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Testimony

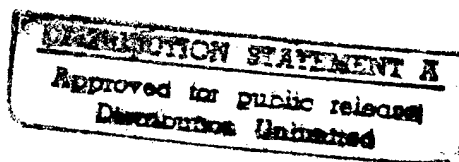
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Committee on Armed Services, United States Senate

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DEFENSE INDUSTRY RESTRUCTURING

Cost and Savings Issues

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here this afternoon to discuss our work on the costs and savings associated with defense industry restructuring. The issue of whether the Department of Defense (DOD) should be paying defense companies for restructuring costs associated with acquisitions and mergers has been a controversial one—and one that is not well understood.

Today, I will provide a brief overview of

- DOD's decision to pay restructuring costs,
- the process DOD uses to ensure that paying restructuring costs is in the government's best interest, and
- the amount and nature of costs that DOD has paid and estimates of savings it has realized.

After this overview, I will provide details about each of these issues.

Overview

Over the last several years, defense contractors have attempted to become more efficient and competitive by such activities as closing or combining facilities and eliminating jobs. DOD has always paid for its share of the costs of these activities when they were undertaken as part of an internal restructuring by a single contractor. Until July 1993, however, DOD did not pay for restructuring costs on certain contracts transferred from one company to another company as a result of a business combination. At that time, DOD changed its practice and began allowing restructuring costs to be charged to these contracts as long as certain conditions were met. Principally, such costs were allowed as long as projected savings exceeded projected costs. The dollar impact of this decision may be less than some anticipated. DOD estimates that only 10 percent of the costs DOD had paid through September 1996 resulted from the change in practice.

As of March 31, 1997, five combinations had gone through a certification process that is required before DOD pays restructuring costs. We recently completed an evaluation of four of the five certified combinations, as well as one additional combination that DOD included in its reports to Congress. Overall, we found that DOD estimated its share of projected restructuring costs was about \$755 million, while its estimated share of the savings resulting from these combinations was at least \$3.3 billion. At the time our review, the five business combinations had incurred about \$849 million for

a wide range of restructuring activities, with about 10 percent of these costs being for benefits and services to laid-off workers. Services for laid-off workers were also being funded by federal grants and through the contractors' normal overhead costs.

Through September 1996, DOD reported that it had paid \$179.2 million in restructuring costs while realizing \$346.7 million in savings. In other words, for every \$1.00 DOD had paid in restructuring costs, it estimated savings of \$1.93 had been realized. However, it is extremely difficult to trace restructuring savings into reduced contract prices because many factors other than restructuring activities affect contract prices. Due to the interest in this area, we plan to further explore whether restructuring savings can be traced to reduced contract prices.

I would now like to go back and discuss each issue in a little more detail.

DOD's Decision to Pay Restructuring Costs

Defense contractors are restructuring and consolidating to become more efficient and competitive as defense business has declined over the last several years. Contractors, whether or not they are involved in an acquisition or merger, have been closing facilities and disposing of assets; eliminating jobs; relocating employees; and combining facilities and operations. The costs incurred for such activities that are undertaken as part of an internal restructuring effort can be charged to defense contracts as long as the costs are allowable, allocable, and reasonable as required by the Federal Acquisition Regulation (FAR).

Prior to July 1993, however, DOD did not permit contractors to charge restructuring costs to flexibly priced¹ contracts that were transferred² from one defense contractor to another as a result of a business combination, such as a merger or acquisition. The rationale was that DOD should not have to pay more for its contracts merely because they were transferred from one contractor to another as a result of a business combination.

In response to industry requests, and in an effort to encourage consolidation in the defense industry and thereby reduce contract costs,

¹Flexibly priced contracts refer to a family of contracts under which the total amount paid to a contractor is dependent on the allowable costs the contractor incurs in performing the contract.

²The transfer of contracts from one contractor to another involves a process called novation. The novation process requires a written agreement executed by the buyer, the seller, and the government, in which the government agrees to the transfer.

DOD changed its long-standing practice. On July 21, 1993, the Under Secretary of Defense for Acquisition issued a memorandum permitting contractors to charge restructuring costs to transferred contracts if certain conditions were met. For example, contractors could charge restructuring costs if it was determined that the restructuring activities would likely result in overall reduced costs to DOD. In other words, projected restructuring savings were to exceed costs. The costs charged to transferred contracts also had to comply with FAR requirements for allowability, allocability, and reasonableness. For example, certain organization costs, such as legal and consulting fees applicable to business combinations, cannot be charged to a government contract.

Some believe that the July 1993 change added substantial costs to DOD's contracts. That does not appear to be the case. Through September 30, 1996, the Defense Contract Audit Agency (DCAA) estimated that DOD had paid \$179.2 million in restructuring costs. We asked DCAA to determine how much of these costs resulted from the change in practice. DCAA's work shows that the July 1993 change added only \$18 million, or about 10 percent, more in restructuring costs than DOD otherwise would have paid. In other words, DOD would have reimbursed most of these costs even if it had not changed its practice. The 10 percent in additional costs, however, may not be the same for future business combinations because of differences in the factors that determine the percentage, including the mix of flexibly priced and firm fixed-price contracts and the period of time required for certification.

Process for Safeguarding the Government's Interest

Congressional concerns about safeguarding the government's interest in paying restructuring costs led to enactment of section 818 of the 1995 DOD Authorization Act (Public Law 103-337). Section 818 prohibits DOD's paying restructuring costs until a senior DOD official certifies that projected savings are expected to exceed restructuring costs and requires DOD to submit annual reports to Congress that provide, among other things, information on the payment of restructuring costs to defense contractors involved in business combinations. Congress modified the authority for paying such costs in section 8115 of the 1997 DOD Appropriations Act (Public Law 104-208) by requiring that projected savings exceed costs by a ratio of at least two-to-one on business combinations occurring after September 30, 1996.

In response to section 818, DOD issued regulations on the payment of restructuring costs.³ The regulations contain several features designed to protect the government's interest. For example, contractors are required to prepare proposals containing projected restructuring costs and savings. DCAA is to audit the proposals and payment is to be authorized only after a high-level DOD official certifies that the projected savings should result in overall reduced costs to DOD.

As of March 31, 1997, five business combinations had gone through the required certification process. These combinations were

- the United Defense Limited Partnership (UDLP) between FMC Corporation's Defense Systems Group and Harsco Corporation's BMY Combat Systems Division,
- Martin Marietta Corporation's acquisition of General Electric Company's aerospace and other business segments,
- Northrop Corporation's acquisitions of the Grumman Corporation and the Vought Aircraft Company to form the Northrop Grumman Corporation,
- the merger of the Lockheed Corporation and the Martin Marietta Corporation to form the Lockheed Martin Corporation, and
- Martin Marietta Corporation's acquisition of General Dynamics' Space System Division.

We examined the process used to certify four of the business combinations and found that DOD complied with the restructuring regulations. We did not examine Martin Marietta's acquisition of General Dynamics' Space System Division because we were already examining two other business combinations involving Martin Marietta. For the combinations examined, the contractors submitted restructuring proposals with projected costs and savings; the proposed costs and savings were audited; and a senior DOD official certified that the projected savings should result in overall reduced costs to DOD.

The Defense Contract Management Command told us that 10 additional business combinations either were in the certification process or may result in restructuring proposals. Appendix II provides additional information on these 10 combinations.

³DOD issued interim regulations on the allowability of restructuring costs effective December 29, 1994. After evaluating public comments, DOD published the final regulations in the Federal Register dated April 18, 1996. Section 818 required us to report on the adequacy of the regulations, which we did in Defense Restructuring Costs: Payment Regulations Are Inconsistent With Legislation (GAO/NSIAD-95-106, Aug. 10, 1995).

Amount and Nature of
Estimated
Restructuring Costs

As you are aware, we issued a report earlier this month⁴ that contains information on the projected and incurred restructuring costs for five business combinations, including four of the five certified business combinations, as well as Hughes Aircraft Company's acquisition of General Dynamics Corporation's Missile Operations. This combination did not have to go through the certification process because payment of the restructuring costs was approved before the 1995 DOD Authorization Act was passed; however, we included it in our review because DOD has included the combination in its restructuring reports to Congress.

Overall, we reported that the projected restructuring costs for these five business combinations totaled about \$1.4 billion. Because these costs will be allocated to all of the contractors' customers, DOD's portion of these costs will depend on its share of the contractors' total business base. Consequently, DOD's estimated share of the \$1.4 billion totaled \$755.2 million. Finally, we reported that the five business combinations had incurred costs of about \$849 million for a wide range of restructuring activities, such as disposing of and modifying facilities, consolidating operations and systems, relocating workers and equipment, and eliminating jobs. We grouped the costs into several broad categories to illustrate their nature (see table 1).

Table 1: Incurred Restructuring Costs
by Category

Dollars in millions	
Category	Amount
Disposal and relocation of facilities and equipment	\$452.7
Relocation of employees	100.0
Benefits and services for laid-off workers	88.9
Consolidation of operations and systems	81.4
Restructuring planning and implementation	57.8
Other	68.5
Total	\$849.3

Disposal and relocation of facilities and equipment was the largest category of incurred restructuring costs, amounting to over \$450 million. Of the \$88.9 million expended for benefits and services for laid-off workers, almost 90 percent was for severance pay, about 6 percent was for the temporary continuation of health benefits, and about 4 percent was for reemployment assistance.

⁴Defense Restructuring Costs: Information Pertaining to Five Business Combinations (GAO/NSIAD-97-97, Apr. 1, 1997).

We also found that services for laid-off workers were being funded by federal grants. We identified about \$48 million in Department of Labor grants made either directly to contractors or to locations where workers were laid off as a result of the business combinations. These grants funded activities to help workers seek new employment regardless of whether they were laid off as a result of a business combination or normal downsizing.

Of the \$48 million in Department of Labor grants, about \$17 million was awarded directly to Hughes and Martin Marietta. We recommended in our April 1997 report that the Secretary of Defense obtain information about significant federal grants made directly to defense contractors and include the information in the DOD reports submitted annually to Congress in response to section 818 requirements. We believe including information about Department of Labor grants would provide the Congress more complete information about federal funding used to assist workers in connection with defense contractor restructuring activities. In response to our recommendation, DOD officials stated that they would meet with Labor officials to determine how such information could be made available to DOD for inclusion in its annual reports to Congress.

In addition to grant funds, contractors were providing some services and charging them as normal overhead costs, rather than restructuring costs. For example, UDLP operated an outplacement center where all terminated employees, regardless of why they were laid off, could obtain assistance in seeking a new job. UDLP spent \$205,000 in operating the center over a 3-year period and paid an additional \$109,000 to a consulting firm to assist mid- and senior-level management officials seek new employment. UDLP charged these costs to overhead rather than restructuring costs. Similarly, Northrop Grumman and Lockheed Martin provided counseling and/or outplacement assistance to help workers seek new employment and charged the costs as overhead expenses rather than restructuring costs.

The process by which defense contractors are to be reimbursed for restructuring costs differs from the typical contract payment process. Normally, contractors are allowed to bill government contracts during the same period they incur costs. That is not the case with restructuring costs. Contractors are required to segregate restructuring costs in their accounting records until the certification process I described earlier is completed. After certification, contractors can begin charging restructuring costs to DOD contracts. Contractors are generally permitted to recover restructuring costs over a 5-year period, but the recoupment

period may be shorter, depending on the terms negotiated between DOD and the contractor.

As I noted earlier, the five business combinations we examined incurred about \$849 million in restructuring costs and these costs will be allocated to each of the contractors' customers and paid over a period of time.

Amount and Nature of Estimated Restructuring Savings

DOD expects the consolidation and restructuring occurring in the defense industry will reduce operating costs and thereby reduce contract costs. However, estimating the savings DOD is likely to realize from restructuring activities is difficult. Unlike restructuring costs, restructuring savings are not recorded in a contractor's accounting records. Therefore, neither the amount nor the nature of the savings can be determined by reviewing the accounting records. Consequently, savings must be estimated.

For four of the business combinations we examined, certified restructuring savings totaled about \$5.3 billion, of which DOD's estimated share is \$3.3 billion. These amounts do not include any savings from the Hughes-General Dynamics business combination because the combination occurred before Section 818 was enacted. Consequently, there is not a certified amount of savings for that combination. Additionally, these amounts do not include any savings resulting from Martin Marietta's acquisition of General Dynamics' Space System Division since it was not included within our review.

I would like to make the following three observations about restructuring savings.

- Certified savings are considerably less than the amounts often reported in the media or proposed to DOD.
- DOD estimated that it had realized net savings of \$167.5 million as of September 30, 1996.
- It is extremely difficult to trace restructuring savings into reduced contract prices.

Let me explain each of these points.

First, defense contractors, in announcing mergers or acquisitions, generally provide initial estimates of savings expected to result from the new business combinations. We have observed a tendency for these initial estimates to be overly optimistic. For example:

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- In the case of UDLP, we found that the savings estimated at the time of DOD's certification represented less than 15 percent of the estimate FMC and Harsco originally presented to DOD.⁵
 - In the case of Martin Marietta-General Electric, the savings estimates used for certification purposes were about 56 percent less than Martin Marietta's original estimate.⁶
 - In the case of Lockheed Martin, the certified savings were less than half of Lockheed Martin's initial proposal.

There are various reasons for such differences, including reductions in estimated savings made by the contractors at the time they prepared their restructuring proposals and negotiated reductions in savings based on DCAA audits of the contractors' proposals. Further, DOD limits savings for certification purposes to 5 years. In the case of Lockheed Martin, excluding savings projected beyond the 5-year limit was the principal reason for the difference between the amount Lockheed Martin initially proposed and the amount certified by DOD.

Second, in terms of savings realized, DOD estimated that it had realized net savings of \$167.5 million as of September 30, 1996. DOD's estimate was based on paying restructuring costs totaling \$179.2 million and realizing savings of \$346.7 million. In other words, for every \$1.00 DOD has paid in restructuring costs, it estimates savings of \$1.93 have been realized. DOD officials noted that savings may actually be higher because DOD reviewed only eight contracts for the Hughes-General Dynamics business combination to demonstrate that savings exceeded costs.

Finally, it is extremely difficult to trace restructuring savings into reduced contract prices because many factors other than restructuring activities affect contractor's operations and costs. For example, changes in inflation rates, business volume, and accounting systems, as well as subsequent restructurings and unexpected events, all affect contract prices. When we attempted to identify reduced contract prices resulting from the UDLP business combination, we found differing views about the impact of the restructuring. At the time of our review, the Army had awarded UDLP only one new contract that was comparable to a contract awarded before restructuring. For that case, we concluded that UDLP's restructuring efforts

⁵Defense Contractor Restructuring: First Application of Cost and Savings Regulations (GAO/NSIAD-96-80, Apr. 10, 1996).

⁶Our prior work on this combination covered the first eight certified projects. See Defense Restructuring Costs: Projected and Actual Savings From Martin-Marietta Acquisition of GE Aerospace (GAO/NSIAD-96-191, Sept. 5, 1996). We updated this figure to include all 13 certified projects.

contributed to a reduction in the contract price, but we could not determine the precise amount. Due to the interest in this area, we plan to further explore whether restructuring savings can be traced to reduced contract prices.

Mr. Chairman, that concludes my statement. I will be glad to respond to any questions you or members of the Subcommittee may have.

Selected Information on Cost and Savings From Five Business Combinations

Dollars in millions

Certified amounts^a	Amount
Costs	\$1,373.9
Savings ^b	5,257.0
DOD share of certified amounts	
Costs	755.2
Savings ^b	3,304.6
Status of September 30, 1996	
Restructuring costs paid by DOD	179.2
Estimated savings realized by DOD	346.7

^aDoes not include any costs or savings resulting from Martin Marietta's acquisition of General Dynamics' Space System Division.

^bDoes not include any savings from the Hughes-General Dynamics business combination since the combination occurred prior to the enactment of section 818 of the 1995 Department of Defense Authorization Act. Consequently, there is not a certified amount of savings for that combination.

Status of Selected Mergers Involving Defense Contractors

Acquirer	Target firm	Date combined	Status of restructuring proposal
Combinations currently with proposals in the certification process			
Westinghouse Electric	Norden Systems	June 1994	Defense Contract Audit Agency (DCAA) audit of proposal complete
Allied Signal	Textron Lycoming	October 1994	Awaiting completion of DCAA audit
Hughes	CAE Link	December 1994	DCAA audit completed
Litton	Varo Night Vision division	June 1995	Awaiting completion of DCAA audit
Mergers that may result in restructuring proposals			
Northrop Grumman	Westinghouse Electronic Systems	March 1996	Not applicable
Lockheed Martin	Loral	April 1996	Not applicable
The Boeing Company	Rockwell's aerospace and defense units	December 1996	Not applicable
Proposed mergers awaiting regulatory approval			
The Boeing Company	McDonnell Douglas Corporation	To be determined	Not applicable
Raytheon Company	Texas Instruments' Defense Systems & Electronics	To be determined	Not applicable
Raytheon Company	Hughes Electronics' defense business	To be determined	Not applicable