

August 1995

DEFENSE RESTRUCTURING COSTS

Payment Regulations Are Inconsistent With Legislation





United States
General Accounting Office
Washington, D.C. 20548

**National Security and
International Affairs Division**

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August 10, 1995

The Honorable Strom Thurmond
Chairman
The Honorable Sam Nunn
Ranking Minority Member
Committee on Armed Services
United States Senate

The Honorable Floyd Spence
Chairman
The Honorable Ronald V. Dellums
Ranking Minority Member
Committee on National Security
House of Representatives

Section 818 of the National Defense Authorization Act for Fiscal Year 1995 sets out certain requirements governing payments made by the Department of Defense (DOD) to its contractors for costs associated with business combinations, including mergers and acquisitions. Normally, after a business combination, a new company will undertake restructuring activities such as closing facilities, eliminating jobs, and relocating employees.

Section 818 prohibits payment of restructuring costs until a senior DOD official certifies that projected savings from the business combination are based on audited cost data and should result in overall reduced costs to DOD. Section 818 also requires the Secretary of Defense to report annually on DOD experience with business combinations, including whether savings associated with each restructuring actually exceed costs.

In response to section 818 requirements, DOD issued interim regulations on restructuring costs effective December 29, 1994. As required by the statute, we reviewed the regulations to determine whether they (1) are consistent with section 818, applicable procurement laws, and the Federal Acquisition Regulation (FAR) and (2) ensure that restructuring costs are paid only when in the best interests of the United States.

Results in Brief

DOD's regulations do not comply with section 818 requirements because all restructuring costs associated with defense contractor business combinations, for which contractors may be reimbursed, will not be

subject to the section's certification requirements. The exclusion of costs from the section's certification requirements is due to a distinction DOD makes in types of restructuring activities. By excluding some restructuring costs that should be subject to section 818 certification requirements, DOD will not be able to ensure that the payment of these costs are made only when in the best interests of the United States.

In addition, the regulations do not contain a mechanism to ensure that DOD will be able to meet the section's annual reporting requirement to the Congress. Moreover, DOD plans to pay restructuring costs up to the amount of savings projected to result from a business combination, which would result in the payment of those costs without significant projected savings to DOD.

Background

Contractors historically have not been permitted to recover restructuring costs through contracts that were transferred from one contractor to another in connection with a business combination. The rationale was that the government should not pay increased contract costs that were incurred only because the contractor decided to combine with another firm.

In July 1993, DOD changed its long-standing practice of not paying restructuring costs. The change, made after several major defense contractors approached DOD, was intended to encourage contractors to consolidate and thereby reduce operating and contract costs. The change allowed contractors to charge DOD for costs incurred in connection with a business combination if such costs were permitted by the FAR¹ and if a DOD contracting officer determined that a business combination would result in overall reduced costs or preserve a critical defense capability.

The Congress enacted section 818 the following year, prohibiting payment of restructuring costs until a senior DOD official certifies that projections of savings have been audited and that the savings should result in overall reduced costs to DOD. The Congress also required the Secretary of Defense to issue implementing regulations by January 1, 1995, and submit annual reports on restructuring activities during 1995-97.

¹The FAR contains guidelines for determining whether a particular cost is an allowable charge to a government contract. Costs associated with business combinations that are specifically identified as unallowable in the FAR include legal and consulting fees.

DOD's Regulations Exclude Some Restructuring Costs From Section 818 Certification Requirements

DOD's regulations do not comply with section 818 requirements because they do not require all costs associated with a business combination to be subject to the section's certification requirements. In its regulations, DOD defines two kinds of "restructuring activities"—internal and external.

- Internal activities are those occurring after a business combination that involve the facilities or workforce of only one of the companies involved in the business combination. These restructuring costs, even if associated with the business combination, would not be subject to the certification requirements of section 818.
- External activities are those occurring after a business combination that involve facilities or workforces from both of the previously separate companies. The costs associated with external activities would be subject to section 818 certification requirements.

Section 818 makes no such distinction but addresses the allowability of restructuring costs regardless of whether the facilities or workforces from both or only one of the previously separate companies were involved. The operative condition in section 818 is that the restructuring costs be "associated with" the business combination.

The significance of the distinction made by DOD between internal and external restructuring activities is illustrated by the following example offered by one of the military services. Assume that Company A purchases Company B and that both companies operate similar test laboratories. Assume further that as a result of the business combination, Company A eliminates its laboratory facilities and workforce. Although Company A would not have closed its laboratory without the business combination, under DOD's interim regulations, the restructuring activity would be defined as internal and thus excluded from the required certification because the facilities and workforce of only one of the two previously separate companies were involved. By excluding these "internal" costs, DOD will not be capturing all restructuring costs subject to section 818 and, therefore, will not be able to determine whether the savings from the business combination result in an overall reduced cost to DOD. Accordingly, DOD will not be able to ensure that restructuring costs are paid only when in the best interests of the United States.

Regulations Do Not Require Data Needed to Respond to Annual Reporting Requirements

DOD's regulations do not address section 818's requirement for the Secretary of Defense to report annually to the Congress on its experience with business combinations, including whether the savings associated with restructuring activities exceed the costs. It is questionable whether DOD can prepare such a report without using contractor cost and savings data because DOD is not independently collecting such data. According to DOD officials, there are no plans at this time to require contractors to submit data that would show that actual savings exceed restructuring costs paid by DOD. Without such data, the Congress will have no assurance that its decision to permit the payment of restructuring costs only in limited circumstances is actually resulting in overall reduced costs to DOD.

DOD Would Pay Restructuring Costs Without Significant Projected Savings

In a July 1994 congressional hearing, the Deputy Secretary of Defense testified that restructuring activities in the defense industry were expected to result in significant benefits to DOD—with savings exceeding costs by as much as 7 times. The Deputy Secretary also testified that DOD should not pay restructuring costs unless it was absolutely sure that savings would exceed costs. According to senior DOD officials, DOD now plans to pay restructuring costs up to the amount of the savings projected to result from the business combination, thus resulting in the payment of these costs without significant projected savings to DOD. A senior DOD official said that payments should be made to contractors even if overall reduced costs do not result because such payments would encourage an orderly downsizing in a defense industry that currently has excess capacity and DOD would benefit in the long run.

Recommendations

We recommend that the Secretary of Defense

- revise the regulations to make clear that all restructuring costs associated with a business combination, whether involving internal or external activities, are subject to section 818 certification requirements and
- determine how DOD will comply with the annual congressional reporting requirement, and if contractor data is necessary for compliance, incorporate such data collection requirements in DOD's regulation.

Agency Comments and Our Evaluations

In commenting on a draft of this report, DOD said that it would revise the definitions of internal and external restructuring activities to clarify that activities affecting the operations of both previously separate companies are external activities. DOD concurred that it should have a workable plan

for collecting data required for the section 818 requirements and stated that it would issue a memorandum to cognizant Defense Contract Management Command and Military Department activities setting forth the methods for complying. (Subsequent to commenting on a draft of this report, DOD issued the memorandum, which we have not reviewed for compliance with section 818 requirements.)

A draft of this report contained a third recommendation that DOD develop an implementation plan to comply with section 818's requirement that restructuring costs be paid only if projected savings from a business combination should result in overall reduced cost to DOD. In commenting on the draft report, DOD stated that it has not seen and does not anticipate situations where costs exceed savings and would not pay costs in excess of savings in the unlikely event that costs were greater. Accordingly, we deleted the recommendation. We will monitor restructuring payments and savings in the future.

DOD indicated that it did not agree with our statement that in 1993 DOD changed its long-standing practice of not paying restructuring costs. Although the FAR provides contracting officers with the flexibility to negotiate appropriate terms on transferred contracts, our observation that a change in practice occurred was based on documents signed by senior DOD officials and interviews. For example, an April 9, 1993, letter from the Commander, Defense Contract Management Command, stated that current standard language in the FAR prevented any increased costs on transferred contracts and suggested that a review of DOD policy in this area may be warranted. The Under Secretary of Defense for Acquisition's July 21, 1993, response stated that restructuring costs should be allowed and the standard language be revised if there were projected savings. DOD officials told us that increased costs had not been allowed on transferred contracts before the July 1993 letter.

DOD's comments are presented in their entirety in appendix I.

Scope and Methodology

We discussed various aspects of restructuring activities with officials from the Offices of the Assistant Secretary of Defense for Economic Security; the Director of Defense Procurement; the Secretaries of the Army, the Air Force, and the Navy; the Cost Accounting Standards Board; the Defense Contract Management Command; the Defense Contract Audit Agency; and the DOD Inspector General.

We compared other procurement laws, applicable regulations, and section 818 and its legislative history to DOD's interim regulations and examined various proposals, documents, reports, and other records related to restructuring activities by defense contractors. We also examined comments by potentially affected parties as the interim regulations were being formulated and after they were issued. We examined various documents, reports, and other records relative to specific restructuring activities by several defense contractors. In addition, we visited a contractor involved in a business combination and examined information related to restructuring projects resulting from the combination.

We performed our review between September 1994 and May 1995 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Chairmen of the Senate Committee on Governmental Affairs and the House Committee on Government Reform and Oversight; the Secretaries of Defense, the Army, the Air Force, and the Navy; the Administrator, Office of Federal Procurement Policy; the Commander, Defense Contract Management Command; and the Director, Defense Contract Audit Agency. We will provide copies to other interested parties upon request.

Please contact me at (202) 512-4587 if you or your staff have any questions concerning this report. Major contributors to this report are listed in appendix II.

A handwritten signature in black ink, appearing to read "David E. Cooper". The signature is stylized with a large, flowing "D" and "C".

David E. Cooper
Director, Acquisition Policy, Technology,
and Competitiveness Issues

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Abbreviations

DOD	Department of Defense
FAR	Federal Acquisition Regulation

Comments From the Department of Defense



ACQUISITION AND
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30 JUN 1995

Mr. David E. Cooper
Director, Acquisition Policy, Technology
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National Security and International
Affairs Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Cooper:

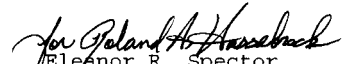
This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report, "DEFENSE INDUSTRY RESTRUCTURING: Deficiencies in Draft Regulation on Payments and Implementation Plan," dated June 8, 1995 (GAO Code 705078/OSD Case 9887). The DoD partially agrees with the report.

The Department concurs that DoD should have a workable plan for collecting data required for the Section 818 reporting requirement. However, the Department nonconcurs that DoD regulations do not comply with Section 818 requirements.

The DoD also disagrees that, in July 1993, DoD changed its long-standing practice of not paying restructuring costs on transferred contracts. The Federal Acquisition Regulation provides flexibility to contracting officers to negotiate appropriate terms for transferred contracts when a business combination occurs. Prior to July 1993, the only restriction DoD placed on the exercise of this flexibility was set forth at Defense Federal Acquisition Regulation Supplement 242.1203(d)(i): before making substantial alterations to the standard novation agreement format, contracting officers must coordinate with the affected Military Departments and NASA. This was the long-standing policy of the Department.

The detailed DoD comments on the report findings and recommendations are provided in the enclosure.

Sincerely,


Eleanor R. Spector
Director, Defense Procurement

Enclosure



See p. 2.

GAO DRAFT REPORT - DATED JUNE 8, 1995
(GAO CODE 705078) OSD CASE 9887

"DEFENSE INDUSTRY RESTRUCTURING: DEFICIENCIES IN DRAFT
REGULATIONS ON PAYMENTS AND IMPLEMENTATION PLAN"

DEPARTMENT OF DEFENSE COMMENTS

* * * * *

FINDINGS

FINDING A: DoD's Regulations Exclude Some Restructuring Costs From Section 818 Certification Requirements. The GAO reported that DoD's regulations do not comply with Section 818 requirements because they do not require all costs associated with a business combination to be subject to the Section's certification requirements. The GAO noted that, because the DoD excludes internal costs of restructuring activities, the DoD will not be capturing all restructuring costs subject to Section 818 and, therefore, will not be able to ensure whether the savings from the business combination results in an overall reduced cost to the DoD. The GAO concluded that, therefore, the DoD will not be able to ensure that restructuring costs are paid only when in the best interests of the U.S. (pp. 1-6/GAO Draft Report)

DoD RESPONSE: Nonconcur. DoD disagrees with the illustration of internal restructuring on page 5 of the draft report. The GAO states that, if Company A purchases Company B and then eliminates duplicative test laboratory facilities and workforce at Company A, the restructuring activity would be defined as internal under the DoD regulations. However, if the laboratory work previously performed at Company A is now performed at Company B, the operations of both previously separate companies are affected. This illustration meets the Defense Federal Acquisition Regulation Supplement (DFARS) definition of external, not internal, restructuring.

Nonetheless, to prevent this unintended interpretation and to reduce potential disagreements, DoD will clarify the definitions of internal and external restructuring activities in the regulations by replacing the phrase "involve facilities or workforce from" with "affect the operations of."

FINDING B: DoD Plans to Pay Contractors Without Overall Reduced Costs. The GAO reported that the DoD plans to pay restructuring costs up to the amount of the savings resulting from the business combination, thus resulting in the payment of the costs without an

ENCLOSURE

See p. 3.

overall savings to the DoD. The GAO concluded that the DoD current plans, therefore, are not consistent with either the July 1994 congressional hearing (OSD Case 9752) previous testimony or Section 818 requirements. (p. 6/GAO Draft Report)

DoD RESPONSE: Nonconcur. The statement on page 6 of the draft report that the Deputy Secretary of Defense testified in a July 1994 congressional hearing that expected savings from restructuring activities would exceed costs by factors of four to seven times is incorrect. In his written statement, the Deputy Secretary testified that rough data on projected savings for four restructurings showed projected savings of one and a half to seven times the projected costs. He went on to state that this suggests the magnitude of savings that are possible, but that necessary reviews and audits were not yet completed.

If the GAO is correctly interpreting Section 818 that overall reduced costs are achieved when savings exceed costs by as little as one cent, then the penny difference between the GAO interpretation and DoD policy is insignificant.

DoD has not seen and does not anticipate situations where contractor restructuring costs exceed projected savings. If there is a contractor in this situation and the GAO interpretation is followed, the contractor might be tempted to understate restructuring costs in its proposal, or reduce its claim for restructuring costs, so that costs are just below savings. While auditors might find this understatement, it would be difficult and additional audit time and effort would be required.

In the unlikely event that savings do not exceed costs, DoD will not pay the excess costs. The policy set forth in DFARS 231.205-70(d)(8) is quite clear that cost ceilings negotiated for restructuring projects may not exceed projected restructuring savings on a present value basis. It would not be fair for DoD to refuse to pay the reasonable portion of such otherwise allowable costs, particularly when it would do so for contractors with small net savings amounts, or those where a restructuring has not taken place, but where similar costs are incurred on a recurring basis as rearrangements.

FINDING C: Regulations Do Not Require Data Needed To Respond To Annual Reporting Requirements. The GAO reported that DoD regulations do not address Section 818 requirements for the Secretary of Defense to report annually to the Congress on its experience with business combinations, including whether the savings associated with restructuring activities exceed the costs. The GAO questioned whether the DoD can prepare such a report without using contractor cost and savings data because the DoD is

See p. 5.

not independently collecting such data. The GAO found that there are no plans at this time to require contractors to submit data that would verify that actual savings exceed restructuring costs paid by the DoD. The GAO concluded that, without such data, we do not believe Congress will have assurance that the DoD decision to permit the payment of restructuring costs is actually resulting in overall reduced costs to the DoD. (p. 7/GAO Draft Report)

DoD RESPONSE: Partially concur. The DoD agrees that the Department should have a workable plan for collecting data required for the Section 818 reporting requirement. However, the DoD does not agree that regulations on cost allowability matters should address this.

"Savings" are not recorded within a contractor's book of accounts and are not readily available. They could be estimated by comparing cost projections before restructuring with actual costs after restructuring, or by comparing actual costs after restructuring with estimated costs that would have been incurred had there been no restructuring. However, restructuring is not the only determinant of actual costs. Other factors such as inflation, business fluctuations, accounting system changes, subsequent reorganizations, and unexpected events are also determinative.

It would not be feasible to completely isolate the effect of restructuring from other complex determinants of the difference between projected and actual costs over a long period of time. For this reason, it appears that actual experience would probably be best estimated by computing the change in forward pricing rates resulting from restructuring activities and applying this difference to actual base costs for each year.

The method chosen should carefully consider the availability and accuracy of the information to be reported and the cost of accumulating that information. In today's environment, scarce resources must be applied with increasing efficiency to effectively accomplish missions. The Section 818 reporting requirement on actual experience should be viewed in this light.

Instead of including the reporting requirement in the DoD regulation on cost allowability, a memorandum will be issued to the cognizant Defense Contract Management Command and Military Department activities establishing the responsibility for providing data responsive to the requirements of Section 818.

See p. 4.

* * * * *

RECOMMENDATIONS

RECOMMENDATION 1: The GAO recommended that the Secretary of Defense revise the regulations to make clear that all restructuring costs associated with a business combination, whether involving internal or external activities, are subject to Section 818 certification requirements. (p. 7/ GAO Draft Report)

DoD RESPONSE: Partially concur. Generally, DoD does not believe that internal restructurings are closely connected to or associated with business combinations. However, as stated in the DoD response to Finding A, DoD will revise the definitions of internal and external restructuring activities to make it clear that activities that affect the operations of both previously separate companies are external restructuring activities.

RECOMMENDATION 2: The GAO recommended that the Secretary of Defense determine how the DoD will comply with the annual Congressional reporting requirement, and if contractor data is necessary for compliance, incorporate such data collection requirements in the DoD regulation. (pp. 7-8/GAO Draft Report)

DoD RESPONSE: Concur. DoD will issue a memorandum by August 1 to cognizant Defense Contract Management Command and Military Department activities setting forth methods for complying with the requirements of Section 818.

RECOMMENDATION 3: The GAO recommended that the Secretary of Defense instruct appropriate DoD personnel to develop an implementation plan that will comply with Section 818 requirements that payment of restructuring costs be made only if projected savings from a business combination will result in an overall reduced cost to DoD. (p. 8/GAO Draft Report)

DoD RESPONSE: DoD believes this has already been accomplished. The regulations are consistent with both previous testimony and Section 818 requirements. See also the DoD response to Finding B.

Major Contributors to This Report

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