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DEFENSE INDUSTRY
CONSOLIDATION

Issues Related to Acquisition
and Merger Restructuring
Costs

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the allowability of restructuring costs incident to mergers and acquisitions. The pace of consolidation of the U.S. defense industry has increased sharply this year. In the 16 months between August 1992 and December 1993, the industry experienced 4 large mergers and acquisitions; but, since only the beginning of this year, the industry has seen 5 major combinations of business firms.

This dramatic reshaping of the industry involves extraordinarily complex transactions with potentially significant cost, benefit, and risk implications for corporate bottom lines, taxpayer expenditures, and national security capabilities. Therefore, the issues surrounding the allowability of restructuring costs incident to mergers and acquisitions are important and deserve careful consideration and deliberation.

Allowing restructuring costs incident to a merger or acquisition is a powerful incentive for defense firms to "right-size" for the current market. The allowability of costs incurred in performing a government contract is governed by the Federal Acquisition Regulation (FAR). Although there is no cost principle on restructuring costs, the FAR provides specific coverage on some costs incident to a merger or acquisition. For example, organization costs--such as brokers or attorneys fees--are unallowable. Likewise, an acquiring company may not include in its overhead accounts amounts for depreciation of acquired assets in excess of the amounts that would have been allowed had the combination not occurred.

With respect to government contracts one company acquires from another, the FAR provides for the parties to sign a novation agreement setting forth the terms under which the government agrees to recognize the successor contractor. The standard novation language for defense contracts does not require the government to pay restructuring costs. On July 21, 1993, however, the Under Secretary of Defense for Acquisition issued a memorandum allowing restructuring costs when it could be shown that (1) savings to the government as a result of the restructuring would exceed the costs or (2) the merger preserved a critical defense capability. The purpose of the change, as I understand it, is to facilitate the intelligent and efficient downsizing of the defense industry.

My remarks will focus on (1) the definition of restructuring costs, (2) the cost impact on DOD contracts, and (3) other issues.

Restructuring is a rapidly evolving area and we do not have a specific body of work to draw on in this regard. My comments today are based largely on documents we have obtained from DOD and our experience over the years of auditing allowable costs on government contracts.

DEFINITION OF RESTRUCTURING COSTS

The FAR currently does not define "restructuring" costs. Our prior work on allowable costs has shown that the lack of clear guidance in the regulations is one of the principal causes of disputes over the allowability of costs. Congress has been concerned for several years about indirect costs that defense companies, universities, hospitals, and others have asked the taxpayer to support. Because DOD has yet to adequately define restructuring costs, the potential exists for disagreement over allowability of specific costs and possibly unfair and inconsistent treatment of such costs by contractors and DOD.

DOLLAR IMPACT UNKNOWN

We are not aware of any reliable estimates of the total amount of restructuring costs that could be charged against defense contracts under the new policy. The amount, however, could be substantial, possibly involving several billions of dollars. These increased costs come on the heels of dramatic reductions in DOD procurement budgets and growing concern among DOD procurement officials about increases in contractors' indirect costs. Restructuring costs will likely place further increased pressure on DOD procurement budgets.

Citing shrinking budgets, DOD procurement officials have indicated that they need to know about the impact of restructuring costs and savings on their programs and contracts as soon as possible. However, restructuring efforts will take time to accomplish. While contractors' restructuring plans are evolving, contractors may not know where their restructuring efforts are headed and information may not always be perfect. Estimates of costs and savings will change as events occur and the process unfolds.

OTHER ISSUES

Because of the pace of acquisitions and mergers in the defense industry, little information and experience is available to measure DOD's effectiveness in implementing its restructuring cost policy. However, a number of concerns have surfaced within DOD. For example, as recently as last month, the Defense Contract Audit Agency headquarters noted that many of the inquiries it received from field offices about restructuring costs centered on one key issue--contractor delays and reluctance in estimating and proposing potential savings resulting from mergers, acquisitions, or other corporate restructuring actions.

In an August 1993 Defense Contract Management Command and Defense Contract Audit Agency workshop on restructuring costs, the following concerns were expressed

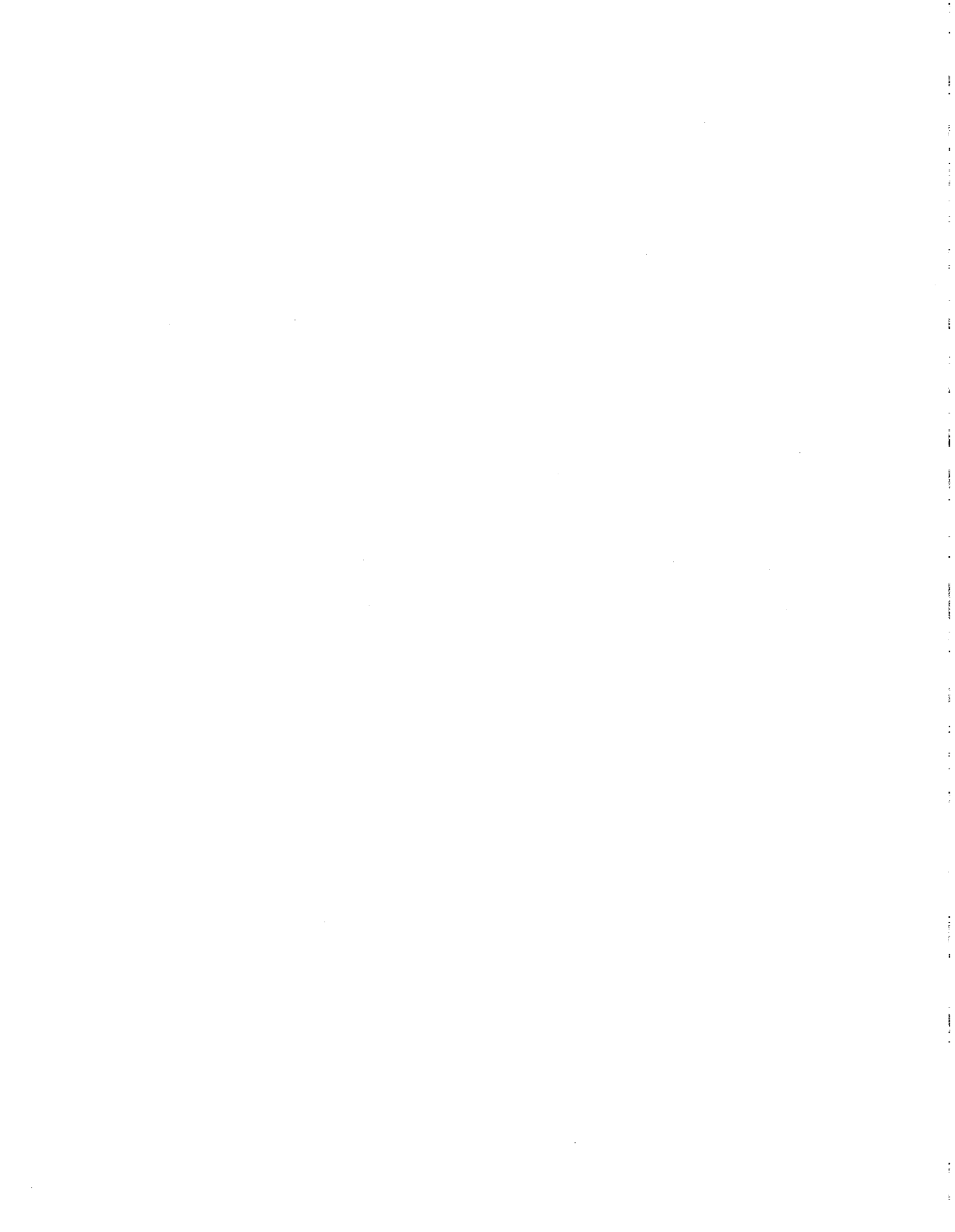
- defining contractor requirements to support estimated restructuring costs;
- defining criteria to determine how savings will be measured;
- defining criteria to establish the period over which savings will be measured;
- establishing requirements for contractors to document and support cost savings;
- establishing criteria to determine the frequency of contractor submissions for savings validation; and,
- determining actions for the government to take if savings are not realized or are only partially realized.

Many of these same concerns were surfaced again last month in another restructuring workshop conducted by the two agencies.

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Mr. Chairman, as DOD implements its restructuring policy, all these issues require further study and analysis. That concludes my statement. I will be pleased to answer any questions you or other members of the subcommittee may have.

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