June 17, 2005

Acquisition

Accounting for Sperry Marine Pension Plan Assets Under an Advance Agreement with Litton Industries, Inc.

(D-2005-077)

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Acronyms

CAS	Cost Accounting Standard
CIPR	Contractor Insurance/Pension Review
DCAA	Defense Contract Audit Agency
DCMA	Defense Contract Management Agency
FAR	Federal Acquisition Regulation
UAL	Unfunded Actuarial Liability

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

June 17, 2005

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

SUBJECT: Report on Accounting for Sperry Marine Pension Plan Assets Under an Advance Agreement with Litton Industries, Inc. (Report No. D-2005-077)

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. Kenneth H. Stavenjord (703) 604-8952 (DSN 664-8952) or Mr. Ronald R. Meissner at (703) 604-8911 (DSN 664-8911). See appendix C for the report distribution. The team members are listed inside the back cover.

By direction of the Deputy Inspector General for Auditing:

Robert K. West

Robert K. West
Assistant Inspector General
for Audit Followup and Technical Support

Department of Defense Office of Inspector General

Report No. D-2005-077 **June 17, 2005**
(Project No. D2004-D000PT-0001.000)

Accounting for Sperry Marine Pension Plan Assets Under an Advance Agreement with 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 for its application in protecting Government-funded pension assets in advance agreement negotiations.

Background. We reviewed the December 1997 advance agreement between Litton Industries, Inc., and the Government concerning the merger of the Sperry Marine, Inc., Employees Retirement Plan and Litton Industries, Inc., Retirement Plan B. The advance agreement also covers the immediate spin-off of a new Sperry Marine, Inc., Employees Retirement Plan from the Litton Industries, Inc., Retirement Plan B and the subsequent termination of the new Sperry Marine, Inc., Employees Retirement Plan. The purpose of the evaluation was to determine whether the advance agreement complies with the Cost Accounting Standards (CASs) and Federal Acquisition Regulation and whether the pension accounting provisions in the advance agreement provide for a fair and equitable settlement to the Government. The CAS most relevant to the advance agreement is CAS 413.50(c)(12), covering the settlement of pension assets when a contractor curtails benefits under a pension plan, terminates a pension plan, or closes a segment.

Results. The advance agreement creates several CAS non-compliance issues regarding the determination of the Government-funded pension asset balance and the calculation of the actuarial liabilities. The advance agreement contains factual errors and omissions of significant pension accounting events. The factual errors include the classification of the March 31, 1997, merger of the Sperry Marine, Inc., plan into the Litton Industries, Inc., plan as a segment closing and an incorrect pension settlement calculation that was performed as though the Plan had been terminated. The amortization schedule covering a Sperry Marine, Inc., deficit was also incorrectly calculated. The advance agreement omits a retroactive change in the actuarial cost method, lost investment earnings due to delayed contributions, curtailment of benefits, and limitations on the liability for plan improvements curtailed or terminated within 60 months of their effective date.

As a result, the Government incurred additional pension costs based on an erroneous calculation that understated Government-funded pension assets and overstated liabilities. The calculation was not performed in accordance with CAS 413.50(c)(12).

The Defense Contract Audit Agency (DCAA) should determine the correct amount of pension cost and the correct value of Government-funded pension assets. The Defense Contract Management Agency (DCMA) Contractor Insurance/Pension Review Team should determine the correct amount of pension liability and the extent of the Government's exposure under CAS 413 to fund the liability. Also, the DCMA Defense

Corporate Executive should renegotiate the advance agreement with the contractor, as provided for in paragraph 13 of the advance agreement and thus incorporate the DCAA and the DCMA Contractor Insurance/Pension Review Team determinations. (See the Finding section of the report for the detailed recommendations.)

Management Comments and Evaluation Response

DCAA concurred and satisfied the intent of the recommendations. On February 3, 2005, DCAA issued a final report, "Implementation of July 28, 1997 and December 3, 1997 Advance Agreements on Litton Corporation Pension Plan Adjustments." DCAA examined the advance agreement for pension accounting, for accuracy, and application under CAS 413 and provided the recommended changes to the Defense Corporate Executive. DCAA also has determined the affect on the pension asset credit due the Government against Litton Industries, Inc., Plan 9, Itek Share Plan Code caused by the incorrect annual amortization of the Sperry Marine, Inc., deficit. Finally, DCAA determined the Government's share of the 1994 through 1997 annual pension cost with actuarial interest based on quarterly funding, and calculated the unallowable interest cost resulting from the contractor's delayed funding beyond the required quarterly funding dates. These actions satisfy the intent of the recommendation.

Although not required to comment on the finding, DCAA commented on certain CAS events in the finding and determined that their comments should be marked "For Official Use Only." DCAA also determined that their comments were predecisional to any contracting officer's decision on the application of CAS 413 to certain report events and requested that their comments not be included in the final report. In deference to that request, the DCAA comments were omitted from the report.

DCMA concurred with the recommendations and agreed to calculate the effect of CAS 413.50(c)(12)(iv) on pension plan improvements for the periods of January 1, 1994, through March 31, 1997, and April 1, 1997, through July 1, 1997, as well as determine the correct amount of the pension deficit. In addition, DCMA agreed to the cost impact of the cost accounting practice change and the cost impact of the CAS 413.50(c)(12)(iv) limitations on pension plan improvements. DCMA also agreed to determine the cost and pricing affect on Government contracts for the unilateral (voluntary) cost accounting practice change of changing actuarial cost methods. DCMA estimated that these actions should be complete by June 2005. Additionally, DCMA stated that if found that the Government had been harmed, the Defense Corporate Executive will renegotiate the advance agreement to incorporate the DCAA and DCMA findings within 60 days after receiving such findings.

See the Finding section of the report for a discussion of management comments and the Management Comments section of the report for the complete text of the DCMA comments.

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Background

Sperry Marine, Inc. The company developed gyroscopes and numerous other navigation products for large, commercial, ocean-going vessels and aircraft and provides marine electronics to commercial and Defense markets.

Sperry Marine, Inc. (Sperry Marine), has undergone several transfers of ownership over the last 10 years. In 1993, the J.F. Lehman & Associates purchased Sperry Marine from Tenneco. In May of 1996, Litton Industries, Inc. (Litton), purchased Sperry Marine and incorporated it into the Litton Guidance and Controls Division. Subsequently, in April 2001, Litton was acquired by Northrop Grumman. The following is a complete chronology of the major pension-related events for Sperry Marine from 1993 through 1997.

Sperry Marine Chronology of Events

11/12/1993	J. F. Lehman & Associates acquired Sperry Marine from Tenneco/Newport News
1/1/1994	Effective date of Sperry Marine, Employees Retirement Plan (the Plan)
2/6/1995	1994 plan year - the Plan Actuarial Valuation was issued with a funding requirement of $1,367,371
4/27/1995	1994 plan year - Sperry Marine contributed $50,000 to the Plan
9/14/1995	1994 plan year - Sperry Marine contributed $1,322,002 to the Plan
1/1/1996	Effective date of retroactive change in the Plan Actuarial Valuation Method from “Entry Age Normal” method to “Projected Unit Credit” method (see 12/17/1996 event)
5/1/1996	Litton acquired Sperry Marine from J.F. Lehman & Associates
8/21/1996	1996 plan year - the Plan Actuarial Valuation was issued with a funding requirement of $1,597,895 but subsequently changed by Litton (see 12/17/1996 event)
9/15/1996	1995 plan year - Sperry Marine contributed $1,486,564 to the Plan
12/17/1996	Litton approved a retroactive change in the Plan Actuarial Valuation method effective back to 1/1/1996
3/31/1997	The Plan merged into Litton Plan 9
3/31/1997	Sperry Marine curtailed the Plan Benefit Accrual with credited service and earnings frozen as of 3/31/1997

3/31/1997	The Plan is spun-off from Litton Plan 9 with a new lump sum benefit election added
4/15/1997	1996 plan year - Sperry Marine contributed $698,728 to the Plan
7/1/1997	Litton terminated the Plan
9/5/1997	Sperry Marine made all distributions to Plan participants (annuity purchases, 401(k) Plan transfers, and cash payments)
11/3/1997	Litton executed the Advance Agreement-Pension Accounting for Merger of Sperry Marine, Inc., and Litton Industries, Inc., Plan "B" Pension Plans (the Agreement)
12/3/1997	The Government executed the Agreement
12/3/1997	Effective date of the Agreement

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, 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. A CIPR is a comprehensive review 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 determines whether the contractor has complied with the special segment closing provisions of Cost Accounting Standard (CAS) 413.50(c)(12). The determination requires an analysis of how the contractor calculated the pension assets and liabilities and how the assets and liabilities of the segments involved in the transaction were allocated. 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 allocation requirements of CAS 412, "Composition and Measurement of Pension Cost," and CAS 413, "Adjustment and Allocation of Pension Cost," and must be allocable, reasonable, and allowable in accordance with Federal Acquisition Regulation (FAR), Subpart 31.2 "Contracts With Commercial Organizations."

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

Objective

The objective was to determine whether the Agreement is in compliance with the CAS and FAR and whether the pension accounting provisions contained in the Agreement provided for a fair and equitable settlement to the Government. See Appendix A for a discussion of the scope, methodology, and prior coverage related to the objectives.

Sperry Marine Advance Agreement

The “Advance Agreement, Pension Accounting for Merger of Sperry Marine, Inc., and Litton Industries, Inc., Plan ‘B’ Pension Plans” (the Agreement) between the Government and Litton did not comply with the CAS 413 pension accounting provisions for the merger, spin-off, benefit curtailment, and termination of the Sperry Marine, Inc., Employee Retirement Plan (the Plan) because the Agreement includes factual errors and omits significant pension accounting events. The factual errors include the incorrect assertion that the March 31, 1997, merger of the Sperry Marine plan into the Litton plan was a segment closing and an incorrect pension settlement calculation that was performed as if the Plan had been terminated. The amortization schedule covering a Sperry Marine deficit was also incorrectly calculated. The Agreement omits consideration of Sperry Marine’s failure to make quarterly pension contributions, a retroactive change in the actuarial cost method, curtailment of benefits, and limitations on the liability for pension plan improvements curtailed or terminated within 60 months of their effective date. As a result, the Government was improperly charged for additional pension costs based on an erroneous calculation that understated Government-funded pension assets and overstated pension liabilities.

Sperry Marine Pension Accounting

The Agreement. In December 1997, Litton and the Government entered into the Agreement. According to the Agreement, the Litton Industries, Inc., Plan B (also referred to as Litton Plan 9), contained the pension plan assets and liabilities of Litton defense divisions. On March 31, 1997, the Plan merged with the Litton Plan 9 to permit a portion of the Litton Plan 9 surplus to be used to offset a funding deficit in the Plan, and defer further contributions by Litton and the Government to the Plan. Also on March 31, 1997, Litton spun-off the Plan from the Litton Plan 9, with assets equal to liabilities. On July 1, 1997, Litton terminated the Plan.

According to the Agreement, the merger of the Plan into Litton Plan 9 on March 31, 1997, resulted in a CAS segment closing, and under CAS 413.50(c)(12) a calculation was required to determine the difference between the market value of the assets and the actuarial liability for the Plan. The Agreement states that the $6,354,419 actuarial liability, as of March 31, 1997, was greater than the $4,304,419 market value of the assets, resulting in a total deficit of $2,050,000.

The Government’s share of the deficit, 59 percent, was based on the percentage of Government sales versus the total sales for Sperry Marine from 1993 through 1996. Thus, the Government’s share of the deficit was calculated to be $1,209,295 (59 percent of $2,050,000).

Litton and the Government agreed to recognize the Government’s share of the deficit by permitting it to be amortized over a 5-year period (1996 through 2000) at 8 percent, by offsetting the deficit against previously agreed-to pension cost credits due the Government.

Adjustments to the Agreement. The Agreement also contains a paragraph by which disputed amounts will be adjudicated. Paragraph 13 states, "In the event of any disagreement or dispute with respect to the terms, operation or administration of this Agreement, and prior to resort to formal 'Disputes' procedures as authorized by law and regulations, the parties hereto commit first to attempt to resolve such disagreement or dispute through alternative means, such means to include escalation to respective higher ranking executives, non-binding mediation whether structured or informal, and (if mutually agreeable) binding arbitration."

Factual Errors in the Agreement

Segment Closing. The assertion that the merger of the Plan into the Litton Plan 9 on March 31, 1997, should be treated as though a CAS 413 segment closing occurred on that date is incorrect. The merger of the plans does not represent a CAS 413 segment closing, and the plan termination calculation of a $2,050,000 deficit as of March 31, 1997, is invalid.

Amortization Schedule. The Plan deficit, as presented in the Agreement, was incorrectly amortized. The Government's share of the Plan deficit of $1,209,295 was amortized at 8 percent over a 5-year period that, according to the Agreement, yields a yearly amortization of $261,207. However, the annual amortization amount obtained using standard amortization calculations and the same assumptions is $302,876. That amount is an annual error of $41,669, or $208,345 over the 5-year amortization period.

Omissions in the Agreement

Cost Accounting Practice Change. A retroactive change in the actuarial cost method resulted in an $899,167 reduction between the pension cost used for contract cost and pricing calculations and the actual pension contribution. The Agreement does not address that event, which was a cost accounting practice change. The 1996 actuarial report for the Plan, dated August 21, 1996, required a contribution of $1,597,895 for 1996 using the "entry-age normal" actuarial cost method. However, the 1996 Sperry Marine Form 5500 (Schedule B), "Actuarial Information," for the Plan, dated May 2, 1997, shows that a change in the actuarial cost method to the "projected unit cost" method was approved on December 16, 1996. The retroactive change in the actuarial cost method reduced the 1996 contribution requirement from $1,597,895 to $698,728, a difference of $899,167. A change in the actuarial cost method was a CAS change that required a revision to the CAS Disclosure Statement and an adjustment to Government contract cost and pricing amounts for 1996.

Delayed Contributions. CAS and FAR require that pension costs charged to Government contracts must be funded on or before a Government contractor's Federal income tax filing date. The Federal income tax filing date is usually

8 and ½ months after the close of a contractor's fiscal year. However, in addition to the annual funding requirement, a quarterly funding stipulation is specified in the FAR. Specifically, FAR 31.205-6(j) states, "Increased pension costs are unallowable if the increase is caused by a delay in funding beyond 30 days after each quarter of the year to which they are assignable." Generally, the increased cost as a result of a delay in funding reflects the additional interest expense incurred (earnings loss) by not having the money deposited timely.

The Plan was effective on January 1, 1994, and was terminated as of July 1, 1997. Contributions to the plan were made for plan years 1994, 1995, and 1996. However, Sperry Marine did not make quarterly contributions but delayed making contributions to the Plan from between 2 to 16 months beyond the quarterly funding dates. Sperry Marine's failure to fund the Plan on a quarterly basis resulted in the required contributions not being available for investment purposes, resulting in lost investment earnings of $118,632, $130,367, and $35,745 for the 1994, 1995, and 1996 plan years respectively.

According to CAS 412.50(a)(2), the lost investment earnings represent an unallowable cost that is accounted for in the Plan's actuarial balance sheet as an unfunded actuarial liability (UAL). CAS 412.50(a)(2) states, "Any portion of unfunded actuarial liability attributable to either (i) pension costs applicable to prior years that were specifically unallowable in accordance with then existing Government contractual provisions . . . shall be separately identified and eliminated from any unfunded actuarial liability being amortized pursuant to paragraph (a)(1) of this subsection. Such portions of unfunded actuarial liability shall be adjusted for interest at the valuation rate of interest."

The lost investment earnings included in the Plan's UAL and adjusted at the Plan valuation interest rate of 9 percent came to approximately $326,000. That pension accounting issue was omitted from the Agreement and must be addressed in the adjustment of previously determined pension cost. See Appendix B Table A4 for the detailed calculation of the lost investment earnings.

Curtailment of Benefits. On March 3, 1997, the Plan was amended to suspend future benefit accruals effective as of March 31, 1997, causing a CAS 413.50(c)(12) benefit curtailment event that was omitted from the Agreement. The event required calculation of an adjustment to the Plan actuarial liability using actuarial assumptions consistent with the current and long term assumptions used in the measurement of pension costs. The difference between the market value of assets and the recalculated actuarial liability represents an adjustment to previously determined pension costs charged to Government contracts.

Limitation on the Liability for Pension Plan Improvements. The application of CAS 413.50(c)(12)(iv) to limit the liability for pension plan improvements that are terminated or curtailed within 60 months of their effective date was omitted from the Agreement. CAS 413.50(c)(12)(iv) states, "Pension plan improvements adopted within 60 months of the date of the event, which increase the actuarial liability shall be recognized on a prorata basis using the number of months the date of adoption preceded the event date."

The effective date of the Plan was January 1, 1994. On March 3, 1997, the Plan was amended to suspend future benefit accruals as of March 31, 1997. The duration of time between the Plan effective date (January 1, 1994) and the Plan benefit curtailment date (March 31, 1997) was 39 months. Based on a calculation of 39/60 or 65 percent, the Government should recognize only 65 percent of the pension plan's liability applicable to Sperry Marine's Government contract business for the period of January 1, 1994, through March 31, 1997.

Also, on March 31, 1997, the Plan was spun-off from the Litton Plan 9 with the benefit accrual frozen as of March 31, 1997, but with a plan improvement of an immediate payout of the benefits options.

On July 1, 1997, the Plan was terminated, causing a CAS 413.50(c)(12) benefit termination event. The duration of time from the March 31, 1997, plan spin-off date until the plan termination date was 3 months. Based on a calculation of 3/60 or 5 percent, the Government should recognize only 5 percent of any increased liability as a result of the immediate payout of benefits option applicable to Sperry Marine's Government contract business for the period of March 31, 1997, through July 1, 1997.

Management Comments on the Finding and Audit Response

DCAA Comments. Although not required to comment on the finding, DCAA commented on certain CAS events in the finding and stated that their comments should be marked "For Official Use Only." DCAA also stated that their comments were predecisional to any contracting officer's decision on the application of CAS 413 to certain report events and requested that their comments not be included in the final report.

Audit Response. In deference to the DCAA request, their comments were omitted from the report.

Recommendations and Management Comments

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

a. Examine the Advance Agreement pension accounting events for their accuracy and application under CAS 413, and provide any recommended changes to the Defense Corporate Executive.

Management Comments. DCAA concurred and satisfied the intent of the recommendations. On February 3, 2005, DCAA issued a final report, "Implementation of July 28, 1997 and December 3, 1997 Advance Agreements on Litton Corporation Pension Plan Adjustments." DCAA examined the advance agreement for pension accounting, for accuracy, and for application under

CAS 413 and provided to the Defense Corporate Executive the recommended changes.

b. Determine any affect on the pension asset credit due the Government against Litton Plan 9, Itek Share Plan Code LSI 47-091-312 caused by the incorrect annual amortization of the Sperry Marine deficit amounts under paragraph 10 of the Advance Agreement, and provide the findings to the Defense Corporate Executive.

Management Comments. DCAA concurred and has determined the affect on the pension asset credit due the Government against Litton Plan 9, Itek Share Plan Code caused by the incorrect annual amortization of the Sperry Marine deficit.

c. Determine the Government's share of 1994 through 1997 annual pension cost to fund the January 1 liability amounts plus actuarial interest based on quarterly funding of the pension cost, and then calculate the excess actuarial interest cost resulting from the contractor's delayed funding to determine the unallowable interest cost under FAR 31.205-6(j)(2)(iii), that is included as an unfunded liability under CAS 412.50(a)(2).

Management Comments. DCAA concurred and determined the Government's share of the 1994 through 1997 annual pension cost plus actuarial interest based on quarterly funding. Also, DCAA calculated the interest cost resulting from the contractor's delayed funding to determine the unallowable interest costs.

2. We recommend that the Director of the Defense Contract Management Agency:

a. Calculate the effect of applying CAS 413.50(c)(12)(iv) which limits the liability for pension plan improvements that are terminated or curtailed within 60 months of their effective date for the periods of January 1, 1994, through March 31, 1997, and from April 1, 1997, through July 1, 1997.

Management Comments. DCMA concurred and stated that the CIPR Center will determine the effect of CAS 413.50(c)(12)(iv) on pension plan improvements January 1, 1994, through March 31, 1997, and April 1, 1997, through July 1, 1997. The DCMA revised estimate of completion for this action item is June 2005.

b. Determine the correct amount of pension liability and the extent of the Government's exposure under CAS 413 to fund the liability caused by the incorrect calculation of a plan deficit as of March 31, 1997, a cost accounting practice change, and CAS 413.50(c)(12)(iv) limitations on the liability for pension plan improvements.

Management Comments. DCMA concurred and stated that the CIPR Center will determine the correct amount of the pension deficit, the cost impact of the cost accounting practice change, and the cost impact of the

CAS 413.50(c)(12)(iv) limitations on pension plan improvements. The DCMA revised estimate of completion for this action item is June 2005.

c. Determine the cost and pricing effect on Government contracts for the voluntary cost accounting practice change of changing actuarial cost methods as prescribed by FAR 30.602-3, "Voluntary Changes."

Management Comments. DCMA concurred and stated that the CIPR Center will determine the cost and pricing effect on Government contracts for the unilateral (voluntary) cost accounting practice change of changing actuarial cost methods. The DCMA revised estimate of completion for this action item is June 2005.

d. Renegotiate the advance agreement with the contractor, as provided for under paragraph 13 of the Agreement, to incorporate the Defense Contract Audit Agency and Defense Contract Management Agency findings.

Management Comments. DCMA concurred and stated if the DCMA CIPR Center and DCAA find that the Government had been harmed, the Defense Corporate Executive will renegotiate the Agreement to incorporate the DCAA and DCMA findings within 60 days after receiving such findings.

Appendix A. Scope and Methodology

We reviewed the primary pension plans for Sperry Marine and the December 1997 "Advance Agreement, Pension Accounting for Merger of Sperry Marine, Inc., and Litton Industries, Inc., Plan 'B' Pension Plans." We also reviewed the pension data DCAA auditors and DCMA pension specialists obtained during their oversight of contractor pensions. We reviewed data for January 1, 1994, through December 3, 1997.

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 obtained some specific Sperry Marine records from DCMA and DCAA related to the Agreement.

We performed this evaluation from April 5, 2004, through September 3, 2004, in accordance with standards implemented by the Inspector General of the Department of Defense (IG DoD).

The scope of the evaluation was 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 DoD. This report provides coverage of the Contract Management high-risk area.

Prior Coverage

During the last 5 years, the DoD Inspector General issued one report that discusses pension plan advance agreements, DoD IG Report No. D-2004-025, "Accounting for Pension Assets Under Advance Agreements with Northrop Grumman and Litton Industries, Inc.," November 25, 2003. Unrestricted DoD IG reports can be accessed at http://www.dodig.osd.mil/audit/reports.

Appendix B. Additional Interest Expense Incurred

Following are the schedules for unallowable interest expenses and unallowable unfunded actuarial liabilities (UAL) for plan years 1994, 1995, and 1996. The unallowable UAL for each year was computed by determining the number of months between the dates of the required quarterly deposits and the date the contributions were actually made. The Plan interest rate of 9 percent was converted to a monthly factor of .0075. The product of the monthly interest factor and the required quarterly contribution amount is the unallowable UAL per quarter. In addition to computing the annual unallowable UAL (costs) for 1994, 1995, and 1996, the unallowable UAL was adjusted for the valuation rate of interest as required by CAS 412-50(a)(2).

Table A1. Plan Year 1994

Quarterly Funding Dates	Actual Payment Dates	Months Funding Delayed	Monthly Rate of Interest	Months times the Monthly Interest Rate	Allocation of Actual Payment to Quarter	Unallowable Interest Expense
04/30/1994	04/27/1995	12.0	0.0075	0.09000	$ 50,000	$ 4,500
	09/14/1995	16.5	0.0075	0.12375	284,222	35,172
					$334,222	
07/31/1994	09/14/1995	13.5	0.0075	0.10125	$334,222	33,840
10/30/1994	09/14/1995	10.5	0.0075	0.07875	$334,222	26,320
01/31/1995	09/14/1995	7.5	0.0075	0.05625	$334,222	18,800
Total						$118,632

Table A2. Plan Year 1995

Quarterly Funding Dates	Actual Payment Dates	Months Funding Delayed	Monthly Rate of Interest	Months times the Monthly Interest Rate	Allocation of Actual Payment to Quarter	Unallowable Interest Expense
04/30/1995	09/12/1996	16.5	0.0075	0.12375	$ 362,130	$ 44,813
07/31/1995	09/12/1996	13.5	0.0075	0.10125	$ 362,130	36,666
10/30/1995	09/12/1996	10.5	0.0075	0.07875	$ 362,130	28,518
01/31/1996	09/12/1996	7.5	0.0075	0.05625	$ 362,130	20,370
Total						$ 130,367

Table A3. Plan Year 1996

Quarterly Funding Dates	Actual Payment Dates	Months Funding Delayed	Monthly Rate of Interest	Months times the Monthly Interest Rate	Allocation of Actual Payment to Quarter	Unallowable Interest Expense
04/30/1996	04/15/1997	11.5	0.0075	0.08625	$ 170,212	$ 14,681
07/31/1996	04/15/1997	8.5	0.0075	0.06375	$ 170,212	10,851
10/30/1996	04/15/1997	5.5	0.0075	0.04125	$ 170,212	7,021
01/31/1997	04/15/1997	2.5	0.0075	0.01875	$ 170,212	3,192
Total						$ 35,745

The following schedule shows the earning amounts each year, using the Plan interest rate of 9 percent, which would have been earned on the contributions had they been made on a quarterly basis (30 days after the end of each quarter). The overall lost interest cost for not making quarterly contributions was $325,964. As such, according to CAS 412-50(a)(2) those lost earning costs (unallowable costs) should be removed from the Plan's overall unfunded actuarial liability amount.

Table A4. Earnings per Year

	1994 Plan Year	1995 Plan Year	1996 Plan Year	Total
Unallowable UAL-1/1/95	$ 118,632			
Interest @ 9%	10,677			
Unallowable UAL-1/1/96	$ 129,309	$ 130,367		
Interest @ 9%	11,638	11,733		
Unallowable UAL-1/1/97	$ 140,947	$ 142,100	$ 35,745	
Interest @ 9% (3 mo.)	3,171	3,197	804	
Unallowable UAL-3/31/97	$ 144,118	$ 145,297	$ 36,549	$ 325,964

Appendix C. Report Distribution

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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
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 Management Agency Comments

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

IN REPLY REFER TO
DCMA-OC

NOV 2 3 2004

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

SUBJECT: Response to DoDIG Draft Report, Accounting for Sperry Marine Pension Plan Assets Under an Advance Agreement with Litton Industries, Inc. (Project No. D2004PT-0001)

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

ROBERT W. SCHMITT
Executive Director
Contract Management Operations

Attachment

SUBJECT: DoDIG Draft Report, Accounting for Sperry Marine Pension Plan Assets Under an Advanced Agreement with Litton Industries, Inc., 8 October 2004, Project Number D-2004PT-0001

FINDING: The "Advance Agreement, Pension Accounting for Merger of Sperry Marine, Inc., and Litton Industries, Inc., Plan 'B' Pension Plans" (the Agreement) between the Government and Litton Industries did not comply with the CAS 413 pension accounting provisions for the merger, spin-off, and termination of the Sperry Marine pension plan because the Agreement includes factual errors and omits significant pension accounting events. The factual errors include the incorrect assertion that the March 31, 1997, merger of the Sperry Marine plan into the Litton plan was a segment closing and an incorrect pension settlement calculation that was performed as if the segment had closed. The amortization schedule covering a Sperry Marine deficit was also incorrectly calculated. The agreement omits consideration of Sperry's failure to make quarterly pension contributions, a retroactive change in the actuarial cost method, and limitations on the liability for pension plan improvements curtailed or terminated within 60 months of their effective date. As a result, the Government was improperly charged for additional pension costs based on an erroneous calculation that understated Government-funded pension assets and that overstated pension liabilities.

SUBJECT: DoDIG Draft Report, Accounting for Sperry Marine Pension Plan Assets Under an Advanced Agreement with Litton Industries, Inc., 8 October 2004, Project Number D-2004PT-0001

RECOMMENDATION 2.a: We recommend that the Director, Defense Contract Management Agency, calculate the effect of applying CAS 413.50(c)(12)(iv) which limits the liability for pension plan improvements that are terminated or curtailed within 60 months of their effective date for the periods of January 1, 1994 through March 31, 1997 and April 1, 1997 through July 1, 1997.

DCMA COMMENTS: Concur. The CIPR Center will determine the effect of CAS 413.50(c)(12)(iv) on pension plan improvements for the periods of January 1, 1994 through March 31, 1997 and April 1, 1997 through July 1, 1997. We will submit the results to you by January 31, 2005.

DISPOSITION:
(X) Action is ongoing. Estimated Completion Date: January 31, 2005
( ) Action is considered complete:

SUBJECT: DoDIG Draft Report, Accounting for Sperry Marine Pension Plan Assets Under an Advanced Agreement with Litton Industries, Inc., 8 October 2004, Project Number D-2004PT-0001

RECOMMENDATION 2.b: We recommend that the Director, Defense Contract Management Agency, determine the correct amount of pension liability and the extent of the Government's exposure under CAS 413 to fund the liability caused by the incorrect calculation of a plan deficit as of March 31, 1997, a cost accounting practice change, and CAS 413.50(c)(12)(iv) limitations on the liability for pension plan improvements.

DCMA COMMENTS: Concur. The CIPR Center will determine the correct amount of the pension deficit, the cost impact of the cost accounting practice change and the cost impact of the CAS 413.50(c)(12)(iv) limitations on pension plan improvements. We will submit the results to you by January 31, 2005.

DISPOSITION:
(X) Action is ongoing. Estimated Completion Date: January 31, 2005
( ) Action is considered complete:

SUBJECT: DoDIG Draft Report, Accounting for Sperry Marine Pension Plan Assets Under an Advanced Agreement with Litton Industries, Inc., 8 October 2004, Project Number D-2004PT-0001

RECOMMENDATION 2.c: We recommend that the Director of the Defense Contract Management Agency determine the cost and pricing effect on Government contracts for the voluntary cost accounting practice change of changing actuarial cost methods as prescribed by FAR 30.602-3, "Voluntary Changes."

DCMA COMMENTS: Concur. The CIPR Center will determine the cost and pricing effect on Government contracts for the unilateral (voluntary) cost accounting practice change of changing actuarial cost methods. We will submit results to you by January 31, 2005.

DISPOSITION:
(X) Action is ongoing. Estimated Completion Date: January 31, 2005
( ) Action is considered complete:

SUBJECT: DoDIG Draft Report, Accounting for Sperry Marine Pension Plan Assets Under an Advanced Agreement with Litton Industries, Inc., 8 October 2004, Project Number D-2004PT-0001

RECOMMENDATION 2.d: We recommend that the Director, Defense Contract Management Agency, renegotiate the advance agreement with the contractor, as provided for under paragraph 13 of the advance agreement, to incorporate the Defense Contract Audit Agency and Defense Contract Management Agency findings.

DCMA COMMENTS: Concur. If the DCMA CIPR Center and DCAA find that the Government has been harmed, the Defense Corporate Executive will renegotiate the advance agreement to incorporate the Defense Contract Audit Agency and Defense Contract Management Agency findings within 60 days after receiving such findings.

DISPOSITION:
(X) Action is ongoing. Estimated Completion Date: March 31, 2005
( ) Action is considered complete:

Team Members

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

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