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Acquisition

Accounting for Pension Assets Under Advance Agreements with Northrop Grumman and Litton Industries, Inc.
(D-2004-025)

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Acronyms

ACO	Administrative Contracting Officer
CAS	Cost Accounting Standards
CIPR	Contractor Insurance/Pension Review
DCAA	Defense Contract Audit Agency
DCMA	Defense Contract Management Agency
ERISA	Employee Retirement Income Security Act
FAS	Financial Accounting Standard

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November 25, 2003

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

SUBJECT: Report on Accounting for Pension Assets Under Advance Agreements with Northrop Grumman and Litton Industries, Inc. (Report No. D-2004-025)

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

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Defense Contract Management Agency comments were nonresponsive to Recommendation A.1.c. As such, additional management comments are requested and should be received by January 26, 2004.

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

By direction of the Deputy Inspector General for Auditing:

Kenneth H. Stavenjord
Program Director, Audit Followup
and Technical Support Directorate

Office of the Inspector General of the Department of Defense

Report No. D-2004-025 **November 25, 2003**
(Project No. D2003PT-0006)

Accounting for Pension Assets Under Advance Agreements with Northrop Grumman and Litton Industries, Inc.

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 pension plans and DoD-funded pension assets affected by the Northrop Grumman acquisition of Litton Industries, Inc. and the Northrop Grumman's merger of its pension plans. The Northrop Grumman acquisition of Litton resulted in $2.9 billion of pension assets being transferred to Northrop Grumman.

In July 1997, prior to the Northrop Grumman acquisition of Litton, the Government and Litton entered into an advance agreement concerning the disposition of pension asset surpluses remaining in the Litton pension trust after the sale by Litton of the Precision Gear and Itek Optical Divisions. The Cost Accounting Standards (CAS) most relevant to the advance agreement are CAS 413.50(c)(7), covering the contractor requirement to maintain pension asset accounting records, and CAS 413.50(c)(12), covering the settlement of pension assets when a contractor sells a business.

On September 15, 1995, the Government and Northrop Grumman entered into an advance agreement on Northrop Grumman's merger of its pension plans. The 1995 advance agreement incorporated a CAS Board waiver of the CAS 413.50(c)(3) requirement to calculate separate pension costs on merged pension plans that have different funding ratios. This waiver was contingent upon Northrop Grumman's continuing to maintain asset records for each pension plan as required by CAS 413.50(c)(7).

Results. Several CAS non-compliance issues exist regarding the pension asset surplus calculation, the allocation of Government-funded surplus assets to segments with commercial pension liabilities, the calculation of investment experience on Government-funded pension assets, and the amortization schedule used on Government-funded pension assets under the 1997 advance agreement between the Government and Litton Industries. As a result, the Government may not have received proper credit under the advance agreement for surplus Government-funded pension assets as determined in accordance with CAS 413.50(c)(12). The Defense Contract Audit Agency (DCAA) should determine the correct amount of Government-funded pension surplus; determine to what extent Government-funded assets were allocated to fund commercial liabilities; determine if the correct trust investment experience was credited for each year in calculating the asset balances; and determine the affect on the pension asset credit due the Government caused by using the incorrect amortization amounts. The Defense Contract

Management Agency should renegotiate the advance agreement with the contractor, as provided for under paragraph 12 of the agreement, to incorporate the DCAA determination of the proper amount of pension funding credit due the Government (finding A).

Also in question is the accuracy of the Northrop Grumman accounting for Government-funded pension assets. The January 1, 1999, market value of assets stated in the Northrop Grumman Pension Plan, CAS Valuation Report, is $4.7 million less than the January 1, 1999, market value of assets stated in a report prepared by the contractor's actuary. Inconsistent reporting gives the Government a reason to question the accuracy of the pension asset records. Since the asset balance is an integral part of actuarial pension cost calculations, future pension costs charged to Government contracts could be affected. The DCAA should review the accuracy of Northrop Grumman's pension accounting from 1995 to the present to determine compliance with CAS 413.50(c)(7), and the 1995 advance agreement (finding B). See the Finding section of the report for the detailed recommendations.

Management Comments and Evaluation Response. The DCAA agreed to determine the correct amount of Government-funded pension surplus; the extent to which Government-funded assets were allocated to fund commercial liabilities; and the effect on the pension asset credit due the Government caused by using the incorrect amortization amounts to allocate the surplus. The DCAA also agreed to review the accuracy of Northrop Grumman's pension accounting. The DCAA did not agree to determine if the correct trust investment experience was credited for each year in calculating the asset balances. The DCAA does not agree with our position that there are conflicting provisions in the advance agreement as to the method for crediting investment experience. However, we maintain that determining whether the Government received proper credit for investment experience under the advance agreement is a valid audit step. If the DCAA determines that there is an error in any of the surplus amounts, allocation amounts, and amortization, it follows that the investment experience calculation also needs to be corrected. Accordingly, we request that the DCAA reconsider their position in responding to this recommendation in their comments on the final report by January 26, 2004.

The Defense Contract Management Agency concurred with the recommendation to renegotiate the advance agreement, therefore, no further comments are required. See the Finding section of the report for a discussion of the management comments on the recommendations and evaluator response, and the Management Comments section of the report for the complete text of the comments.

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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 by a corporation would rarely equal the annual pension funding amount that ERISA requires. The FAS 87 asset accounting also differs from the asset 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). Rules for pension accounting fall 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. However, 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.

Another major difference between CAS and ERISA is the method for allocating pension plan assets when plan assets are 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, pension costs charged to a business segment with Government contracts become assets assigned to the segment. The segmented assets are designated to cover the segment liabilities. The findings in this evaluation substantially relate to differences between ERISA and CAS accounting for pension assets.

Several of the more pertinent CAS references pertaining to the issues in this report are 413.50(c)(3), 413.50(c)(7), and 413.50(c)(12). CAS 413.50(c)(3) requires the calculation of separate pension costs on merged pension plans that have different funding ratios. CAS 413.50(c)(7) covers how a contractor must maintain pension asset accounting records. CAS 413.50(c)(12) covers the settlement of pension assets when a contractor sells a business.

Litton Industries Inc. Litton Industries, Inc., designs, builds, and overhauls surface ships for Government and commercial customers, and is a provider of defense and commercial electronics technology, components, and materials. In addition, the company is a prime contractor to the U.S. Government for information technology and provides specialized information technology services to commercial and Government customers. The Company was founded in California in 1953 and has approximately 40,300 employees. On January 5, 2001, the Northrop Grumman Corporation bought Litton Industries, Inc., for $5.1 billion.

Northrop Grumman Corporation. Northrop Grumman is an advanced technology company with corporate offices in Los Angeles, California, and sites in 37 other states. The corporation's business includes the design, development, and production of military aircraft, radar and electronics systems, airspace management and information systems, marine propulsion, precision weapons, information technology, and commercial and military aerostructures. The company also provides information systems support and services, training and training system development and support, and military and commercial technology research and development. There are approximately 20 business units with Government contracts.

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. DCMA also provides program and technical support by analyzing costs, schedules, and technical performance of contractor programs and systems.

Contractor Insurance/Pension Review Teams. The Contractor Insurance/Pension Review (CIPR) team is responsible for conducting CIPRs, which are comprehensive reviews of contractors' insurance programs, pension plans, other deferred compensation plans and related policy, procedures, practices, and costs. A CIPR is initiated at the request of the Administrative Contracting Officer. DCAA auditors and DCMA insurance/pension specialists comprise the CIPR team.

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). The 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 which 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 in accordance with Federal Acquisition Regulation, Subpart 31.2.

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

Litton Pension Plans. As of January 1, 1989, Litton changed the name of their pension plan (Plan number 4) from Litton Industries Retirement Plan to Litton Industries Retirement "Plan A" and created a second plan—Plan number 9, Litton

Industries Retirement Plan B. As of December 31, 1988, 20 of the approximately 53 segments under Plan A were transferred to Plan B. The reason for the division of the two plans was to maintain Plan A for commercial divisions (segments) and to establish Plan B for Government divisions (segments). The Northrop Grumman acquisition of Litton resulted in $2.9 billion of pension assets being transferred to Northrop Grumman.

Objectives

Our objective was to evaluate the pension plans and DoD-funded pension assets affected by the Northrop Grumman acquisition of Litton Industries, Inc.

A. Litton Industries Advance Agreement

Several CAS non-compliance issues exist regarding the calculation, disposition of surplus, crediting of investment experience, and the amortization schedule, used to account for Government-funded pension assets under the advance agreement between the Government and Litton Industries covering the sales of Precision Gear and Itek Optical (Itek) Divisions. The surplus amount in the advance agreement is less than the amount detailed in the concurrent financial statement. Government-funded assets were allocated to underfunded segments resulting in Government funding of commercial liabilities. There are conflicting agreement provisions for crediting investment experience. The annual amortization amounts according to the advance agreement do not agree with standard amortization calculations. As a result, the Government has not received proper credit under the advance agreement for surplus Government-funded pension assets as determined in accordance with CAS 413.50(c)(12).

Defense Contract Management Agency CIPR

Request for CIPR Assistance. In May of 1996, DCAA requested a DCMA CIPR of Litton's 1994 sale of its Precision Gear Division to the Boeing Company and the 1996 sale of its Itek Division to the Hughes Company. According to DCAA, both segments had surplus pension assets at the time of the sale. Additionally, DCAA stated that the sale of both segments represented a segment closing in accordance with CAS 413.50(c)(12) and that the Government should share in the surplus assets of the closed segments.

CIPR Conclusions. In September of 1996, DCMA responded to the DCAA request for assistance. DCMA agreed that the sale of a segment coupled with retention by the seller of pension assets and liabilities of a segment is equivalent to the closing of a segment and therefore a credit is due the Government as an adjustment of previously determined pension costs.

Advance Agreement on Pension Accounting for Sale of Litton Itek Optical and Precision Gear Divisions

On July 28, 1997, the Government and Litton Industries entered into an advance agreement regarding the Precision Gear and Itek pension segments. The purpose of the agreement was to resolve pension cost accounting issues under CAS 413.50(c)(12) as a result of the sale of Precision Gear and Itek.

The methodology set forth by the advance agreement is as follows:

- The pension asset surplus (or deficit) associated with the sale of Precision Gear and Itek is the difference between the actuarial liability and the market value of the assets on December 31, 1994, for Precision Gear and on December 31, 1995, for Itek.

- The Government's share of the pension asset surplus will be calculated using the segment's business contract base. The percentage of CAS covered contracts was determined to be 95 percent of the total dollar value of all Precision Gear contracts and 80 percent of the Itek contracts.

- The Government pension asset surplus will be 95 percent of $4,323,496 (or $4,107,321) for Precision Gear and 80 percent of $24,837,283 (or $19,869,826) for Itek.

- The Government will recognize its share of the pension asset surplus by receiving credits against otherwise allowable pension costs. This will be accomplished using an amortization schedule based on a 5-year annual payout and an 8-percent interest rate. The annual amortization amount will be allocated to other segments with pension asset deficits.

Review of Advance Agreement

Several CAS non-compliance issues exist in the advance agreement between the Government and Litton Industries concerning the treatment of the Itek and Precision Gear pension asset surpluses.

- The surplus of Government-funded pension assets as stated in the advance agreement does not agree with the surplus asset balance as stated in financial reports prepared by Litton's actuary.

- Government-funded pension surplus assets have been allocated to segments with Government and commercial pension liabilities, but without any corresponding commercial payment.

- There are conflicting provisions in the advance agreement as to the method for crediting investment experience on Government-funded pension assets. The conflict involves using the actual investment experience versus a fixed interest rate of 8 percent.

- The Precision Gear and Itek annual amortization amounts as stated in the advance agreement are incorrect.

Government-Funded Pension Asset Surplus

The surplus of Government-funded pension assets, as stated in the advance agreement between the Government and Litton, is understated as compared to the actuarial financial report surplus asset balance. This indicates the Government may not have received proper credit for surplus Government-funded pension assets relative to the difference between the advance agreement and the financial report surplus balances.

According to the July 1997 advance agreement between Litton and the Government, the amount of Itek surplus to be amortized should be the difference between the actuarial liability and the market value of the assets on December 31, 1995, as indicated in the January 1, 1996, actuarial valuation report for Itek. There is a discrepancy between the Itek surplus amount to be amortized, as stated in the advance agreement, and the amount as presented in the actuarial report. The amount stated in the advance agreement as the difference between the actuarial liability and the market value of the assets, as of December 31, 1995, for Itek, is $24,837,283. However, according to the actuarial statement, the difference between the actuarial liability and the market value of the assets as indicated in the January 1, 1996, actuarial valuation is $25,712,530. This represents a net discrepancy of $875,247 in the amount of pension asset surplus available for calculating the Government's share.

We also question the correctness of the amount stated in the advance agreement as the difference between the actuarial liability and the market value of the assets for Precision Gear as of December 31, 1994. The surplus amount, as of December 31, 1994, according to the advance agreement is $4,323,496. However, the Precision Gear surplus as of April 30, 1994, according to Litton's actuary, was $5,714,058; and as of December 31, 1995, was $7,606,024. The two actuarial reports bracket the advance agreement and show a surplus difference of $1,390,562 recorded prior to the agreement, and a surplus difference of $3,282,528 subsequent to the agreement. An actuarial report as of January 1, 1995, was not available for comparison to the surplus amount in the advance agreement. However, we do not find it reasonable that there was a 24 percent decrease in the surplus between April 30, 1994, and December 31, 1994, and an increase of 76 percent in the surplus between December 31, 1994, and December 31, 1995.

The differences between the advance agreement and the actuarial financial reporting need to be reconciled in order to determine the correct amount of the Precision Gear and Itek pension asset surplus for calculating the credit due the Government.

Allocation of Government-Funded Pension Asset Surplus to Segments With Commercial Liabilities

Amortization of Surplus to Segments With Commercial Liabilities. Government-funded pension surplus assets have been used to fund commercial pension liabilities. The contractor allocated 100 percent Government-funded pension assets to segments that have Government and commercial liabilities without a corresponding input of commercial funding by the contractor. As a result, the Government funding covered both Government and commercial liabilities, and the Government has not received proper credit under the advance agreement for surplus Government-funded pension assets.

According to the advance agreement: "The Government's share of any pension surplus or deficit of the former divisions retained in Plan 9 [Plan B], as described in paragraph 9 hereof, shall be credited first to each Plan 9 Share Plan Code which is in a deficit status, on a pro-rata basis, based upon the ratio of the deficit level of the Share Plan Code to the total of all Plan 9 [Plan B] Share Plan Codes with a deficit. Any credit not used shall be credited to all Share Plan Codes (excluding those of the former divisions) on a similar pro-rata basis. The company shall maintain records identifying the allocation of surplus, or deficit, as applicable, among share plan codes of Plan 9, and shall furnish such information to the Government on request."

Litton, as of December 31, 1994, had 27 Government segments in Plan B, 12 of which required funding. Prior years' sales reviews show that most, if not all, segments in Plan B have a mix of Government and commercial business. Thus, the method of allocating the Government-funded surplus, as provided for in the advance agreement, without a corresponding input of commercial funding, is inequitable to the Government. The conclusion is that part of the Government-funded surplus allocated to under-funded segments was used to fund commercial liabilities.

Crediting of Investment Experience on the Precision Gear and Itek Principal Sums

There are conflicting provisions in the advance agreement as to the method for crediting investment experience on Government-funded pension assets. As a result, the Government may not have received proper credit under the advance agreement for the amortization of the Precision Gear and Itek surpluses.

The advance agreement stated that the Precision Gear and Itek sales would be treated as if a CAS 413 segment closing occurred on their respective dates of sale. Paragraph 4 of the agreement states that the Precision Gear and Itek pension assets will remain as part of Litton Plan 9 (Plan B), and otherwise be accounted for in the same manner as before the sale of the former Divisions. This accounting for assets "in the same manner" includes the crediting of the same investment experience to the Precision Gear and Itek assets as is applied to all other Litton Plan 9 segments. Thus, based on this provision of the advance agreement, the Precision Gear and Itek pension fund should be credited with the actual investment income rates of return for the years in question. The actual trust fund investment experience realized on the assets was 17.7 percent for 1996, 19.3 percent for 1997, 15.8 percent for 1998, 39.7 percent for 1999, and a negative 5.33 percent for 2000.

However, paragraph 9 of the agreement provides for a distribution of the Precision Gear and Itek asset surplus balances to under-funded segments using an amortization schedule based on an 8-percent interest rate and a 5-year payment duration.

Differences Between Investment Experience Calculations. Compounding the actual investment experience over the 5-year period calculates to a factor of 2.15 ($1.00 in the trust on 1/1/96 has appreciated to $2.15 on 12/31/2000).

Compounding the amortization interest rate, as stated in the advance agreement, over the 5-year period calculates to a factor of 1.47 ($1.00 on 1/1/96 has appreciated to $1.47 on 12/31/2000).

The difference between the two compounding factors (2.15 and 1.47) is 68, or $0.68 per $1.00 of principal sum. However, the advance agreement does not address how the Government and Litton should handle the difference between the actual investment experience and the 8-percent interest rate.

At the end of 5 years, there should be an estimated remaining balance of approximately $2.0 million in the Precision Gear segment trust account and approximately $9.0 million in the Itek segment trust account. The estimate is based on CAS 413.50(c)(7) segment accounting which starts with the beginning asset balance, adds the actual investment experience, and subtracts the annual amortization transfer for each of the 5 years.

The difference between the actual investment experience and the 8-percent amortization interest rate must be addressed to determine if the Government received proper credit on the asset balance as determined using CAS 413.50(c)(7) accounting.

Amortization Schedule

The Precision Gear and Itek annual amortization amounts as stated in the advance agreement are incorrect. The annual amortization amounts as stated in the advance agreement do not agree with calculations performed using standard amortization calculations. As such, the amortization amount of the Precision Gear and Itek pension credit due the Government may be incorrectly stated in the advance agreement.

Precision Gear. The Precision Gear surplus of $4,107,321 was amortized at 8 percent over a 5-year period which, according to the advance agreement, yields a yearly amortization of $882,070. However, the annual amortization amount as stated in the advance agreement differs from results obtained using standard amortization calculations. The correct annual amortization amount, using the same assumptions, is $1,028,705. This is a difference of $146,635. This difference needs to be reconciled to determine if the amortization amount of the Precision Gear pension credit due the Government has been understated in the agreement.

Itek. A similar situation exists for Itek. The Itek surplus of $19,869,826 was amortized at 8 percent over a 5-year period which, according to the advance agreement, yields a yearly amortization of $5,067,246. However, the annual amortization amount as stated in the advance agreement differs from results obtained using standard amortization calculations. The correct annual amortization amount, using the same assumptions, is $4,976,526. This is a difference of $90,720. This difference needs to be reconciled to determine if the amortization amount of the Itek pension credit due the Government has been misstated in the agreement.

Recommendations, Management Comments, and Evaluation Response

A.1. We recommend that the Director, Defense Contract Audit Agency:

a. Determine the correct amount of Government-funded pension surplus for Precision Gear and Itek as of 1996 calculated in accordance with CAS 413.50(c)(12).

Management Comments. The DCAA concurred and stated that their determination should be completed by October 31, 2003. A December 2003 estimate of completion has since been given to IG evaluators.

b. Determine to what extent Government-funded pension assets for Precision Gear and Itek were used to fund commercial pension liabilities.

Management Comments. The DCAA concurred and stated that their determination should be completed by October 31, 2003. A December 2003 estimate of completion has since been given to IG evaluators.

c. Determine the accuracy of the trust investment experience credited for each year for Precision Gear and Itek in calculating the surplus asset balances from 1996 through 2000 in accordance with CAS 413.50(c)(7).

Management Comments. The DCAA nonconcurred with the recommendation. The DCAA stated that there are not conflicting provisions in the advance agreement regarding the method for crediting investment experience on Government-funded pension assets, and that the Government was not harmed. The DCAA stated that the purpose of Paragraph 4 of the advance agreement which states, in part, "The pension assets and liabilities of the Former Divisions will continue as part of Litton Plan 9, assigned to their respective Plan 9 Share Plan Codes, and otherwise accounted for in the same manner as when the Former Divisions were a part of Litton," was to establish that the retained assets and liabilities of the former divisions, Precision Gear and Itek, would continue to be separately accounted for. Additionally, the DCAA stated that while they agree that the retained assets earn the actual investment income rates of return, the administrative contracting officer (ACO) negotiated with the contractor in the advance agreement that the Government's share of the segment closing adjustment surplus assets would earn at an annual rate of 8 percent. The DCAA further stated that the ACO was within his authority under CAS 413.50(c)(12) to negotiate a fixed interest rate. In addition, the DCAA is of the opinion that during the 5-year period that the segment closing adjustment was amortized, the actual rate of return on the pension assets could have potentially been less than the 8 percent provided for in the advance agreement. As such the advance agreement has, in effect, placed the risk associated with subsequent fluctuations in investment experience on the contractor.

Evaluation Response. The DCAA comments are nonresponsive. We requested that the DCAA determine the accuracy of the trust investment experience credited for each year for Precision Gear and Itek in calculating the surplus asset balances from 1996 through 2000 in accordance with CAS 413.50(c)(7). The DCAA has already agreed to perform an audit of the advance agreement, and has concurred with recommendations to include the surplus amounts, allocations, and amortization in the audit scope. The DCAA has nonconcurred with our recommendation to include an audit of the investment experience as part of their audit scope. Their reason for not including the investment experience as part of the audit scope is that they disagreed that there are conflicting provisions in the advance agreement on the crediting of investment experience. They refer to paragraph 9 of the advance agreement without giving a specific citation to support their position. We maintain our position that determining whether the Government received proper credit for investment experience under the advance agreement is a valid audit step. If the DCAA determines that there is an error in any of the surplus amounts, allocation amounts, and amortization, it follows that the investment experience calculation also needs to be corrected. Accordingly, we request that the DCAA reconsider their position in responding to this recommendation in their comments on the final report by January 26, 2004.

d. Determine the effect on the pension asset credit due the Government caused by using the incorrect annual amortization amounts for the allocation of the Precision Gear and Itek asset surpluses.

Management Comments. The DCAA concurred and stated that their determination should be completed by October 31, 2003. A December 2003 estimate of completion has since been given to IG evaluators.

A.2. We recommend that the Director, Defense Contract Management Agency renegotiate the advance agreement with the contractor, as provided for under paragraph 12 of the agreement, to incorporate the determinations reached by DCAA in complying with recommendation A.1.

Management Comments. The DCMA concurred and stated that it is in the process of jointly reviewing, with the DCAA, to determine if the Government received the proper credit under the advance agreement for surplus Government-funded pension assets as determined in accordance with CAS 413.50(c)(12). The report should be issued by October 31, 2003. A December 2003 estimate of completion has since been given to IG evaluators. Also, the DCMA stated that if the joint report indicates that the Government has not received the proper amount of credit, the advance agreement will be renegotiated with Northrop Grumman.

B. Accuracy of Northrop Grumman's Pension Asset Records

The January 1, 1999, market value of assets for the primary Northrop Grumman Pension Plans, as stated in the Northrop Grumman Pension Plan CAS Valuation Report, is $4.7 million less than the January 1, 1999, market value of assets as stated in a report prepared by the contractor's actuary. Northrop Grumman has not reconciled two separate reports provided to DCAA which contain different January 1, 1999, asset balances. Inconsistent reporting brings into question the accuracy of the pension asset balances maintained by Northrop Grumman as required by CAS 413.50(c)(7). Since the asset balance is an integral part of actuarial pension cost calculations, future pension costs charged to Government contracts could be affected.

Northrop Grumman Advance Agreement

On September 15, 1995, the Government and Northrop Grumman entered into an advance agreement on Northrop Grumman's merger of its pension plans.

The agreement incorporated a Cost Accounting Standards Board waiver of CAS 413.50(c)(3) requested by Northrop Grumman affecting the merger of the primary defined benefit pension plans sponsored by Northrop Grumman. The Cost Accounting Standards Board granted the waiver contingent upon Northrop Grumman continuing to maintain records of contributions, investment experience, benefit payments, expenses, and transfers as required by CAS 413.50(c)(7) so that a segment closing adjustment in accordance with CAS 413.50(c)(12) could readily be calculated. The stated purpose of the merger was to eliminate the need for required contributions to the Grumman and Rolling Meadows Plans. The Government would benefit from reduced acquisition costs estimated at approximately $390 million.

CAS 413.50(c)(7) Records. We requested DCAA to provide the Northrop Grumman records that demonstrate compliance with the Advance Agreement of September 1995 for maintaining CAS 413.50(c)(7) records. In September of 1999, DCAA issued report number 4721-99F19413001, Report on Compliance with CAS 413-Allocation of Pension Costs. The report stated that no issues of noncompliance with CAS 413 were noted. However, the records DCAA accepted as CAS 413.50(c)(7) records did not have all of the elements needed to constitute a complete record. The records did not show the contributions, investment experience, benefit payments, expenses, and transfers. The records, as provided by DCAA, only showed the beginning of the year market value of assets for the primary plans. The total January 1, 1999, market value of the Northrop, Grumman, and Rolling Meadows asset balances was $10,615.9 million. DCAA agreed to determine if the contractor was maintaining a complete CAS 413.50(c)(7) record.

DCAA Followup. On May 12, 2003, DCAA sent us the CAS 413.50(c)(7) records as provided by Northrop Grumman. The records, covering the years 1999 and 2000, comply with CAS 413.50(c)(7). However, we question the accuracy of the records. We compared the records we received to the DCAA working papers to support the September 1999 CAS 413 audit of Northrop Grumman. The report we originally obtained from the DCAA audit work paper, as prepared by the Northrop Grumman actuary, stated the total January 1, 1999, market value of the Northrop, Grumman, and Rolling Meadows asset balances was $10,615.9 million. However, the Northrop Grumman CAS 413.50(c)(7) record as provided by DCAA on May 12, 2003, stated the total January 1, 1999, market value of the Northrop, Grumman, and Rolling Meadows asset balances as $10,611.2 million. This represents a net difference of $4.7 million. The discrepancy in the January 1, 1999, market value as stated in the two Northrop Grumman reports may have an effect on subsequent market values. The fact that we uncovered this asset balance discrepancy in a limited number of records brings into question the accuracy of Northrop Grumman's CAS 413.50(c)(7) records.

Recommendation

B. We recommend that the Director, Defense Contract Audit Agency review the accuracy of Northrop Grumman's pension accounting from 1995 to the present. The review should determine compliance with CAS 413.50(c)(7) for the period during which the advance agreement has been in effect.

Management Comments. The DCAA concurred and stated that their determination should be completed by October 31, 2003. A December 2003 estimate of completion has since been given to IG evaluators.

Appendix A. Scope and Methodology

We reviewed the primary pension plans for Litton Industries Inc. and Northrop Grumman Corporation. We also reviewed the pension data DCAA auditors and DCMA pension specialists obtained during their oversight of contractor pensions. We reviewed data for January 1988 through January 2001.

We obtained the pension reports prepared by the contractor to comply with ERISA reporting requirements from the Department of Labor. Our 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 requested the contractor CAS pension records through DCAA to minimize duplicative requests to the contractors. As of May 2003, the Litton pension records have not been made available. We obtained some specific Litton records from DCMA and DCAA covering the advance pension agreements resulting from the sale of the Precision Gear and Itek Divisions. DCAA provided us with a limited number of Northrop Grumman records that caused us to question Northrop Grumman's compliance with CAS 413.50(c)(7).

We performed this evaluation from October 1, 2002, through October 2003 in accordance with standards implemented by the Inspector General of the Department of Defense.

We limited the scope because the contractor did not furnish CAS 413.50(c)(7) pension plan asset accounting records within a reasonable amount of time. The scope of the evaluation was also limited in that we did not review the management control program.

Use of Computer-Processed Data. We did not use computer-processed data to perform this evaluation.

General Accounting Office High-Risk Area. The General Accounting Office has identified several high-risk areas in the Department of Defense. This report provides coverage of the Contract Management high-risk area.

Appendix B. Prior Coverage

During the last 5 years, the Inspector General of the Department of Defense (IG DoD) has issued three 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 19 reports relating to Litton's or Northrop Grumman's pension costs (now parent to Litton). Unrestricted IG DoD reports can be accessed at http://www.dodig.osd.mil/audit/reports.

IG DoD

IG DoD Report No. D-2002-145, "Effect of the Raytheon Defense Business Acquisitions on Pension Plans and DoD-Funded Pension Assets," September 11, 2002

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

DCAA

DCAA Report No. 4721-2002F23000007, "Report on Audit of Litton Pension Plan Projections and Allocations for 2002 Through 2006 Forward Pricing," June 12, 2002

DCAA Report No. 4721-2002F23000004, "Report on Audit of Pension Plan Projections and Allocations for 2002 Through 2006 Forward Pricing," February 28, 2002

DCAA Report No. 4721-2001F19412001, "Compliance with CAS 412-Composition and Measurement of Pension Costs," November 6, 2001

DCAA Report No. 4721-2001F10160002, "Report on Audit of 1999 Pension Costs," September 10, 2001DCAA Report No. 4231-2000G14410001, "Audit of Contractor Fiscal Year (CFY) 2000 Pension and Restoration Plan Costs," May 30, 2001

DCAA Report No. 4721-2001F23000005, "Report on Audit of Pension Plan Cost Projections for CFY 2000 Through 2007," April 6, 2001

DCAA Memorandum No. 4721-2001F17900002, "Request for CAS Waiver for Proposed Merger of the Northrop Grumman and Logicon RVP Pension Plans," December 15, 2000

DCAA Report No. 4721-2000F10160008, "Report on Audit of 1998 Pension Costs," September 27, 2000

DCAA Report No. 4231-2000G19412001, "Audit of Compliance with Cost Accounting Standard 412 Composition and Measurement of Pension Cost," September 12, 2000

DCAA Report No. 4231-2000G19413001, "Audit of Compliance with Cost Accounting Standard 413 Adjustment and Allocation of Pension Cost," September 12, 2000

DCAA Report No. 4231-2000G14410001, "Audit of Contractor Fiscal Year 1999 Insurance, Pension, and Restoration Plan Costs," September 12, 2000

DCAA Report No. 4721-99F23000006, "Report on Audit of ESSS Pension Plan Cost Projections For Calendar Years 1999 through 2006," January 5, 2000

.DCAA Report No. 4721-2000F10160003, "Report on Audit of Northrop Grumman Corporation's Pension Plan Costs for Calendar Year 1997," December 17, 1999

DCAA Report No. 4231-99G14410202, "Report on Audit of Contractor Fiscal Year 1998 Pension and Restoration Plan Costs," September 24, 1999

DCAA Report No. 4721-99F19412001, "Report on Compliance with CAS 412 – Composition and Measurement of Pension Costs," September 21, 1999

DCAA Report No. 4721-99F19413001, "Report on Compliance with CAS 413 Allocation of Pension Cost," September 8, 1999

DCAA Memorandum No. 4721-99F17900004, "Review of Accounting Data for Northrop Grumman Corporation's Proposed Merger of the Northrop Grumman, ESSS, and Vought Pension Plans," June 28, 1999

DCAA Report No. 4231-98G14980202, "Audit of Contractor Fiscal Year 1997 Pension and Restoration Plan Costs," May 13, 1998

DCAA Report No. 4231-98G14980201, "Audit of Contractor Fiscal Year 1996 Pension and Restoration Plan Costs," May 13, 1998

DCAA Comments on Appendix B. The DCAA also commented on the statement that DCAA has issued two reports that deal with Litton's pension costs and one report dealing with Northrop Grumman's allocation of pension costs in the last 5 years. DCAA issued several audit reports in the last 5 years dealing with Litton and Northrop Grumman pension costs in addition to the three listed in the draft report. This appendix has been amended to incorporate the additional DCAA audit reports.

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)/Chief Financial Officer
  Deputy Chief Financial Officer
  Deputy Comptroller (Program/Budget)

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

Auditor General, Department of the Air Force

Unified Commands

Inspector General, U.S. Joint Forces Command

Other Defense Organizations

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

Non-Defense Federal Organization

Office of Management and Budget
  Office of Federal Procurement Policy
    Executive Secretary Cost Accounting Standards Board

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 and Financial Management, Committee on Government Reform
House Subcommittee on National Security, Emerging Threats, and International Relations, Committee on Government Reform
House Subcommittee on Technology, Information Policy, Intergovernmental Relations, and the Census, Committee on Government Reform

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 730.3.B.08/2003-1 September 16, 2003

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

SUBJECT: Response to DoDIG Draft Report on Accounting for Pension Assets Under Advance Agreements with Northrop Grumman and Litton Industries, Inc. (Project No. D2003PT-0006)

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

Recommendation A.1.a

We recommend that the Director, Defense Contract Audit Agency determine the correct amount of Government-funded pension surplus for Precision Gear and Itek as of 1996 calculated in accordance with CAS 413.50(c)(12).

DCAA Response

Concur. DoDIG representatives visited the DCAA Northrop Grumman Corporate Suboffice on December 9 through 13, 2002. During that visit, the FAO agreed to review the implementation of the advance agreement between the government and Litton Industries concerning the Precision Gear and Itek segment closing adjustments and share the results of that review with the DoDIG upon completion. That review has not been completed. The FAO will determine the correct amount of the government's share of the pension surplus for Precision Gear and Itek segment closings in conjunction with that review. The FAO anticipates issuing a final report to the DCE by October 31, 2003.

Recommendation A.1.b

We recommend that the Director, Defense Contract Audit Agency determine to what extent Government-funded pension assets for Precision Gear and Itek were used to fund commercial liabilities.

DCAA Response

Concur. As discussed in our response to Recommendation A.1.a, the FAO agreed to review the implementation of the advance agreement between the government and Litton Industries concerning the Precision Gear and Itek segment closing adjustments and share the results of that review with the DoDIG upon completion. One of the objectives of that review is to determine the amount of government-funded assets that were used to fund pension costs attributable to commercial work. The FAO will recommend to the DCE that the existing advance agreement be revised so that government-funded assets be applied to fund only government contract costs. As stated previously, the FAO anticipates issuing a final report to the DCE by October 31, 2003.

Recommendation A.1.c

We recommend that the Director, Defense Contract Audit Agency determine the accuracy of the trust investment experience credited for each year for Precision Gear and Itek in calculating the surplus asset balances from 1996 through 2000 in accordance with CAS 413.50(c)(7).

DCAA Response

Nonconcur. We disagree with the conclusions in the draft DoDIG report that there are conflicting provisions in the advance agreement as to the method for crediting investment experience on government-funded pension assets and that as a result, the government may not have received proper credit under the advance agreement for the amortization of the Precision Gear and Itek surpluses. Paragraph 4 of the agreement states in relevant part:

> The pension assets and liabilities of the Former Divisions will continue as part of Litton Plan 9, assigned to their respective Plan 9 Share Plan Codes, and otherwise accounted for in the same manner as when the Former Divisions were a part of Litton.

Paragraph 9 of the advance agreement states in relevant part:

> [T]he Government shall "recognize" its "share" of the surplus set forth in paragraph 8 above by permitting the retention of such share in Plan 9 and receiving credits against otherwise allowable pension costs amortized over 5 years at 8.0%.

We believe that the purpose of Paragraph 4 was to establish that the retained assets and liabilities of the former divisions, i.e., Precision Gear and Itek, would continue to be separately accounted for. While we agree that the retained assets earn the actual investment income rates of return, the ACO negotiated with the contractor in the advance agreement that the government's share of the segment closing adjustment surplus assets would earn at an annual rate of 8 percent (paragraph 9).

We believe that the ACO was within his authority under CAS 413.50(c)(12) to negotiate a fixed interest rate. CAS 413.50(c)(12)(vii) provides that "...if the contractor continues to perform Government contracts, the contracting parties may negotiate an amortization schedule [for the government's share of the segment closing adjustment], <u>including interest</u> adjustments.

..." (emphasis added). CAS 413 is silent as to what rate is to be used for the "interest adjustments." The segment closing adjustment represents the excess or shortage of pension assets needed to satisfy pension liabilities as of the date of the segment closing. The government's share in the closed segment's pension costs is settled at that time. The actual rate of return on the pension assets during the 5-year period that the segment closing adjustment was amortized could have potentially been less than the 8 percent provided for in the advance agreement. The subject advance agreement has, in effect, placed the risk associated with subsequent fluctuations in investment experience on the contractor.

Recommendation A.1.d

We recommend that the Director, Defense Contract Audit Agency determine the effect on the pension asset credit due the Government caused by using the incorrect annual amortization amounts for the allocation of the Precision Gear and Itek asset surpluses.

DCAA Response

Concur. As discussed in our response to Recommendation A.1.a, the FAO agreed to review the implementation of the advance agreement between the government and Litton Industries concerning the Precision Gear and Itek segment closing adjustments and share the results of that review with the DoDIG upon completion. As part of that review, the FAO will seek an explanation of the methodology used by the contractor in the calculation of the amortization of the government's share of the retained segment closing adjustment surplus. The FAO will also evaluate the accuracy of the amount of the amortized government-funded pension surplus that was transferred to remaining government segments for each period under the terms of the advance agreement. As stated previously, the FAO anticipates issuing a final report to the DCE by October 31, 2003.

Recommendation B

We recommend that the Director, Defense Contract Audit Agency review the accuracy of Northrop Grumman's pension accounting from 1995 to the present. The review should determine compliance with CAS 413.50(c)(7) for the period during which the advance agreement has been in effect.

DCAA Response

Concur. During the DoDIG representatives' visit to the DCAA Northrop Grumman Corporate Suboffice in December 2002, the FAO agreed to review the segment accounting records of the merged Northrop Grumman Pension Plan to determine whether the contractor is complying with the terms of the advance agreement, and to share the results with the DoDIG upon completion. That review is on-going and includes obtaining an explanation for the asset balance discrepancy discussed in Section B of the draft DoDIG report. However, based on preliminary results of that review, it appears that the discrepancy may be explained by the fact

Final Report
Reference

PAC 730.3.B.08/2003-1 September 16, 2003
SUBJECT: Response to DoDIG Draft Report on Accounting for Pension Assets Under Advance Agreements with Northrop Grumman and Litton Industries, Inc. (Project No. D2003PT-0006)

that the schedules provided by the contractor in 1999 included preliminary figures and were not based on the final 1999 actuarial report. The FAO anticipates issuing a final report to the DCE by October 31, 2003.

Other Comments

Appendix B of the draft report discusses relevant reports issued by the DoDIG and DCAA within the last five years. The second sentence of the first paragraph of the appendix states:

> *Also, within the last 5 years, DCAA has issued two reports that deal with Litton's pension costs and one report dealing with Northrop Grumman's (now parent to Litton) allocation of pension costs.*

Revised
Page 14

The draft DoDIG report includes a listing of three DCAA audit reports issued in 1998 and 1999. DCAA has issued several audit reports dealing with Litton and Northrop Grumman pension costs in addition to the three listed in the draft report. We believe that the information in the appendix as currently written gives the inaccurate impression that DCAA has performed only three audits related to Litton and Northrop Grumman pension costs in the last five years. We suggest that the appendix be revised to reflect that the reports listed are only a portion of the relevant reports issued by DCAA during the last five years.

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

Robert DiMucci

Robert DiMucci
Assistant Director
Policy and Plans

4

Defense Contract Management Agency Comments

DEFENSE CONTRACT MANAGEMENT AGENCY
6350 WALKER LANE, SUITE 300
ALEXANDRIA, VIRGINIA 22310

IN REPLY
REFER TO

SEP 8 2003

DCMA-OCB

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

SUBJECT: Response to OIG Draft Report No. D-2003PT-0006, Accounting for Pension Assets Under Advance Agreements with Northrop Grumman and Litton Industries, Inc. (Project No. D2003PT-0006)

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

ROBERT W. SCHMITT
Executive Director
Contract Management Operations

Attachment

SUBJECT: DoD IG Draft Report, Accounting for Pension Assets Under Advance Agreements with Northrop Grumman and Litton Industries Inc, 8 August 2003, Project No. D2003PT-0006

FINDING A. Litton Industries Advance Agreement

Several CAS non-compliance issues exist regarding the calculation, disposition of surplus, crediting of investment experience, and the amortization schedule, used to account for Government-funded pension assets under the advance agreement between the Government and Litton Industries covering the sales of Precision Gear ad Itek Optical (Itek) Divisions. The surplus amount in the advance agreement is less than the amount detailed in the concurrent financial statement. Government-funded assets were allocated to underfunded segments resulting in Government funding of commercial liabilities. There are conflicting agreement provisions for crediting investment experience. The annual amortization amounts according to the advance agreement do not agree with standard amortization calculations. As a result, the Government has not received proper credit under the advance agreement for surplus Government-funded pension assets as determined in accordance with CAS 413.50(c)(12).

DCMA COMMENTS: DCAA and DCMA's Contractor Insurance and Pension Review (CIPR) Center are jointly reviewing this issue to determine if the Government received the proper credit under the advance agreement for surplus Government-funded pension assets as determined in accordance with CAS 413.50(c)(12). The joint report will be issued by October 31, 2003.

RECOMMENDATION A.2. We recommend that the Director, Defense Contract Management Agency renegotiate the advance agreement with the contractor, as provided for under paragraph 12 of the agreement, to incorporate the DCAA determinations under recommendation A.1.

DCMA COMMENTS: Concur. If the joint DCMA/DCAA report indicates that the Government has not received the proper amount of credit, the advance agreement will be renegotiated with Northrop Grumman.

DISPOSITION:
(x) Action is ongoing. Estimated Completion Date: 12/31/03
( ) Action is considered Complete:

Team Members

The Audit Followup and Technical Support Directorate, Office of the Deputy 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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