September 11, 2002

Acquisition

Effect of the Raytheon Defense Business Acquisitions on Pension Plans and DoD-Funded Pension Assets
(D-2002-145)

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Acronyms

CAS	Cost Accounting Standards
CIPR	Contractor Insurance/Pension Review
DCAA	Defense Contract Audit Agency
DCE	Defense Corporate Executive
DCMA	Defense Contract Management Agency
ERISA	Employee Retirement Income Security Act
FAS	Financial Accounting Standard
GD	General Dynamics
HAC	Hughes Aircraft Company
HDC	Hughes Defense Company
HEC	Hughes Electronics Corporation
SERP	Supplemental Executive Retirement Plan
TI	Texas Instruments

INSPECTOR GENERAL
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September 11, 2002

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY
DIRECTOR, DEFENSE CONTRACT MANAGEMENT AGENCY

SUBJECT: Report on the Effect of the Raytheon Defense Business Acquisitions on Pension Plans and DoD-Funded Pension Assets (Report No. D-2002-145)

We are providing this report for information and use. We considered management comments on a draft of this report in preparing the final report.

Comments on the draft of this report conformed to the requirements of DoD Directive 7650.3 and left no unresolved issues. Therefore, no additional comments are required.

We appreciate the courtesies extended to the staff. Questions should be directed to Mr. Ken Stavenjord at (703) 604-8952 (DSN 664-8952) (kstavenjord@dodig.osd.mil) or Mr. Ron Meissner at (703) 604-8911 (DSN 664-8911) (rmeissner@dodig.osd.mil). See Appendix C for the report distribution. The team members are listed inside the back cover.

Thomas F. Gimble
for David K. Steensma
Deputy Assistant Inspector General
for Auditing

Office of the Inspector General of the Department of Defense

Report No. D-2002-145 **September 9, 2002**
(Project No. D2001PT-0060)

Effect of the Raytheon Defense Business Acquisitions on Pension Plans and DoD-Funded Pension Assets

Executive Summary

Who Should Read This Report and Why? DoD and private sector contracting, accounting, and audit officials who deal with Defense contractor business combinations, divestitures, and pensions, should be interested in this report.

Background. This report is a review of the effect of the Raytheon Company acquisitions of E-Systems, Inc., Texas Instruments Defense Systems and Electronics, and Hughes Defense Company on pension plans and DoD-funded pension assets. The acquisitions resulted in $6.9 billion of pension assets being transferred to the Raytheon Company.

Results. Adequate contractor records that would ensure the Government received proper credit for its share of contributed pension assets under several of the pension plans transferred to the Raytheon Company did not exist. The Government is at risk of either overpaying or not receiving proper credit for certain contributions made to the pension funds. The Defense Contract Management Agency (DCMA) should request that the Raytheon Company and Raytheon's certified public accounting firm correct their respective financial reports for the E-Systems Salaried Plan to report the unauthorized withdrawal of $7.9 million. The Defense Contract Audit Agency (DCAA) should also review and verify the E-Systems Supplemental Executive Retirement Plan asset balances and record the balances in the E-Systems permanent audit file; review and verify the Texas Instruments pension plan asset balances and record the balances in the Texas Instruments permanent audit file; determine the cost impact to the Government that Hughes caused by not properly segmenting the pension assets transferred as a result of the General Dynamics acquisition in 1992; determine the cost impact to the Government that Hughes caused by not properly segmenting the newly created Direct TV segment from the Government segments in 1994; and revise the pension audit guidance program to require that periodic reviews of Cost Accounting Standard 413.50(c)(7) asset balances are performed. (See the Finding section of the report for the detailed recommendations.)

Management Comments. The Director, DCAA and the Director, DCMA both concurred with the recommendations; therefore, no further comments are required. DCMA will request the Raytheon Company to amend their Form 5500 for 1998 and 1999, and have their accounting firm amend the pension plan's financial statements for 1998 and 1999 to reflect the $7.9 million withdrawal and repayments. Additionally, DCMA voluntarily plans to amend the Contractor Insurance and Pension Review process to emphasize segment accounting of pension assets in future reports.

DCAA agreed to review and verify the E-Systems and Texas Instrument's pension plan asset balances. DCAA will also record the Cost Accounting Standard 413.50(c)(7) asset balances in the respective permanent audit files. In addition, DCAA will address the issue of not properly segmenting pension assets from the Hughes acquisition of General Dynamics and the creation of Direct TV as part of the DCAA review of the Hughes sale of Government segments to the Boeing Company. Further, DCAA will revise their audit plans to add the year-end pension asset balances to the list of historical pension cost information required to be maintained in the permanent file and revise the joint DCMA and DCAA pension review programs to require that periodic reviews of the Cost Accounting Standard 413.50(c)(7) asset balances be performed.

Table of Contents

Background

Pension accounting is unique in that the majority of pension accounting transactions are not entered in the financial accounting records of a public corporation. Financial Accounting Standard (FAS) No. 87, "Employers Accounting for Pensions," controls the way corporations determine and record pension information for financial accounting purposes. The Employee Retirement Income Security Act (ERISA) of 1974, as amended, provides regulations for pension accounting on a plan basis. The annual FAS 87 pension expense recorded on a corporate income and expense statement would rarely correspond to the annual pension funding that ERISA requires. The FAS 87 balance sheet accounting also differs from the balance sheet accounting maintained under ERISA.

Generally, corporations that negotiate contracts of $50 million or more with the Government are also required to comply with Government contract accounting rules under the Cost Accounting Standards (CAS). This includes rules for pension accounting under CAS 412, "Composition and Measurement of Pension Cost," and CAS 413, "Adjustment and Allocation of Pension Cost." The pension accounting rules under CAS 412 and CAS 413 closely parallel ERISA pension accounting. A major difference between CAS and ERISA is that CAS provides for segment accounting, which is more detailed if a pension plan has several segments. CAS 413, in addition to being a cost accounting standard, is also an asset accountability standard under CAS 413-50(c)(7).

Another major difference between CAS and ERISA is the method for allocating pension plan assets when a plan is divided as the result of a business divestiture. Under ERISA, all of the plan assets are available to cover all of the plan liabilities, and the assets are substantially allocated in proportion to the liabilities. Under CAS, segment pension costs charged to Government contracts become segment assets. The segmented assets are designated to cover the segment liabilities. An allocation of assets under ERISA is usually different from an asset allocation under CAS because of the segment accounting provisions. The findings in this evaluation substantially relate to differences between ERISA and CAS accounting for pension assets.

Raytheon Acquisitions. Based in Lexington, Massachusetts, the Raytheon Company (Raytheon) is a global technology company that operates in three core business segments: Defense and commercial electronics, business aviation and special mission aircraft, and engineering and construction. From 1995 through 1997, Raytheon actively pursued and completed several major acquisitions in the Defense electronics business.

In early 1995, Raytheon merged its Missile Systems Division and Equipment Division, creating Raytheon Electronic Systems. In April 1995, Raytheon acquired E-Systems for $2.2 billion. E-Systems was a Defense and Government electronics company with a specialty in intelligence, reconnaissance, and surveillance systems; command and control; specialized aircraft modification; and guidance, navigation, control, communications, and data systems.

The company acquired the assets of Texas Instruments' (TI) Defense Systems and Electronics business in July 1997 for $2.95 billion, adding complementary businesses and expertise in precision-guided weapons, anti-radiation and strike missiles, airborne radar, night vision systems, and electronic warfare systems.

In December 1997, Raytheon merged with the Defense operations of Hughes Electronics, a leading supplier of advanced Defense electronics systems and services. The $9.5 billion transaction with Hughes is the largest in Raytheon's history.

With the completion of the Raytheon/Hughes merger, Raytheon announced the formation of its new, consolidated Defense business--Raytheon Systems Company--bringing together the combined capabilities of Raytheon Electronic Systems, Raytheon E-Systems, Raytheon TI Systems, and Hughes Aircraft Company (HAC). The Washington, D.C., based Raytheon is organized into five major business segments that bring together the resources of the company in key product areas. The five business segments are: Defense Systems; Sensors and Electronic Systems; Command, Control, Communications and Information Systems; Aircraft Integration Systems; and Training and Services.

Defense Contract Audit Agency. The Defense Contract Audit Agency (DCAA) performs the contract audits for DoD and provides accounting and financial advisory services regarding contracts and subcontracts to the DoD Components responsible for procurement and contract administration.

Defense Contract Management Agency. The Defense Contract Management Agency (DCMA) performs price/cost analyses, overhead and contractor system reviews, financial services, property and plant clearance, transportation and packaging, and termination settlements for DoD. The DCMA also provides program and technical support by analyzing costs, schedules, and technical performance of contractor programs and systems.

Contractor Insurance/Pension Review Teams. A Contractor Insurance/Pension Review (CIPR) is initiated at the request of the Administrative Contracting Officer. The CIPR team consists of a joint DCAA and DCMA team comprising DCAA auditors and DCMA insurance/pension specialists.

The CIPR team is responsible for conducting a CIPR, which is a comprehensive review of a contractor's insurance program, pension plans, other deferred compensation plans and related policy, procedures, practices, and costs.

If a business combination (merger) occurs, the CIPR team must determine whether the contractor has complied with the special segment closing provisions of CAS 413.50(c)(12). Determination requires an analysis of the contractor's calculation of the pension assets and liabilities, and the allocation of the assets and liabilities to the segments involved in the transaction. The asset and liability balances determine the basis for measuring the effect of the adjustment on previously determined pension costs that CAS 413.50(c)(12) requires.

The contractor's accounting for pension assets and liabilities must comply with the measurement and allocability requirements of CAS 412 and CAS 413 and must be allocable, reasonable, and allowable as Federal Acquisition Regulation Subpart 31.2 provides.

The CIPR program review steps cover the key aspects of accounting for pension assets and liabilities for segment closings, benefit curtailments, and plan terminations.

Objectives

Our objective was to evaluate the effect of the Raytheon acquisition of Hughes, Texas Instruments, and E-Systems on the respective pension plans, DoD pension costs, and DoD-funded pension assets. We also identified the Government-funded pension assets under the individual pension plans by segment as of the date of each acquisition, and evaluated the distribution of assets between the contractors to determine compliance with CAS 413.

Accounting for Government-Funded Pension Assets

Adequate contractor records did not exist that would ensure the Government received proper credit for its share of contributed pension assets under several of the pension plans transferred to Raytheon. The contractors did not maintain by segment under certain plans the required CAS 413.50(c)(7) pension asset accounting records. Additionally, no documented evidence existed that DCAA or DCMA performed any periodic audits of CAS 413.50(c)(7) pension asset records or maintained any records to document the Government's interest in the contractor pension funds. As a result, the Government is at risk of overpaying or not receiving proper credit for certain contributions made to the pension funds.

Pension Costs

The measurement, assignment, and allocation of pension cost to a cost accounting period is performed by a contractor in accordance with the provisions of CAS 412. Generally, pension cost charged to Government contracts during a cost accounting period is not paid out as benefits during the performance of a contract. Rather, pension cost is accumulated as Government-funded assets in a pension trust for future payment of benefits when the employees retire.

Records. CAS 413.50(c)(7) sets forth the procedure for maintaining accurate permanent records of pension cost charged to Government contracts and accumulated as Government-funded pension assets. The standard requires that after the initial allocation of assets, the contractor shall maintain a record of the portion of subsequent contributions, income, benefit payments, and expenses attributable to the segment and paid from the assets of the pension plan. CAS 413.50(c)(12) covers the procedures that a contractor must follow when a segment is sold. The contractor is required to determine the difference between the actuarial accrued liability for a segment and the market value of assets allocated to a segment. The difference between the market value of assets and the actuarial liability for a segment represents an adjustment of previously determined pension cost. CAS 413.50(c)(12) further requires that the Government's share of the adjustment amount is based on a percentage of total pension costs assigned during a period that is representative of the Government's participation in the pension plan. The percentage should represent the pension costs allocated to all of the contracts and subcontracts during the representative period. If a segment is closed because of a sale or other transfer of ownership to a successor interest in the contracts of the segment and all of the pension plan assets and actuarial accrued liabilities pertaining to the closed segment are transferred to the successor segment, then no adjustment amount pursuant to CAS 413.50(c)(12) is required. If only some of the pension plan assets and actuarial accrued liabilities of the closed segment are transferred, then the adjustment amount shall be determined based on the pension plan assets and actuarial accrued liabilities remaining with the contractor. In either case, the effect of the transferred assets and liabilities is carried forward and recognized in the accounting for pension cost at the successor contractor. The key to compliance with the segment closing requirements is continuing maintenance of accurate permanent records of Government pension costs by cost accounting period and accumulation of the Government-funded pension assets in the pension trust.

The potential impact on Government-funded pension assets as a result of a business combination is significant. A close examination of the transactions is critical to ensure appropriate amounts are transferred from seller to buyer and that the accounting matches the transactions. If a shortfall occurs in the assets transferred from seller to buyer, the Government may have to make up the shortfall by paying additional future pension costs. In effect, the Government would pay again to cover pension liabilities previously funded because the pension assets retained by the seller included Government-funded pension assets that should have been transferred. Contractor maintenance of accurate CAS 413.50(c)(7) records is imperative so the Government can perform an adequate examination and assessment of the transactions.

E-Systems

In May 1995, Raytheon acquired E-Systems for $2.2 billion. Immediately after the purchase, Raytheon established defined benefit pension plans for the newly acquired Defense employees and retired Defense employees covered by the E-Systems Salaried Plan, HRB Systems Plan, Greenville Plan, Garland Plan, the ECI Plan, and the E-Systems Supplemental Executive Retirement Plan (SERP). E-Systems transferred pension plan assets totaling $613,209,810 from the E-Systems retirement plans to the plans that Raytheon established.

E-Systems SERP. In 1982, E-Systems established a SERP for corporate officers and specified executives. A SERP is a plan designed to provide additional retirement income in excess of the maximum benefits established under ERISA for qualified plans to highly compensated individuals. Through 1986, the SERP was unfunded and E-Systems made benefit payments. In 1987, E-Systems established a funded trust and made payments of $26 million to the trust. In 1987, an agreement signed between E-Systems and the Government covered the basis for Government funding of the E-Systems SERP. From 1987 through 1997, the Government-funded SERP costs of $21.8 million. As of May 31, 1995, approximately $50.8 million of E-Systems and Government-funded assets were in the E-Systems SERP trust. As of August 31, 1999, the assets had appreciated to approximately $70.8 million.

Withdrawal of SERP Assets by Raytheon. In December 1999, Raytheon withdrew $42 million from the E-Systems SERP trust and transferred the funds to a Raytheon general asset account. Raytheon did not inform the Government of the $42 million withdrawal until March 2001 when the Inspector General of the Department of Defense initiated through DCAA an inquiry on the SERP funding status. Because the SERP funding consisted of both E-Systems contributions and pension costs charged to Government contracts, whether sufficient E-Systems contributed assets exist that cover the withdrawal without also withdrawing Government-funded pension assets is not known.

Analysis of the Raytheon Withdrawal. We were interested in examining the SERP because it was a funded, nonqualified plan. Nonqualified plans are not usually funded and are not as closely regulated as ERISA qualified plans. DCAA requested from Raytheon specific financial data not previously obtained prior to the start of our review. At the time of the DCAA request for financial data, Raytheon revealed to DCAA that the company made the $42 million withdrawal from the trust. The data included incurred cost records that identified all of the contractor reimbursable Government-funded pension costs for the period of 1987 through 1997, and annual summary financial statements prepared by an independent actuarial firm for 1987 through 1997. The summary statements were purported to be from the trust records and did not separately account for the Government-funded trust assets. Without the CAS 413.50(c)(7) records to separately account for the Government-funded assets, we were unable to determine whether the contractor had inappropriately withdrawn assets that were attributable to the Government.

Defense Contract Audit Agency Follow-up. After the evaluation, DCAA determined that sufficient E-Systems funded assets were available to cover the withdrawal without using Government-funded assets. Based on the DCAA review, no adverse cost impact to the Government was found from the withdrawal by Raytheon of SERP assets. However, DCAA indicated that a weakness existed in the contractor's system of internal controls. Raytheon's internal controls do not require prompt notification in writing to the contracting officer when the contractor withdraws assets from a Government-funded pension plan. DCAA recommended to Raytheon that internal controls needed improvement. Raytheon agreed to the recommendation and is taking action to correct the problem. Additional DCAA review is still required to determine the present value of the remaining trust assets applicable to Government funding.

Raytheon's Withdrawal From the E-Systems Salaried Plan. As a result of the review of the E-Systems SERP, DCAA initiated a review of Raytheon trust fund withdrawals and discovered that Raytheon had also withdrawn $7.9 million from the E-Systems Salaried Pension Plan in June 1998 and had repaid the $7.9 million to the trust fund with interest of $614,593 by September 1999. The additional payment equates to an approximate 7.7 percent interest rate to cover for the loss of trust fund investment earning. The DCAA audit report, "Noncompliance with Federal Acquisition Regulation Clause 52.215-15, Pension Adjustments and Asset Reversions," October 2, 2001, covers the impact of the missing assets in calculating pension costs. DCAA did not take exception to the repayment or to the amount of interest paid on the withdrawn amount. We were concerned that removal of the $7.9 million from the cash account caused the conversion of equity investments into cash to cover benefit payments totaling approximately $3 million each month. DCAA confirmed that assets were more than sufficient in the pension fund's cash account and that no equity or debt instruments with substantially higher investment yields had to be converted into cash. However, we still find fault with the Raytheon Financial Reporting for the E-Systems Salaried Pension Plan. The Form 5500 Report should comply with the reporting requirements under ERISA and provide the opportunity to compare CAS pension data furnished to DoD with pension financial information prepared for the Internal Revenue Service and the Department of Labor. A review of the Raytheon 1998 Form 5500, "Annual Return/Report of Employee Benefit Plan," did not disclose the withdrawal. The Form 5500 for 1999 did not disclose the reimbursement to the trust fund. The withdrawal and the repayment were also not reported in either the 1998 or the 1999 Annual Financial Reports prepared by Raytheon's certified public accountants. Issuing revised reports should correct the omission in reporting.

Texas Instruments

In July 1997, Raytheon acquired the assets of TI Defense Systems and Electronics for $2.95 billion. Raytheon then established a defined benefit plan for the transferred TI employees in their Raytheon TI Systems entity. TI in turn transferred pension plan assets and actuarial liability attributable to the Defense operations from the TI Retirement Plan to the newly established plan. The methodology for the transfer of pension plan assets and actuarial liabilities was set forth in the Purchase/Sale Agreement between Raytheon and TI. In compliance with the agreement, TI transferred pension assets to Raytheon totaling $305,102,650 on September 30, 1997, and Raytheon assumed the actuarial liabilities associated with employees transferred to Raytheon.

Prior to the sale in 1997, TI had a single plan that covered both its commercial and Defense operations. Beginning in 1985, TI agreed to establish segmented pension records for the Defense division in accordance with CAS 413.50(c)(3). From 1985 through 1997, the costs for the Defense division were purportedly segmented within the independent actuary's records—CAS 413.50(c)(7) data—in compliance with CAS 413.

Accounting Record Review. We requested that the contractor and the actuary provide the CAS 413.50(c)(7) data for 1985 through 1997. Our plan was to use the data to determine whether the amount that TI claimed to represent the Government-funded pension assets was correct. A properly maintained CAS 413.50(c)(7) record would show by year all of the additions and subtractions to both the commercial and the Government segmented assets. The segmented records would verify that the Government received proper credit for their contributions. The TI records for 1994 through 1997, however, showed that the commercial and Government funding ratios were actually equal. We wanted to find out the reason for the identical funding ratios, especially because the DCMA CIPR records identify that substantially higher pension contributions were charged from 1985 through 1996 to the Defense segment. According to the CIPR records, $225,457,508 in contributions were made on behalf of the TI pension plan from 1985 through 1996. The Government contributed 62 percent ($139,022,127) of the contributions, whereas the commercial contributions was 38 percent ($86,435,381).

The company's actuary prepared CAS segmented asset records for 1985 through 1997. Both TI and the actuary confirmed that the records were provided to TI.

However, TI and the actuary claimed that they only retained the segmented records for 1994 through 1997.

A review of available DCAA and DCMA records was conducted but no copies of the missing segmented asset records were found. Also, no evidence was available in the files that would substantiate whether DCAA performed any audit checks of the CAS 413.50(c)(7) records for 1985 through 1996. Further, we did not find any evidence of a review of the segmented pension assets in any of the DCMA CIPR reports.

We reviewed all of the available pension financial records from DCAA and DCMA to validate the 1994 beginning asset balance and to reconstruct the missing records for 1985 through 1993. We were unsuccessful in our attempt to reconstruct the missing records. As a result, we are unable to reconcile the apparent anomaly between the final asset allocation of $305 million for the Defense segment (37 percent of the trust assets) and the total pension cost of $139 million (62 percent of the total trust funding for these years) charged to the Defense segment for 1985 through 1996. A closer correlation between the funding level and the asset allocation should exist. Without a review of the missing 1985 through 1993 records, an opinion as to whether the $305 million asset transfer was in compliance with CAS 413 cannot be accurately determined.

Hughes

Raytheon completed its purchase of Hughes Defense Company (HDC), a subsidiary of Hughes Electronics Corporation (HEC) in December 1997. HDC was made up of segments that primarily performed Defense efforts. Raytheon then established defined benefit pension plans for the newly acquired Defense employees and retired Defense employees who were previously covered by the Hughes Non-Bargaining Retirement Plan and Hughes Bargaining Retirement Plan. HEC transferred the pension plan assets and actuarial liabilities attributable to the transferred employees and retirees from the Hughes retirement plans to the plans Raytheon established. The assets transferred from Hughes to Raytheon were valued at $6,053,004,534. The Employee Matters Agreement between Raytheon and HEC established the manner and times of the transfer.

Defense Contract Management Agency Review. The DCMA CIPR Branch performed a review of the pension matters between Hughes and Raytheon. DCMA concluded that the pension transfers complied with the pension agreement and issued a letter to the Defense Corporate Executive (DCE) on March15, 2000, recommending that the DCE accept the allocation of assets between Hughes and Raytheon. On August 18, 2000, the letter was reissued to incorporate certain revisions to the transfer amounts, and again DCMA recommended that the DCE accept the transfer as being in compliance with the pension agreement. On October 20, 2000, DCMA issued another letter that cancelled and superseded the previous letters and identified a need to establish an earlier date for allocation of assets and liabilities to segments.

Defense Contract Audit Agency Review. On April 14, 2000, DCAA initiated an audit to determine CAS 413 compliance for the pension transactions that resulted from the sale of HDC to Raytheon. On July 31, 2001, DCAA issued a report that concluded the determination of the pension asset transfer by Hughes was not performed in accordance with the provisions of CAS 413.50(c)(12). DCAA also determined that Hughes was in noncompliance with CAS 413.50(c)(5)(i) and 413.50(c)(5)(ii), sections that address allocation of pension assets to segments. The specific incidents which caused the CAS 413 noncompliances were the Hughes acquisition of the General Dynamics (GD) Missile Systems on August 22, 1992, and the creation of commercial segments (for example, Direct TV) subsequent to the pension plans becoming fully funded in 1992.

Hughes Acquisition of General Dynamics. On August 22, 1992, HEC acquired the GD Missile Systems. HEC had merged the acquired GD pension plan assets and liabilities with its plan. The purchase/sale agreement required HEC to retain the GD pension plan benefits for the former GD employees. The GD plan differed materially from the HEC plan with a substantially different benefit formula, no requirement for participant contributions, and a different funding ratio of assets to liabilities. The HEC plan was contributory; the GD plan was noncontributory--and the level of benefits materially different. When employees contribute a share of the pension costs, the employer's share, that is, pension costs charged to Government contracts, is less. Those conditions require HEC to maintain segment accounting for the acquired GD plan.

To be in compliance with CAS 413.50(c)(2) and CAS 413.50(c)(3), segmentation of the GD pension assets transferred to the Hughes Pension Trust should have been maintained beginning with the date of acquisition in 1992.

Hughes Startup of Direct TV. The requirement to isolate Direct TV as a pension segment separate from the Government business entity segments occurred with creation of Direct TV as a commercial business entity in 1994. Direct TV is a subsidiary of Hughes that provides satellite television services. Hughes should have separated Direct TV from any Defense business segment to comply with CAS 413.50. CAS 413.50(c)(2) requires establishment of a separate segment when the level of benefits, eligibility for benefits, age distribution, or the appropriate actuarial assumptions are, in the aggregate, materially different for the segment than for the average of all segments. In general, actuarial provisions applicable to a newly created segment are substantially different in every respect than the provisions applicable to the older established Defense segments. In addition, the last pension contribution by Hughes to the Hughes Pension Plans was made in 1992. That means that Direct TV has never made a contribution to the Hughes Pension Trust to fund the benefits for the Direct TV commercial employees. The only pension assets assignable to Direct TV would be assets transferred from other segments to cover the liabilities of any employees transferred to Direct TV from other business segments. The allocation of pension assets to Direct TV made in accordance with the provisions of the purchase/sale agreement complied with ERISA but was not in compliance with CAS 413. CAS 413 requires identification of the source of the pension assets. In this case, the source of the pension assets was substantially pension costs charged to CAS-covered Government contracts.

Cost Accounting Standard 413.50(c) Citations. The DCAA Audit Report No. 4511-2000F19200004, "Report on Noncompliance with CAS 413 Adjustment and Allocation of Pension Cost," July 31, 2001, cites the noncompliance with CAS 413.50(c)(5) and CAS 413.50(c)(12) as it relates to the segmenting of assets between Hughes and Raytheon in 1997. We agree with the DCAA report. However, we believe the requirement for Hughes to establish segment pension asset accounting occurred prior to the acquisition of HDC by Raytheon in 1997. Hughes was in noncompliance with CAS 413.50(c)(2) and CAS 413.50(c)(3) when they failed in 1992 to establish a separate pension segment upon acquiring GD Missile Systems. Hughes was also in noncompliance with CAS 413.50(c)(2) when they failed to establish in 1994 Direct TV as a pension segment separate from the Defense segments. The requirement to provide the segment accounting can be established separate and distinct from the requirements established in 1997 under CAS 413.50(c)(12) by the Raytheon acquisition.

Prior Audit. In June 1996, we issued an Inspector General of the Department of Defense Report PO-96-012, "Department of Defense Oversight of Defense Contractor Business Combinations." The report stated that in 1994, DCAA reviewed the 1992 pension fund transfer from the GD Missile Systems to the Hughes Aircraft Company (HAC) and found that the contractor had merged the acquired GD pension plan assets and liabilities with the HAC plan. The report recommended that the DCE should request technical assistance to evaluate the pension fund transfer.

The report states that DCAA had sufficient information to advise the DCE of the potential CAS 413 noncompliance and to request technical assistance in calculating the general dollar magnitude of the noncompliance in accordance with Federal Acquisition Regulation Subpart 30.602-2, "Noncompliance With the CAS Requirements." The report further states that the DCAA audit working paper file contained sufficient information for the auditors to determine whether the pension plan merger complied with the CAS requirements. HAC planned to retain the GD pension plan benefits for former GD employees although the GD benefits differed from the HAC plan. For example, the HAC plan was contributory and the GD plan was noncontributory. When employees contribute a share of the pension costs, the employer share of pension costs charged to Government contracts is less. Those two conditions indicate that the HAC would be required to maintain segment accounting for the acquired GD plan.

The report recommended that permanent file information from incurred cost audits should be maintained as a record of the total annual pension costs. As an example, the permanent file could include sufficient records to determine the total pension costs incurred each year, the total payroll used to allocate the costs to the segments, and any other factor used in calculating the allocation of pension costs to the segments. The records should be maintained to facilitate Government verification of contractor implementation of CAS 413.50(c)(12).

In October 1996, the DCAA agreed with the report recommendation and included the requirement to maintain the historical pension cost information in the update of the DCAA Contract Audit Manual, January 1997.

Segmented Records. Hughes should have maintained, at a minimum, segmented records for pension transactions since 1992. If the records had been established and audited by DCAA, a non-CAS compliant allocation of Government-funded pension assets to commercial segments could have been avoided.

Potential Risk to the Government

Government Interest in Surplus Assets. DoD has an interest in Government contractor pension funds in which assets are funded through pension costs charged to CAS-covered Government contracts. The market value and percentage of the assets allocable to Government contract segments directly impact not only future contracting pension costs but also the amount of any adjustments to previously determined pension costs DoD might receive in the event of a curtailment of pension benefits, a termination of the pension plan, or the closing of a Government segment.

Effect to the Government. Because the asset balance is an integral part of the pension cost computation, the accuracy of Government pension cost calculations cannot be determined if all assets are not properly audited and accounted for. Our evaluation showed that adequate and audited pension asset accounting records as required by CAS 413.50(c)(7) were not always available because the contractors did not maintain adequate records. Without the required records, the Government cannot accurately determine the value of the Government-funded pension assets or the assignment of the assets by segment. Therefore, the Government cannot determine the assets in excess of pension liabilities available to offset current or future contract pension costs or assets potentially available for recovery in the event of a segment closing or pension plan curtailment.

Summary

One of the major overhead expenses incurred on Government contracts is pension cost. Pension costs are unique in that they represent an actuarial estimate for providing future retirement benefits for employees who worked on the contracts. Unlike other contract costs, retirement benefits may not occur until long after the contracts have been closed.

A lack of adequate records and review for Government-funded pension assets presents a high risk to the Government. The acquisition by Raytheon of E-Systems, TI, and Hughes resulted in $6,971,316,994 in pension assets being transferred to Raytheon. The Government must ensure that the paid-in funds are accounted for so that any excess funding is potentially available to cover pension costs on future Government contracts. If a contractor transfers employee benefit liabilities without all of the related pension fund assets, the transferee has to make new contributions to the pension fund. As a result, the Government is at risk of overpaying or not receiving proper credit for certain contributions made to the pension funds.

Recommendations and Management Comments

1. We recommend that the Director, Defense Contract Management Agency request that Raytheon and Raytheon's certified public accounting firm correct the respective financial reports for the E-Systems Salaried Plan to report the unauthorized withdrawal of $7.9 million.

DCMA Comments. DCMA concurred with the recommendation. DCMA will request that Raytheon amend their 1998 and 1999 Forms 5500 and have their accounting firm amend the pension plan's financial statements for 1998 and 1999 to reflect the $7.9 million withdrawal and repayments. Additionally, DCMA voluntarily plans to amend their CIPR process and to emphasize that segment accounting of pension assets needs to be explicitly addressed in future reports.

2. We recommend that the Director, Defense Contract Audit Agency:

a. Review and verify the E-Systems Supplemental Executive Retirement Plan asset balances that are available as part of their periodic Cost Accounting Standard 413 reviews. The Government's interest in the Cost Accounting Standard 413.50(c)(7) asset balances should be documented and made a part of the E-Systems permanent audit file.

b. Review and verify the Texas Instruments pension plan asset balances that are available as part of their periodic Cost Accounting Standard 413 reviews. The Government's interest in the Cost Accounting Standard 413.50(c)(7) asset balances should be made a part of the Texas Instruments permanent audit file.

c. Determine the cost impact to the Government with regard to a Hughes noncompliance with Cost Accounting Standards 413.50(c)(2) and 413.50(c)(3) caused by not properly segmenting the pension assets transferred as a result of the General Dynamics acquisition in 1992.

d. Determine the cost impact to the Government with regard to a Hughes noncompliance with Cost Accounting Standard 413.50(c)(2) caused by not properly segmenting in 1994 the newly created Direct TV segment from the Government segments.

e. Revise the pension audit guidance program to require that periodic reviews of the Cost Accounting Standard 413.50(c)(7) asset balances maintained by Cost Accounting Standard covered Government contractors are performed. Periodic reviews will ensure that the Government's interest in the Cost Accounting Standard 413.50(c)(7) pension plan asset balances are documented and made a part of the permanent audit file for each Cost Accounting Standard covered Government contractor.

DCAA Comments. DCAA concurred with the recommendations. DCAA agreed to review and verify the E-Systems and TI pension plan asset balances. DCAA will also record the CAS 413.50(c)(7) asset balances in the respective permanent audit files. DCAA will also address the issue of not properly segmenting pension assets from the Hughes acquisition of GD and the creation of Direct TV as part of the DCAA review of the Hughes sale of Government segments to the Boeing Company. Further, DCAA will revise their audit plans to add the year-end pension asset balances to the list of historical pension cost information required to be maintained in the permanent file and to revise the joint DCMA and DCAA pension review programs to require that periodic reviews of the Cost Accounting Standard 413.50(c)(7) asset balances be performed.

Appendix A. Scope and Methodology

We reviewed the primary salaried and hourly pension plans for Raytheon, E-Systems, TI, and Hughes. We also reviewed the segmented pension data DCAA auditors and DCMA pension specialists obtained during their oversight of contractor pensions. We reviewed data for January 1985 through July 2001.

At the beginning of our evaluation, we requested contractor pension records through DCAA to minimize duplicative requests to the contractors. We reviewed records prepared to comply with ERISA reporting requirements. The review included the Department of Labor/Internal Revenue Service Form 5500 (Plan Annual Report), Schedule B, prepared by the plan's actuary, and the supporting plan financial reports prepared by the contractor's public accounting firm.

We performed this evaluation from January 2001 through January 2002 according to standards implemented by the Inspector General of the Department of Defense.

We limited the scope because of the lack of CAS 413.50(c)(7) pension plan asset accounting records by segment under certain plans. The required CAS records were either never prepared or the contractor's record retention policy resulted in the destruction of records.

The General Accounting Office has identified several high-risk areas in the DoD. This report provides coverage of the Contract Management high-risk area.

We relied on computer-processed pension data furnished by the Government contractors through DCAA in the performance of this evaluation. We accepted the Government contractor Accounting System Review performed by DCAA as validation of computer processed data.

Appendix B. Prior Coverage

During the last 5 years, the Inspector General of the Department of Defense has issued two reports that discuss the effects of business combinations on pension plans and DoD-funded pension assets. Also within the last 5 years, DCAA has issued 5 reports that deal with the Raytheon business combinations in relationship to pension plans. Unrestricted Inspector General of the Department of Defense reports can be accessed at http://www.dodig.osd.mil/audit/reports.

Inspector General of the Department of Defense (IG DoD)

IG DoD Report No. D-2000-126, "Evaluation of Boeing and Rockwell Corporation Pension Asset Transfers," May 19, 2000

IG DoD Report No. 99-156, "Evaluation of the Effect of the Boeing, Rockwell, and McDonnell Douglas Business Combination on Pension Plans and DoD-Funded Pension Assets," May 13, 1999

Defense Contract Audit Agency

DCAA Report No. 4511-2000F1920004, "Report on Noncompliance with CAS 413 Adjustment and Allocation of Pension Cost," July 31, 2001

DCAA Report No. 2671-2001A19200016, "Noncompliance with Federal Acquisition Regulation Clause 52.215-15 - Pension Adjustments and Asset Reversions," October 2, 2001

DCAA Report No. 4511-2000F17900001, "Split of the Hughes Electronics Pension Plan Assets and Liabilities Due to the Raytheon/Hughes Aircraft Company Merger," December 7, 2000

DCAA Report No. 4121-2000D17900009-S1, "Supplemental Agreed-Upon Procedures," December 4, 2000

DCAA Report No. 4121-2000D17900009, "Agreed-Upon Procedures Report," November 2, 2000

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Technology, and Logistics
Deputy Under Secretary of Defense (Industrial Affairs)
Director, Defense Procurement
Under Secretary of Defense (Comptroller)/Chief Financial Officer
Deputy Chief Financial Officer Accounting Policy Directorate
Deputy Comptroller (Program/Budget)

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Inspector General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Contract Management Agency

Non-Defense Federal Organizations

Office of Management and Budget
Office of Federal Procurement Policy
Executive Secretary Cost Accounting Standards Board
National Security Programs
Deputy Associate Director National Security Division

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Efficiency, Financial Management, and Intergovernmental Relations, Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International Relations, Committee on Government Reform
House Subcommittee on Technology and Procurement Policy, Committee on Government Reform

Defense Contract Management Agency Comments

DEFENSE CONTRACT MANAGEMENT AGENCY
8725 JOHN J. KINGMAN ROAD, SUITE 4539
FORT BELVOIR, VIRGINIA 22060-6221

JUL 19 2002

IN REPLY REFER TO

DCMA-OCB

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL, POLICY AND OVERSIGHT, DEPARTMENT OF DEFENSE

SUBJECT: Response to DoD IG Draft Report on Effect of the Raytheon Defense Business Acquisitions on Pension Plans and DoD Funded Pension Assets. (Project No. D2001-D000PT-0060)

This is in response to the Department of Defense Inspector General audit report, subject as above. The Defense Contract Management Agency comments to the findings and recommendation are attached. Please refer any questions you may have to Mr. Patrick Ring, email: pring@hq.dcma.mil, telephone, (703) 428-1010.

ROBERT W. SCHMITT
Executive Director
Contract Management Operations

Attachment

FINDING: Adequate contractor records did not exist to ensure that the Government received proper credit for its share of contributed pension assets under several of the pension plans transferred to Raytheon. The contractors did not maintain the required CAS 413.50(c)(7) pension asset accounting records by segment under certain plans. Additionally, no documented evidence existed that DCAA or DCMA performed any periodic audits of CAS 413.50(c)(7) pension asset records or maintained any records to document the Government's interest in the contractor pension funds. As a result, the Government is at risk of overpaying or not receiving proper credit for certain contributions made to the pension funds.

DCMA COMMENTS: Concur. DCMA Contractor Insurance and Pension Review (CIPR) Teams take a global approach when reviewing contractors' pension programs. They focus on the overall measurement of assets, liabilities and costs of the entire pension plan, as opposed to detailed auditing of the pension assets within a segment. The finding highlights an improvement which we will make to the CIPR process. Consequently, we have amended our One Book Chapter 7.2 to emphasize that segment accounting of pension assets needs to be explicitly addressed in the CIPR report.

RECOMMENDATION 1: We recommend that the Director, Defense Contract Management Agency request that Raytheon and Raytheon's certified public accounting firm correct the respective financial reports for the E-Systems Salaried Plan to report the unauthorized withdrawal of $7.9 million.

DCMA COMMENTS: Concur. DCMA will request Raytheon to amend the 1998 and 1999 Forms 5500, and have their accounting firm amend the pension plan's 1998 and 1999 financial statements to reflect the $7.9 million withdrawal and subsequent repayment to the E-Systems' Salaried Pension Plan. Raytheon has indicated it would request the Department of Labor and the Internal Revenue Service to provide the impact of such a change before making the revisions.

Disposition:
(X) Action is ongoing. ECD: December 31, 2002
( ) Action is considered complete.

Defense Contract Audit Agency Comments

DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
8725 JOHN J. KINGMAN ROAD, SUITE 2135
FORT BELVOIR, VA 22060-6219

IN REPLY REFER TO

PAC 730.47/2002-6

July 19, 2002

MEMORANDUM FOR DEPUTY ASSISTANT INSPECTOR GENERAL FOR AUDITING, DEPARTMENT OF DEFENSE

ATTENTION: Mr. David A. Brinkman

SUBJECT: Response to DoDIG Draft Report on Evaluation of the Effect of the Raytheon Defense Business Acquisitions on Pension Plans and DoD-Funded Pension Assets (Project No. D2001-D000PT-0060)

As requested we are providing responses to the recommendations for DCAA contained in the subject draft report.

Recommendation 2a

We recommend that the Director, Defense Contract Audit Agency review and verify the E-Systems Supplemental Executive Retirement Plan asset balances that are available as part of their periodic Cost Accounting Standard 413 reviews. The Government's interest in the Cost Accounting Standard 413.50(c)(7) asset balances should be documented and made a part of the E-Systems permanent audit file.

DCAA Response

Concur. This will be accomplished with the issuance of the guidance discussed in our response to Recommendation 2e.

Recommendation 2b

We recommend that the Director, Defense Contract Audit Agency review and verify the Texas Instruments pension plan asset balances that are available as part of their periodic Cost Accounting Standard 413 reviews. The Government's interest in the Cost Accounting Standard 413.50(c)(7) asset balances should be made a part of the Texas Instruments permanent audit file.

DCAA Response

Concur. This will be accomplished with the issuance of the guidance discussed in our response to Recommendation 2e.

PAC 730.47/2002-6
SUBJECT: Response to DoDIG Draft Report on Evaluation of the Effect of the Raytheon Defense Business Acquisitions on Pension Plans and DoD-Funded Pension Assets (Project No. D2001-D000PT-0060)

Recommendation 2c

We recommend that the Director, Defense Contract Audit Agency determine the cost impact to the Government with regard to a Hughes [Hughes Electronics Corporation (HEC)] noncompliance with Cost Accounting Standards 413.50(c)(2) and 413.50(c)(3) caused by not properly segmenting the pension assets transferred as a result of the General Dynamics acquisition in 1992.

DCAA Response

Concur in principle. In a letter to the DCE, dated February 20, 1997, the DCMC (currently DCMA) Pension Specialist stated that GD transferred sufficient pension assets to HEC so that the ratios of pension assets to actuarial accrued liabilities for the merged plans (i.e., the GD plans and the HEC plans) were equal. Therefore, HEC was not required to segment pension assets transferred under the CAS 413.50(c)(3) requirements. The letter also recommended that the contractor perform an analysis to demonstrate that the level of benefits at Hughes Missiles Systems Company (HMSC), the HEC segment into which the acquired GD segments were consolidated, after the merger of the GD plans was not materially different than the average benefits for all HEC segments (i.e., that it was not required to segment pension assets transferred under the CAS 413.50(c)(2) requirements). Based on the DCMC Pension Specialist's recommendation, the DCE requested the contractor perform the recommended analysis and stated if it failed to do so, HEC would be required to calculate separate pension cost for HMSC. We have been unable to find any documentation regarding how this issue was resolved; however, HEC did not calculate separate pension cost for HMSC nor was it cited for noncompliance with CAS 413.50(c)(2). In its response to a recent DCAA audit report related to the segment closing that resulted from the sale of HEC government segments to Raytheon, the contractor stated that the former GD employees became participants in the HEC pension plans. If that is the case, the level of benefits at HMSC after the merger of the GD plans would not have been materially different than the average benefits for all HEC segments. Accordingly, it appears that a cost impact relating to the merger of the GD plans and the HEC plans is not likely to be significant.

In any event, since HEC pension plans for all its segments have been overfunded from 1992 to present, no pension costs have been charged to government contracts. Any cost impact from merging the GD pension plans with the HEC pension plans would not arise until the HEC pension plans come out of full funding or until HMSC is part of a CAS 413.50(c)(12) event, such as a sale of HMSC. In December 1997, HEC sold HMSC as a part of the sale of Hughes Defense Company (HDC) to Raytheon. The cost impact requested by the DoDIG cannot be readily separately calculated because it would require a reconstruction of the merged pension plan data into separate plans as far back as 1992. However, the excess pension assets that were transferred from GD will be a part of the government's calculation of the estimated CAS 413.50(c)(12) adjustment related to the most recent sale of the HEC's government segments to Boeing. (See the discussion related to Recommendation 2d below.) We believe this will result in an equitable recovery of government-contributed pension assets.

2

PAC 730.47/2002-6
SUBJECT: Response to DoDIG Draft Report on Evaluation of the Effect of the Raytheon Defense Business Acquisitions on Pension Plans and DoD-Funded Pension Assets (Project No. D2001-D000PT-0060)

Recommendation 2d

We recommend that the Director, Defense Contract Audit Agency determine the cost impact to the Government with regard to a Hughes noncompliance with Cost Accounting Standard 413.50(c)(2) caused by not properly segmenting in 1994 the newly created Direct TV segment from the Government segments.

DCAA Response

Concur in principle. The cost impact requested by the DoDIG cannot be readily separately calculated. Government-contributed excess assets which may have been used to fund pension benefits for HEC's commercial segment, Direct TV will be a part of the government's calculation of the estimated CAS 413.50(c)(12) adjustment related to the sale of the HEC's government segments to Boeing on October 6, 2000. That calculation will also include excess assets related to the segment closing resulting from the sale of HDC to Raytheon on December 17, 1997. Details of the actions taken to date and planned future actions are discussed in the paragraphs below.

DCAA Hughes Corporate Office Audit Report 4511-2000F19200004, dated July 31, 2001, recommended that HEC submit the "adjustment of previously determined pension cost" in accordance with CAS 413.50(c)(12) for the segment closing that resulted from the sale of HDC to Raytheon on December 17, 1997.

On January 17, 2002, the cognizant DCAA field audit office (FAO) held an entrance conference regarding its audit of HEC's compliance with the provisions of CAS 413.50(c)(12) related to the sale of the HEC government segments to Boeing. On April 16, 2002, the DCE sent a letter to HEC requesting that it calculate an "adjustment to previously determined pension costs" pursuant to CAS 413.50(c)(12). The letter was drafted as a DCAA/DCMA CIPR team effort and provided that the initial allocation of assets to segments be based on the 1994 actuarial liabilities for three groups: (i) segments sold to Raytheon, (ii) segments sold to Boeing, and (iii) the remaining Hughes segments.

The contractor contends that it transferred all of the pension plan assets and actuarial accrued liabilities pertaining to the sold segments to Raytheon and Boeing. HEC claims that, as a result of that transfer, based on CAS 413.50(c)(12)(v), it is not required to perform the segment closing adjustment for either segment closing. The government believes that the method used by the contractor for the initial allocation of assets to segments resulted in government-funded pension plan asset being assigned to Direct TV. Therefore, all the pension plan assets pertaining to the closed segments were not transferred to Raytheon and Boeing.

Since HEC has not provided the requested information, at the DCE's request, the DCMA actuaries will estimate the CAS 413.50(c)(12) adjustment using 1994 actuarial data and other relevant information obtained during prior CIPR reviews. The estimated "adjustment to previously determined pension cost" will be used by the FAO in the CAS 413 noncompliance report. The FAO will present the draft audit report to HEC for comments within the next month. HEC will have 30 days to provide comments or a realistic action plan for producing its own calculation.

Recommendation 2e

We recommend that the Director, Defense Contract Audit Agency revise the pension audit guidance program to require that periodic reviews of the Cost Accounting Standard 413.50(c)(7) asset balances maintained by Cost Accounting Standard covered Government contractors are performed. Periodic reviews will ensure that the Government's interest in the Cost Accounting Standard 413.50(c)(7) pension plan asset balances are documented and made a part of the permanent audit file for each Cost Accounting Standard covered Government contractor.

DCAA Response

Concur. We will revise the joint DCMA/DCAA pension review programs to require that periodic reviews of the Cost Accounting Standard 413.50(c)(7) asset balances be performed whether or not there are incurred pension costs. Revisions will also be made to require periodic reviews of the plan activity as a whole, in those cases where the contractor does not maintain Cost Accounting Standard 413.50(c)(7) records (i.e., the contractor does not separately calculate pension costs by segment). We will also revise CAM to add the year-end pension asset balance to the list of historical pension cost information required to be maintained in the permanent file.

Your staff may direct any questions regarding this memorandum to Ms. Anita Homburg, Program Manager, at (703) 767-3250.

Lawrence P. Uhlfelder
Assistant Director
Policy and Plans

Team Members

The Audit Followup and Technical Support Directorate, Office of the Assistant Inspector General for Auditing of the Department of Defense prepared this report. Personnel of the Office of the Inspector General of the Department of Defense who contributed to the report are listed below.

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