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The Honorable Tom Harkin
United States Senate

The Honorable Peter A. DeFazio
The Honorable Christopher H. Smith
House of Representatives

Subject: Defense Industry Restructuring: Clarification of Cost and Savings Issues

Over the past 3 years, we have issued a series of reports on reimbursements to defense contractors for restructuring subsequent to their business combinations. On June 10, 1997, you asked our office to address several questions related to those reports. This letter responds to your request, and a list of our reports on restructuring appears at the end of this letter.

OUR RESPONSES TO QUESTIONS

(1) Can DOD's claim that savings are resulting from its policy of reimbursing contractors for merger-related restructuring costs be verified by reviewing the accounting records of the merging companies? What is the difference between a cost avoidance and savings?

The "savings" from restructuring activities are generally in the form of future cost avoidances, which are not recorded in a contractor's accounting records. Defense contractors are required to maintain accounting records showing the actual amount and nature of costs charged to government contracts, but these records do not reflect costs that would have been incurred had an action—such as restructuring—not occurred. Consequently, restructuring "savings" have to be estimated using assumptions about what costs would have been had a merger or an acquisition not occurred.

The Department of Defense (DOD) has defined cost avoidances, in discussing the impact of acquisition reform efforts, as "cost reductions resulting in

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avoidance of costs that were not budgeted," and it has defined savings as "cost reductions from an approved budget baseline that result in program funds being recouped or used elsewhere in the program." From a budgetary perspective, DOD's definitions would imply that cost avoidances do not affect budgetary requirements, while savings may, depending on whether they were simply applied elsewhere within a program.

(2) How much has DOD spent on taxpayer funded restructuring and has DOD cited any specific cases where this restructuring has directly caused an actual reduction in contract or product prices?

The Defense Contract Audit Agency (DCAA) estimated that as of September 30, 1996, DOD had reimbursed 4 business combinations about $179 million toward its share of the costs the combinations had incurred for restructuring activities. Of this amount, about $18 million was the additional cost resulting from DOD's decision in July 1993 to allow restructuring costs to be charged to flexibly priced contracts transferred from one company to another, provided that the savings from restructuring exceeded those costs or the merger preserved a critical defense capability. The remainder was associated with the acquiring company's existing contracts or new contracts awarded after the acquisition—costs DOD has historically paid.

In testimony before the Senate Committee on Armed Services, Subcommittee on Acquisition and Technology, the Director, Defense Procurement, identified two instances—the Advanced Medium Range Air-to-Air Missile (AMRAAM) and the Bradley Fighting Vehicle—in which DOD believes that restructuring resulted in contract price reductions.[1] The Director noted, however, that DOD had maintained a competition between the two companies that produced the AMRAAM, so it was difficult to isolate the impact of restructuring activities. Nonetheless, the Director believed that overhead rates have been reduced as a result of cost savings from mergers and acquisitions.

Concerning the Bradley Fighting Vehicle, we previously attempted to identify lower contract unit prices as a result of restructuring at the United Defense, Limited Partnership, which manufactures the Bradley. At the time of our review, DOD had awarded United Defense only one new contract that was comparable to a contract awarded prior to restructuring. While we were unable to determine the precise amount of restructuring savings on the contract, we estimated 8 to 16 percent savings based on differences in projected number of units to be remanufactured and the inflation rate used to adjust the unit price of the initial contract. We are attempting to find additional instances of lower contract prices resulting from restructuring "savings."

[1] Hearing before the Subcommittee on Acquisition and Technology, Senate Committee on Armed Services, Apr. 15, 1997.

(3) Is the key premise behind which all of DOD's claims of savings are based the idea that taxpayer reimbursement for restructuring costs will cause defense contractors to restructure sooner than they would otherwise?

While we believe this is a policy question best asked of DOD, three statements made by senior DOD officials indicate that this is an important, if not the key, premise. On July 27, 1994, the Deputy Secretary of Defense testified that strong incentives for mergers and acquisitions already existed in the defense industry; however, the issue remained as to whether the resulting restructuring would happen sooner or later.[2] The Deputy Secretary indicated that the longer a restructuring was delayed, the more U.S. taxpayers would pay for a less efficient operation. The Deputy Secretary also indicated that DOD's restructuring policy was encouraging a rational downsizing in the defense industry and would ensure that taxpayers would receive cost savings as a result. The Under Secretary of Defense (Acquisition and Technology) expressed a similar view in a January 27, 1997, letter to Representative Christopher Smith. In this letter, the Under Secretary stated that DOD's decision to reimburse contractors for certain restructuring-related expenses was based on the assumption that by paying its share of restructuring costs, DOD would pay less for the goods and services it buys because companies would restructure a year or two sooner. The Secretary of Defense reiterated this position in a March 17, 1997, letter to Representative Smith.

(4) Do DOD's savings estimates used in the certification process rely entirely on the assumption that everything else, but for the restructuring, will remain the same after a business combination as before? What other factors that affect contract prices normally change?

The initial estimate of restructuring savings assumes that everything else, except for the restructuring, is the same after a business combination as before. As DOD's December 1996 report to Congress stated, other factors, such as inflation, business fluctuations, accounting system changes, subsequent reorganizations, and unexpected events also affect actual costs.

Such factors can have a significant impact on the amount of savings achieved. For example, the certified savings for one business combination we reviewed was about $111 million.[3] The contractor provided DOD quarterly reports to demonstrate the actual savings realized. These reports provided such

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[2] Hearing before the Subcommittee on Oversight and Investigations, House Committee on Armed Services, July 27, 1994.

[3] DOD does not reimburse a contractor for restructuring costs until the contractor's restructuring proposal is audited by DCAA and a high-level DOD official certifies that projected savings should result in reduced overall costs to DOD.

information as baseline and current headcounts, and based savings on the resulting difference multiplied by the labor and fringe benefit costs. This approach produced savings estimates to within 5 percent of the certified amount, but gave no consideration to changes in the business base that occurred during the restructuring. However, when DCAA considered such factors as changes in the business base, differences in where certain work was accomplished, and the stretch-out of other work, it estimated that actual savings were less than two-thirds of the certified amount.

(5) How significant are employee layoffs in DOD's estimates of savings?

The savings resulting from employee layoffs constitute a significant element of DOD's estimates of savings. Using information on the nature of savings from four of the five business combinations included in our April 1, 1997, report,[4] we estimated that the savings attributed to the salaries and benefits avoided by laying off workers were the largest single category of certified savings, about 48 percent of the certified savings for these 4 business combinations. The amount of savings due to laying off workers varied among contractors due to the type of restructuring undertaken. For the 4 restructurings, the certified savings attributable to lay-offs varied from 8 to 100 percent.

(6) When calculating its estimates of savings, does DOD assume that such savings are recurring in nature? Given that DOD has said that restructuring payments are designed to move up mergers and acquisitions by a year or two, what would be the effect on DOD's estimates of savings of counting them for two years as opposed to the maximum of five years that is the current practice?

Defense contractors used various methodologies for savings and cost estimates, which DOD certifies after DCAA audits. In some cases, the contractor prepared estimates based on the projected impact in one year and then simply multiplied the resulting figure by five—the maximum number of years over which DOD allows savings to be counted. In other cases, the contractor attempted to estimate the savings for each year individually. In either case, however, limiting the period for counting savings to the first 2 years, rather than the 5 years currently allowed, would have a significant impact on the amount of certified savings. For combinations that used a single, recurring figure, limiting the savings to 2 years for certification purposes would reduce the amount of certified savings by 60 percent. For combinations that attempted to discretely estimate restructuring savings, the impact would vary. For example, for one business combination we reviewed, limiting the period to the first 2 years would

[4]The fifth combination was unable to provide us such information due to the methodology used to calculate savings.

reduce the certified savings by almost 80 percent, provided the restructuring still took place.

(7) What would have been the effect of legislation disallowing the recoupment of restructuring costs, had it been enacted, on the additional costs to DOD as a result of its July 1993 decision to pay for restructuring costs on flexibly-priced contracts transferred from one company to another after a business combination?

The DCAA estimated that $18 million—or about 10 percent of the $179.2 million that DOD had paid for restructuring costs as of September 1996—was charged to flexibly priced contracts transferred after business combinations. Had DOD maintained its long-standing practice of not reimbursing contractors for restructuring costs on these contracts, then DOD would not have paid the $18 million, assuming that the business combinations and the subsequent restructurings would have occurred in the same manner and in the same time frame.

(8) Given the difficulties inherent in estimating savings due to payment of restructuring costs, what would GAO recommend with respect to the continuation of mandated reporting requirements for DOD, which will expire this year?

During our April 15 testimony before the Subcommittee on Acquisition and Technology, Senate Committee on Armed Services, we suggested that Congress may wish to consider extending, at least for the short term, that reporting requirement to provide further visibility into the actual savings resulting from restructuring activities.

It should also be noted that in our April 1997 report, we identified about $48 million in federal grants administered by the Department of Labor that were provided either directly to defense contractors involved in business combinations or to locations where workers were laid off as a result of the business combinations or normal downsizing. These grant funds were provided to assist laid-off workers find new employment. Because these grant funds can be substantial, we recommended that the Secretary of Defense obtain information about such grants and include this information in DOD's annual report to Congress. DOD officials indicated that they would meet with Department of Labor officials to determine how information on the amount of such grants could be made available to DOD for inclusion in its annual report to Congress.

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In preparing this letter, we relied primarily on our work over the past 3 years. We will provide copies of this letter to the Secretaries of Defense and Labor; the Commander, Defense Contract Management Command; the Director, Defense Contract Audit Agency; the Director, Office of Management and Budget; and interested congressional committees. Copies will also be made available to others upon request.

If you have any questions, please contract me at (202) 512-4841. The principal contributors to this letter were John K. Harper, George C. Burdette, Timothy J. DiNapoli, and Paula J. Haurilesko.

David E. Cooper
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Defense Acquisitions Issues

LIST OF RELATED REPORTS

Defense Industry Restructuring: Cost and Savings Issues (GAO/T-NSIAD-97-141, Apr. 15, 1997).

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

Defense Restructuring Costs: Projected and Actual Savings From Martin Marietta Acquisition of GE Aerospace (GAO/NSIAD-96-191, Sept. 5, 1996).

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

Defense Restructuring Costs: Payment Regulations are Inconsistent With Legislation (GAO/NSIAD-95-106, Aug. 10, 1995).

Defense Industry Consolidation: Issues Related to Acquisition and Merger Restructuring Costs (GAO/T-NSIAD-94-247, July 27, 1994).

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