character should only be erected when the Annexe contractor has given a definite undertaking to purchase on an acceptable basis at the conclusion of the agreement between the Commonwealth and the contractor. In the absence of such an undertaking, buildings should be of the temporary, easily removable type.

PLANT AND EQUIPMENT.

9. With minor exceptions the Commonwealth provides the plant and equipment necessary for the operation of Annexes. No rental charge is made against the contractor nor is depreciation allowed as a cost against production upon which the contractor's profit is based. The practice is for the Department to charge depreciation against the manufactured goods in its own accounts.

FINANCIAL ASSISTANCE FROM COMMONWEALTH.

10. Prior to 1st July, 1941, it was the practice of the Department to make periodical progress payments to contractors based generally on the work performed to a given date. Under this system costs had to be carefully checked by the Departmental Costing Officers before payment could be effected. This often involved considerable delay, and contractors were thus liable to be placed in an embarrassing position.

11. To remedy this unsatisfactory position, and to place all contractors on an equal financial basis, the Director of Finance authorized, as from 1st July, 1941, that funds sufficient to meet working expenses be made available to contractors by means of an imprest cash advance. Under this system a Commonwealth Bank Account is opened for the Annexe contractor, to the credit of which is placed an advance of Commonwealth funds estimated as sufficient to meet the Annexe expenditure for material, labour, &c., for a particular period, usually three weeks. Fortnightly, the contractor lodges a claim for expenditure incurred, and the amount of the claim is paid to the credit of the Imprest Account, thus restoring the advance to its original total. A continuous audit of these claims is made by the Cost Investigation Section.

12. From evidence tendered it appears that this system is proving in practice to be most satisfactory. It should be noted that in this way the contractor is called upon to provide little, if any, working capital to finance the operations of the Annexe.

DETERMINATION OF PROFIT.

13. The question of the determination of Annexe profits is one to which the Committee has devoted much attention.

14. Annexe contractors with existing organizations embracing trained executives, technical staff and skilled operatives, are eminently placed to render great assistance to the Commonwealth in the manufacture of munitions. There is abundant evidence that they have done so, and in many instances at some dislocation to their customary business activities. Generally, they have received the benefit accruing from preference in supplies of plant and

material for Annexe production. Notwithstanding that Annexe contractors generally have been called upon to provide little, if any, capital, and are reimbursed for all direct expenditure, excepting those who provide buildings and plant without charge to the Commonwealth, they do render valuable services of an intangible nature. In view, therefore, of the unusual circumstances surrounding the establishment and operation of Annexes, and the complexity of relating profits to the several other factors which should be considered in arriving at an equitable basis of remuneration, it must generally be conceded that the question of what is a reasonable profit is largely one of opinion.

15. It has been ascertained that the Principal Supply Officers' Committee, acting on the advice of the Advisory Panel on Industrial Organization, adopted, as a general basis, a rate of profit to Annexe contractors of 4 per cent. on cost of production.

16. Although some contractors operate without remuneration, or on a margin of profit below 4 per cent., the majority of Annexe contracts have been entered into on a basis of 4 per cent. profit on cost of production, but even on that basis variations have been made in a few instances, such as:—

(a) payment of a fixed remuneration per unit of production with provision for fixation of a Target price; and

(b) payment of an annual Management Fee subject to reduction in the event of unsatisfactory production, with provision for the fixation of a Target price.

17. It must be accepted that the rate of 4 per cent. on production as the general basis of profit was the margin adopted as the measure for computing a reasonable return for services rendered. There is clear evidence that, at the time the rate was fixed, only a moderate volume of production was anticipated. The normal working week was then 40 44 hours, whereas, with the necessity for greatly increased production, multiple shifts were introduced, working hours thereby being increased nearly threefold, and greater in many cases. The question arises as to whether the same margin of profit should continue to operate to an unlimited extent in proportion to this higher output. If no limit is applied it is understandable that unreasonable high profits may be attained.

18. Costs of material and wages have increased substantially since 1939. It is, therefore, evident that the resultant profit was much greater in 1941 than in 1939 when the rate of 4 per cent. profit on the cost of production was assessed.

19. In accordance with the Standard Conditions of Contract laid down by the Department of Munitions, Production Cost, on which is calculated the percentage of profit, is the total ascertained cost of operating the Annexe, and includes direct charges for labour, material and other expenses, also overhead costs. The latter includes a reasonable charge for Directors' fees and administrative expenses. The contractor is, therefore, relieved of all expenditure connected with the operation of the Annexe.

20. It has been advanced in evidence that, with the considerable increase in the volume of turnover, substantial reductions have been effected in the unit costs of production. This is undoubtedly correct. Results indicate that this reduction is attributable mainly to the greater skill of operatives as the result of experience, and to more efficient management. It is obvious that if twice the number of units were produced at half the original cost, the contractor's remuneration would remain the same, while, for the same outlay, the Government would derive the benefit of the greater quantity produced. Where, however, increased output is the result of the introduction of multiple shifts, it will be seen that the total costs of operations will (though to a somewhat lesser degree) be correspondingly increased. There is a similar effect on the total reward earned by the contractor, even though unit costs may have been reduced as a result of the larger output. Take as an illustration the production of 702,139 units at a cost of £338,113, with a resulting reward to the contractor of £12,525, and contrast this with a production for a similar period of 1,418,434 units at a cost of £543,798 and a return to the contractor of £21,476. Although the unit cost of production has been reduced, by reason of the greatly increased output the total reward payable to the contractor would be approximately 50 per cent. higher than in the previous period. To the mind of this Committee, it is considered that the burdens of management are not likely to increase in proportion to the growth in the value of output, and if 4 per cent. be regarded as a reasonable remuneration for the management of a factory with a turnover of £338,113, it becomes an unnecessarily high basis when applied to an output of similar units to a value of £543,798.

21. An important anomaly occasioned by the allowance of a flat rate of 4 per cent. on cost of production is cited in the case of materials. The variation in some types as compared with others is very substantial—in one type material might represent less than 40 per cent. of the total cost of production, while in another it may be as high as 60 per cent.

RESULTS OF OPERATIONS.

22. The Committee has not been able to examine the results of the operations of all Annexes. Approximately 80 are operating at the present time, but many of them are not yet in production, while others have not been operating long enough to enable the Committee to arrive at any definite conclusions. It has, however, endeavoured to secure a cross section covering many types of work, both light and heavy, carried out in Munition Annexes, and the operations of eleven companies were selected—five in Victoria and six in New South Wales—and it considers that the conditions of "Cost-plus" contracts applying to these companies can be regarded as applying generally to the majority of Annexes.

23. Statements have been made before the Committee indicating that the present system has resulted in satisfactory costs to the Commonwealth and reasonable returns to contractors. The Committee, however, while admitting that contractors generally have made every endeavour to keep production costs at a minimum, is of opinion that excessive profits have been and are being made in many instances under the existing arrangement of determining profits solely on costs of production.

24. The Committee realizes, however, that as a result of greater efficiency in management and the increased skill of operatives as a result of experience, and the fact that overhead charges have risen to a relatively small extent as compared with the additional production, the unit costs of munitions have been greatly reduced. Evidence has been tendered showing that in some instances the reduction has been as much as 50 per cent. on the first production order, and that had such contractors been operating on a fixed price, based on original estimates, much greater profits would have been made.

25. The Committee attributes the excess profits made to the huge increase in the volume and value of production brought about mainly by—

- (a) the introduction of multiple shifts; and
- (b) the increase in wages and costs of material on pre-war levels.

26. In a number of Annexe contracts provision was made for the determination of a Target price based on the cost of a trial order. This provision has been applied in only a few instances and generally contractors have continued to operate on a cost-plus-percentage-of-profit basis. However, in two cases investigated by the Committee, Target prices were fixed on the costs of production covering a comparatively small output. Following the fixation of the Target prices unit costs were very much reduced, and contractors operating on such prices benefited considerably from the savings effected.

27. The value of the Target price is more theoretical than real. If it is fixed too high the remuneration to the contractor is much higher than it would be on an ordinary "Cost-plus" basis. Where experience has shown that the contractor is conscientious and efficient the interests of the Commonwealth are better served by a straight-out "Cost-plus" contract without the Target price.

28. The Committee is strongly of opinion that no Target price should be fixed unless the costs, based on full-capacity production, can be ascertained with a substantial degree of accuracy.

29. Further, in view also of changing conditions, and in the light of previous experience, it is considered that where Target prices have been determined, these should be subject to review at intervals of not more than six months.

30. The Committee notes that the cost-plus-percentage-of-profit basis was departed from in connexion with a recently established Annexe. The conditions regarding the establishment of this Annexe are similar to those of several others of longer standing, but the terms of contract provide for the payment of an annual Management Fee which may be subject to reduction if a satisfactory volume of production is not maintained. This fee is equivalent to little more than 2 per cent. on the estimated cost of production for one year. The Committee is of opinion that even the fee fixed in this case is excessive and should be immediately reviewed.

31. As previously mentioned, the Commonwealth provides nearly all the capital necessary for the establishment of Annexes. Therefore, in the majority of cases, contractors are merely acting in a managerial capacity for the Commonwealth Government, and the payment of a fee to cover such services appears to the Committee as being an improvement on the older system of allowing a profit calculated on total production costs. It considers, however, that the fixation of a Management Fee should be made on the recommendation of a Panel comprised of a qualified engineer, a skilled cost accountant, and a business man. Provision should also be made whereby the incentive to maximum production is maintained.

TAXATION OF COMPANY PROFITS.

32. It has been argued, and perhaps with some justification, that the chief concern of the Commonwealth should be to ensure that its munitions are being produced at the minimum cost, and that if excessive profits are being made by contractors, the question of such profits can be safely left in the hands of the Commissioner of Taxation to deal with.

33. The Committee does not subscribe to this view. In the first place, as pointed out in the Committee's Second Progress Report, not even at the peak of the taxation scale are all excess profits collected, and, further, that as the allowance of State Income Tax as a deduction in the assessment of Commonwealth tax is permitted, the tax payable to the Commonwealth is reduced accordingly. Secondly, taxation in its many forms may vary according to Government policy. Finally, it believes that, as the amount of profit earned by the contractor forms part of the ultimate cost to the Government, the aim of maintaining costs at a minimum is not being achieved if profits are allowed in excess of what are considered reasonable.

COST INVESTIGATION.

34. The importance of a thorough system of cost investigation as an integral feature of the economic operation of "Cost-plus" contracts was stressed by the Committee in its Second Progress Report. Further evidence taken in this connexion indicates that owing to the shortage of suitably skilled staff the position is still not satisfactory.

35. In regard to sub-contractors' costs it is understood that, generally, these are the responsibility of the major contractor, and no regular check is undertaken by Departmental officers.

36. The Committee again recommends that every effort should be made, in particular by means of salary inducement, to augment the staff of the Cost Investigation Branch with officers qualified in this specialized field of accountancy. It is also considered highly desirable that sub-contractors' costs should be the subject of check whenever possible.

SPECIAL CONTRACTS FOR MACHINING TOOLS AND GAUGES.

37. Reference was made in the Committee's Second Progress Report to the special form of contract known as the "D.M.T." contract drawn up by the Directorate of Machine Tools for the manufacture of machining tools (loose tools for operation in machine tools) and gauges, in order to meet the convenience of small contractors who do not keep proper books. Preliminary investigations in course at that time indicated that the then basis of contract was proving unsatisfactory in operation. Unduly high profits were made, the system being faulty in that provision was not made for varying rates of wages. It was thus open for a contractor to employ juvenile operatives at a low hourly wage and receive payment on the basis laid down for adult employees.

38. As from 1st January, 1942, however, the rates payable under these contracts were amended by the Department of Munitions. The Committee has observed this alteration with satisfaction, and it is anticipated that the anomalies noted previously will be overcome. These contracts actually represent only a small fraction of the total expenditure on munitions.

SUMMARY OF CONCLUSIONS.

39. As a result of its inquiries the Committee has arrived at the following conclusions:—

- (a) Contractors operating Annexes have rendered valuable service to the Commonwealth in the speeding up of munitions and armament production.
- (b) The Committee is of opinion that, in the case of Annexes, some form of "Cost-plus" contract was inevitable. It does not maintain that there was no justification for the general principle of calculating profits to Annexe contractors at a rate of 4 per cent. on cost of production. It considers, however, that, in view of the vastly increased volume of production and the fact that the major elements of cost are always subject to fluctuation, a fixed remuneration, based generally on the value of the services to be rendered, would have been preferable to the basis adopted, provided that the incentive to maximum production is always maintained.
- (c) By reason of the fact that contractors are called upon to provide little, if any, capital, and further, that all current production expenses are met by the Government by means of an *Imprest cash advance*, such contractors are merely acting in a managerial capacity for the Commonwealth.