United States General Accounting Office

GAO

Report to Congressional Committees

April 1998

DEFENSE INDUSTRY RESTRUCTURING

Updated Cost and Savings Information

GAO/NSIAD-98-156

GAO

United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-279390.2

April 30, 1998

The Honorable Ted Stevens
Chairman
The Honorable Daniel K. Inouye
Ranking Minority Member
Subcommittee on Defense
Committee on Appropriations
United States Senate

The Honorable C. W. Bill Young
Chairman
The Honorable John P. Murtha
Ranking Minority Member
Subcommittee on National Security
Committee on Appropriations
House of Representatives

Section 8092 of the Department of Defense (DOD) Appropriations Act, 1998,[1] required us to report by April 1, 1998, on restructuring costs of defense contractors involved in business combinations since 1993. This is a non-proprietary version of our April 1, 1998, proprietary report.

The legislation required us to analyze the specific costs associated with workforce reductions, the services provided to workers affected by business combinations, and the savings reached from the business combinations relative to the restructuring costs paid by DOD. This report provides the requested information and also discusses the budgetary implications of reported restructuring savings.[2]

The legislation also requested that we analyze the effectiveness of the services provided to assist laid-off workers gain new employment. In our April 1997 report on defense restructuring costs, we described the factors that precluded us from determining the effectiveness of such services.[3] Consequently, as agreed with your offices, we limited our efforts in this area. We did, however, obtain descriptive information on the assistance

[1]Public Law 105-56, October 8, 1997.

[2]Section 804 of the National Defense Authorization Act for Fiscal Year 1998 requires us to provide updated information on restructuring costs paid and savings realized by DOD by December 1, 1998.

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

provided by business combinations and included such information, as appropriate, in this report.

To accomplish our work, we obtained information in February 1998 on six business combinations for which DOD certified that the proposals' estimated savings will exceed their projected costs. These combinations include:

- the United Defense Limited Partnership (UDLP), a joint venture between FMC Corporation's Defense Systems Group and Harsco Corporation's BMY Combat Systems Division;
- Martin Marietta Corporation's acquisition of General Electric Company's aerospace and other business segments;
- Martin Marietta's acquisition of General Dynamics Space Systems Division;
- Northrop Corporation's acquisitions of the Grumman Corporation and the Vought Aircraft Company to form the Northrop Grumman Corporation;
- the merger of the Lockheed Corporation and Martin Marietta to form the Lockheed Martin Corporation; and
- Hughes Electronics' acquisition of CAE-Link Corporation.

We also obtained information pertaining to a seventh combination, Hughes Aircraft Company's acquisition of General Dynamics' missile operations. This combination was consummated prior to the requirement for DOD to certify that savings will exceed costs. However, DOD has included this combination in its reports to Congress on defense industry restructuring.

Background

In July 1993, DOD changed a long-standing practice and permitted defense contractors to charge restructuring costs to transferred[4] flexibly priced[5] contracts, provided (1) the restructuring costs were allowable under the Federal Acquisition Regulation and (2) a DOD contracting officer determined the business combination would result in overall reduced costs to DOD or preserve a critical defense capability.

Concerns over the payment of such costs led Congress to pass legislation requiring that certain conditions be met before DOD reimbursed defense

[4]Following a business combination, contracts may be transferred from one contractor to another through a written agreement executed by the seller, buyer, and government, under which the government agrees to the transfer of its contracts.

[5]Flexibly priced contracts comprise a family of contracts under which the total amount paid to the contractor is dependent upon the allowable costs the contractor incurs in performing the contract.

contractors for restructuring-related expenses.[6] The legislation required, in part, that

- a senior DOD official certify that projections of restructuring savings are based on audited cost data;
- DOD's share of projected savings exceeds allowed costs; and
- the Secretary of Defense reports to Congress on DOD's experience with defense contractor business combinations, including whether savings associated with each restructuring actually exceed restructuring costs.

The Secretary of Defense is currently required by 10 U.S.C. 2325 to determine in writing that the savings will be at least twice the amount of allowed costs or that projected savings will exceed costs allowed and that the combination will result in the preservation of a critical capability.

DOD's process to comply with these provisions requires, in part, that (1) the contractor submit a restructuring proposal, including details on planned restructuring activities, their projected costs, and anticipated savings; (2) the Defense Contract Audit Agency (DCAA) audits the proposal; and (3) following the audit, a DOD contracting official recommends whether the proposal should be certified. Assuming a favorable recommendation, a senior DOD official issues a written certification stating that projected savings should exceed the projected costs. The certification enables the contractor to bill restructuring costs to DOD and, in turn, allows DOD to reimburse the contractor for DOD's share of such costs.

Through December 31, 1997, DOD issued nine certifications for restructuring proposals associated with six business combinations. DOD officials indicated that another six restructuring proposals are in various stages of review within DOD, and several significant business combinations may result in future restructuring proposals. This latter category includes Raytheon's acquisition of the defense units of Texas Instruments and Hughes Electronics, respectively, and the merger of Boeing and McDonnell Douglas.

Results in Brief

The seven business combinations estimated they had spent $1.2 billion at the time of our review for such restructuring activities as the disposal and relocation of facilities and equipment, consolidation of operations and systems, relocation of employees, and workforce reductions. Of this amount, the business combinations spent about $115 million on expenses

[6]Public Law 103-337, § 818, October 5, 1994.

related to workforce reductions. Severance pay constituted the majority of these expenses, with less amounts provided for temporary health benefits and outplacement services. Outplacement services included career transition workshops, resume development, career counseling services, job listings, and information on state and federal programs. Overall, the business combinations reported that about 18,000 workers or positions were eliminated due to restructuring activities.

DOD estimated it would realize a net benefit of about $3.3 billion from certified restructuring activities. Further, DOD estimated that as of August 1997 it had realized a net savings of about $1.9 billion, or more than half of the certified amount. However, DOD's figures may overstate the amount that is directly attributable to restructuring. The lack of specific DOD guidance on evaluating savings may contribute to this condition.

Caution should be exercised when using or interpreting estimates of restructuring savings. In a budgetary context, the $3.3 billion of estimated restructuring savings represents a cumulative amount of savings for each business combination, often spread over a 5-year period. Such savings constituted less than 1 percent of DOD's research and procurement budgets over the period for which the savings were projected. With one exception, DOD officials told us they did not consider restructuring savings when formulating DOD's budget requests. The one case cited by DOD involved two Air Force and Navy missile programs. While DOD had initially proposed reducing the programs' budgets to reflect anticipated restructuring savings, DOD subsequently agreed with the military services that the projected savings were needed to fund other program-related needs. In cases in which restructuring activities influenced a particular weapon system's cost, projected savings were often offset by nonrestructuring-related events.

Restructuring Costs

For the seven business combinations we examined, certified restructuring costs totaled about $1.5 billion. At the time of our review, the businesses estimated they had spent about $1.2 billion (see table 1). Restructuring costs are allocated to all of a contractor's customers; consequently, DOD's portion of these costs depends on its share of the contractor's total business base. Based on estimates made at the time of certification, DOD projected it would pay about 56 percent of the restructuring costs.

Table 1: Certified and Estimated Restructuring Costs of Seven Business Combinations

Dollars in millions

Business combination	Certified	Estimated cost
Hughes-General Dynamics	$366.1[a]	$319.1
UDLP	36.4	38.5
Martin Marietta-General Electric	241.6	233.9
Northrop-Grumman-Vought	70.4	75.1
Martin Marietta-General Dynamics	71.4	63.0
Lockheed-Martin Marietta	686.5	419.5
Hughes-CAE Link	50.1	38.7
Total	**$1,522.5**	**$1,187.8**

[a]Costs for the Hughes-General Dynamics combination were not subject to the certification process.

Restructuring after a business combination includes a wide range of activities, such as the disposal and modification of facilities, consolidation of operations and systems, relocation of workers and equipment, and workforce reductions. We grouped the estimated amount of restructuring costs incurred by the seven business combinations into broad categories (see table 2). Of the $1.2 billion in estimated restructuring costs, disposal and relocation of facilities and equipment was the largest cost category.

Table 2: Estimated Restructuring Costs by Category

Dollars in millions

Category	Estimated cost
Nonemployee-related cost	
Disposal, modification, or relocation of facilities and equipment	$547.4
Consolidation of operations and systems	93.7
Restructuring planning and implementation	124.8
Other	146.3
Cost for employees remaining with company	
Relocation	140.4
Retraining	10.5
Other	9.3
Cost of benefits and services for laid-off workers	
Severance pay	95.8
Continuation of health benefits	4.1
Outplacement services	4.1
Other	11.4
Total	**$1,187.8**

Impact on Defense Workers

The seven business combinations included in our review projected that about 21,000 workers or positions would be eliminated as a result of restructuring activities. The business combinations also reported that, at the time of our review, about 18,000 workers or positions had actually been eliminated (see table 3).

Table 3: Projected and Actual Number of Workers or Positions Eliminated as a Result of Restructuring

Business combination	Projected	Actual
Hughes-General Dynamics	6,600	6,441
UDLP	483	500
Martin Marietta-General Electric	1,453	1,504
Northrop-Grumman-Vought	450	450
Martin Marietta-General Dynamics	1,150	1,250
Lockheed-Martin Marietta	10,678	7,049
Hughes-CAE Link	548	665
Total	**21,362**	**17,859**

While the job losses attributed to restructuring are significant, the losses reflect the overall downsizing in defense-related employment. DOD estimates that defense-related industry employment will decrease from about 2.7 million workers in 1993 to about 2.1 million workers by the end of 1998.

Costs of Benefits and Services Provided to Laid-Off Workers

The seven business combinations estimated they spent about $115.4 million—or about 10 percent—of the total restructuring costs for benefits and services associated with workforce reductions. The majority of these costs were for severance pay, with less amounts for temporary health benefits and outplacement services. Outplacement included such services as career transition workshops, resume development, career counseling services, job listings, and information on state and federal programs. The costs for worker benefits and services varied by business combination, ranging from 3 percent to 14 percent of the combination's total restructuring costs.

A key determinant in whether laid-off workers received severance payments was whether the company provided such benefits prior to the business combination. For example, General Dynamics, Northrop, and the Vought corporations did not provide severance benefits to their workers prior to the combination; consequently, workers who were laid off as a result of restructuring received no severance benefits from their former employer. For those companies that provided severance pay, the amount varied, depending on such factors as whether the workers were salaried or hourly employees and the length of time they had been with the corporations.

Laid-off workers may also be provided benefits and services that were not funded by DOD. For example, the state of California, through the San Diego Consortium and the Private Industry Council, awarded Martin Marietta $935,000 to assist General Dynamics' laid-off employees.

Some Reported Savings May Not Be Directly Attributable to Restructuring

Each of the combinations that sought payment for restructuring activities was required to demonstrate that DOD's share of the estimated savings from the restructuring would exceed DOD's share of the projected costs. Overall, DOD estimates that it should realize a net savings of about $3.3 billion from restructuring activities (see table 4). DOD's figures indicate that for each dollar of restructuring costs it expects to pay, it will receive about $4.81 in benefits. However, not all of the reported savings may be directly attributable to restructuring.

Table 4: DOD's Share of Projected Restructuring Costs and Savings

Dollars in millions

Business combination	Savings	Cost	Net savings	Ratio
Hughes-General Dynamics[a]	$505.8	$132.5	$373.3	3.82 - 1
UDLP	79.7	29.1	50.6	2.74 - 1
Martin Marietta-General Electric	305.4	156.3	149.1	1.95 - 1
Northrop-Grumman-Vought	263.4	46.7	216.7	5.64 - 1
Martin Marietta-General Dynamics	139.6	50.7	88.9	2.75 - 1
Lockheed-Martin Marietta	2,675.8	405.9	2,269.9	6.59 - 1
Hughes-CAE Link	148.1	35.0	113.1	4.23 - 1
Total	**$4,117.8**	**$856.2**	**$3,261.6**	**4.81 - 1**

[a]With the exception of Hughes-General Dynamics, all costs and savings figures reflect the values used in DOD's certification decision. As the Hughes-General Dynamics combination occurred prior to the requirement for DOD to certify that savings will exceed costs, DOD did not prepare a comparable figure for total restructuring savings. The $505.8 million shown in table 4 reflects DOD's share of a March 1997 estimate of total restructuring savings; the cost figure represents DOD's original estimate of costs.

DCAA's guidance on auditing restructuring proposals may not provide sufficient criteria to ensure that the proposed savings are directly due to restructuring. DCAA's guidance discusses at length factors to consider in evaluating proposed costs, but it provides far less guidance on evaluating savings. Relative to evaluating projected restructuring savings, the guidance notes that contractor restructuring efforts are intended to result in the combinations of facilities, operations, or workforce that eliminate redundant capabilities, improve future operations, and reduce overall costs. It further notes that it is the contractor's responsibility to establish and support the reasonableness of the baseline to measure restructuring savings, but notes that various techniques can be used to do so. Finally, the guidance requires DCAA auditors to ensure that the estimates of future savings are reasonable and not due to other factors, such as changes in inflation or interest rates.

This broad framework may result in DOD's accepting proposed savings that are not directly attributable to restructuring. For example, as part of our ongoing work at Lockheed Martin's Space and Strategic Missiles sector, we attempted to isolate the effects of restructuring from nonrestructuring-related activities. The overall savings from this sector are considerable, amounting to about 43 percent of the total amount of projected restructuring savings from the seven combinations in our review. Of the savings accepted by DOD for certification purposes, about $489 million was attributed to increased operational efficiencies at one location through the adoption of improved business practices.

Contractor officials acknowledged that some of the improvements and associated savings could have been implemented without restructuring, noting that the contractor had various efforts to improve its operational efficiency underway or planned prior to restructuring. However, these officials believed that the business combination provided the means to overcome organizational and cultural barriers that might otherwise have hindered these efforts. A senior Lockheed Martin official emphasized that the merger provided the company a unique opportunity to evaluate and implement the best practices from four Lockheed and Martin Marietta facilities.

DCAA officials told us that during their audit of the restructure proposal for certification, they did not consider whether such savings could have been accomplished in the absence of restructuring. They noted, however, that they did not believe that DCAA's guidance provides sufficient criteria to distinguish savings attributable to restructuring from those savings that would have occurred regardless of the restructuring.

The Department of Justice and the Federal Trade Commission face a similar issue during their reviews of proposed mergers and acquisitions. In April 1997, the agencies issued revised guidance that discusses the types of efficiencies they consider germane to their reviews. In general, while the agencies will consider savings as part of their analysis, these agencies consider only those savings that are specific to the merger and that are unlikely to be accomplished in the absence of the merger. For example, the guidance notes that efficiencies resulting from shifting production among facilities formerly owned by the separate firms are more likely to be related to the merger. On the other hand, the guidance notes that other efficiencies, such as those relating to management improvements, are less likely to be specifically related to the merger. In our view, while evaluating proposed savings requires flexibility and the use of professional judgment, reflecting a similar approach in DCAA's guidance would provide a better depiction of the impact of restructuring activities.

Estimating Actual Savings Inherently Difficult

While DOD reports to Congress its estimates of whether savings associated with each business combination actually exceed restructuring costs, it acknowledges that making accurate estimates is inherently difficult. DOD reported that, as of August 1997, it had reimbursed defense contractors approximately $294.3 million in restructuring-related expenses, while it estimated that savings of about $2.2 billion had been realized (see table 5). As a result, DOD estimated that it has realized a net benefit of about $1.9 billion, or more than half the $3.3 billion in net savings certified for the seven business combinations. The savings reported by DOD were generally not developed from a detailed analysis of the effect of restructuring on individual contract prices, but rather were calculated using the same or similar methodologies employed during the certification process.

Table 5: DOD Estimates of Its Share of Paid Restructuring Costs and Realized Savings as of August 31, 1997

Dollars in millions

Business combination	Paid cost	Realized savings	Net savings
Hughes-General Dynamics	$121.4	$505.8[a]	$384.4
UDLP	14.0	37.6[b]	23.6
Martin Marietta-General Electric	71.9	198.2	126.3
Northrop-Grumman-Vought	14.5	98.2[c]	83.7
Martin Marietta-General Dynamics	26.4	163.7	137.3
Lockheed-Martin Marietta	35.3	1,118.4[d]	1,083.1
Hughes-CAE Link	10.8	32.1	21.3
Total	**$294.3**	**$2,154.0**	**$1,859.7**

[a]The report indicated that the Hughes-General Dynamics savings related to only eight contracts; however, the estimate was for the total business combination.

[b]DCAA reported that the UDLP savings were inadvertently overstated by about $10.3 million.

[c]Estimated savings are based on two of the six projects certified. These two projects accounted for 90 percent of total projected savings.

[d]The estimated savings reflect about $869 million attributed to restructuring activities at two of Lockheed Martin's business units. At one unit, due to time constraints, DCAA limited its review to determining whether the claimed savings were consistent with those accepted during certification, and did not verify savings to specific contracts or verify the accuracy of the amounts claimed. To a lesser degree, time constraints also limited DCAA's efforts at the other unit. However, DCAA did reject about 13 percent of the savings claimed by Lockheed Martin at these locations.

Caution should be exercised when interpreting the reported savings. DOD has consistently said that it is inherently difficult to precisely identify the amount of actual savings realized through restructuring activities several years after the initial estimate. For example, DOD has stated it is not feasible to completely isolate the effects of restructuring from such other factors as fluctuations in a contractor's business base, changes in the inflation rate, accounting system changes, subsequent reorganizations, and unexpected events, which also impact a contractor's cost of operations. Recognizing such difficulties, DOD initially agreed that it would not require validation of the projected savings for two business combinations, noting in one agreement that such a validation was not practical because of business dynamics and future uncertainties. However, DOD estimates actual savings resulting from these two business combinations in response to the reporting requirement.

The difficulty in isolating the effect of nonrestructuring activities and their impact on estimating savings is illustrated by restructuring activities following Martin Marietta's acquisition of General Dynamics Space Systems Division. In this case, DCAA used a different business base in estimating actual restructuring savings than was used to estimate the certified savings. The use of a different business base led, in part, to DOD's share of net savings shown in table 5—$137.3 million—being considerably higher than the $88.9 million of net savings expected at certification. DCAA officials told us that they were unaware of any way to isolate changes in Martin Marietta's current business base to make it comparable to that used during the certification process.

Impact of Restructuring Savings on DOD Budget Requirements Has Been Limited

The impact of restructuring savings on DOD's budget requirements has been limited. Projected savings constituted a small percentage of DOD's budgets and were generally not considered by DOD officials in formulating budget requests. Also, even when restructuring activities influenced a weapon system's cost, the impact was often offset by nonrestructuring-related events or used to fund other program-related needs.

DOD's estimate of restructuring savings—which includes those savings that may not be directly related to restructuring—represents a cumulative amount of savings, often spread over a 5-year period, for each business combination. Overall, DOD estimated it would realize a net savings of about $3.3 billion between 1993 and 2000.[7] In comparison, DOD's approved or projected budgets for research and procurement totaled more than $658 billion over that same period. Consequently, DOD's share of certified savings constitutes less than 1 percent of DOD's budgets.

A senior DOD budget official stated that DOD generally has not considered restructuring savings when formulating its budget requests and relied on the individual program offices to do so. He acknowledged, however, that

[7]The actual figure for DOD's share of net savings is slightly higher than the figure reflected above, principally because restructuring costs are generally amortized. Consequently, while certified savings are to be realized between 1993 and 2000, DOD will incur restructuring costs through 2004.

DOD's budget guidance does not specifically require the program offices to consider restructuring savings. This official also told us that the one exception that he was aware of involved Raytheon's recent acquisition of Hughes' defense business, for which DOD considered reducing the projected budgets for the advanced medium range air-to-air missile (AMRAAM), a joint Air Force/Navy program, and the Navy's standard missile program to reflect anticipated savings. Regarding the AMRAAM, Air Force officials argued that any savings that resulted from the business combination were needed to fund future programmatic needs. According to Navy officials, the savings were used to budget for additional missiles for both programs. DOD subsequently agreed not to reduce the proposed budgets to reflect restructuring savings.

Our work provides two other examples of how restructuring activities influenced the costs of major weapon systems without directly affecting budgetary requirements. For example, following the Northrop Grumman business combination, several restructuring activities, including closing Grumman's former headquarters in Bethpage, New York, were undertaken. Consequently, the amount of corporate overhead costs allocated to Northrop Grumman's business units, including the B-2 program, was less than projected before the business combination. B-2 program officials told us that no adjustments were made to the B-2 program's estimated costs or future budget requests due to restructuring.

According to these officials, projected savings from the combination may have been reflected in new overhead rates, which would then be used in preparing new contract proposals or finalizing overhead rates on existing flexibly priced contracts. In fact, the B-2's general and administrative overhead rate—to which corporate overhead costs are allocated—actually rose significantly from 1993 to 1996, due principally to the decrease in the planned procurement of B-2s. Consequently, while the lower corporate overhead costs resulted in the B-2's general and administrative overhead rate being slightly lower than it would have been without the restructuring, the changes in planned procurement more than offset the impact of restructuring.

Similarly, the Air Force's Titan IV launch vehicle program was affected by the Martin Marietta-General Dynamics and Lockheed-Martin Marietta business combinations. According to Lockheed Martin, restructuring activities resulted in a benefit of over $600 million to the Titan IV program. Titan IV program officials agreed that restructuring activities reduced projected program costs, but indicated that it was not possible to precisely quantify the impact of restructuring. These officials explained that a number of changes were occurring concurrently on the Titan program, including a reduction in the number of launch vehicles and the implementation of various acquisition reform initiatives.[8] Nevertheless, program officials told us that restructuring activities contributed to their ability to absorb congressional, DOD, or Air Force budget cuts or to fund other program-related needs.

Recommendation

Our work indicates that DCAA's guidance does not provide sufficient criteria to evaluate restructuring savings, particularly savings that may have been achievable without restructuring. Estimates based on this guidance may not accurately depict the savings associated with restructuring. Consequently, we recommend that the Secretary of Defense direct the Director, DCAA, to clarify DCAA's guidance on evaluating restructuring savings. In particular, the guidance should discuss how to evaluate proposed savings based on activities that were ongoing or planned prior to restructuring or that could have been achieved absent restructuring, such as those achievable by management improvements.

Agency Comments and Our Evaluation

DOD commented on a draft of the proprietary report. DOD disagreed with our finding that some of the savings it reports may not be directly attributable to restructuring. DOD also disagreed with our recommendation that DCAA's guidance needs to be clarified. DOD believed DCAA's current guidance properly implements the legislative requirements. DOD indicated that in reviewing restructuring proposals, it is most concerned with ensuring both that savings exceed costs by the required ratio and that restructuring costs and savings are factored into contract pricing mechanisms as quickly as possible. DOD further noted that when a contractor can demonstrate that savings will significantly exceed costs, there is usually no reason to argue over whether the savings could have been accomplished without restructuring.

We agree with DOD that it has established a process to comply with the legislative intent that DOD's share of projected savings exceeds its projected share of costs, and strongly agree that DOD should ensure that the impact of restructuring is factored into contract pricing mechanisms as

[8]We reported on the effects that acquisition reform initiatives had on weapon system funding in our report, Acquisition Reform: Effect on Weapon System Funding (GAO/NSIAD-98-31, Oct. 29, 1997). We reported that the Titan IV's estimated cost, measured in terms of changes to its December 1993 and December 1995 selected acquisition reports, fell from $37.7 billion to $23.6 billion. DOD attributed $661.8 million of this reduction to acquisition reform initiatives.

quickly as possible. We also believe DCAA's guidance provides an overall framework to evaluate savings. For example, the guidance states contractor restructuring efforts are intended to result in the combinations of facilities, operations, or workforce that eliminate redundant capabilities, improve future operations, and reduce overall costs. The guidance further states that auditors should ensure that future savings are reasonable and not due to other factors, such as changes in inflation or interest rates.

Nevertheless, our work indicates that this broad framework may result in DOD accepting savings that may not be directly attributable to restructuring. At one location at which a considerable amount of savings were proposed due to the adoption of improved business practices, contractor officials acknowledged that some of the improvements and associated savings could have been implemented without restructuring, noting that the contractor had various efforts to improve its operational efficiency underway or planned prior to restructuring. DCAA officials indicated that DCAA's guidance does not provide sufficient criteria to allow them to question such savings.

Ensuring that such savings are related to restructuring would seem a basic element necessary to satisfy the legislative criteria and DCAA's own guidance. Further, DOD reports annually to Congress on the net savings expected from combinations certified during the preceding year, as well as estimates of savings actually realized. While making such estimates is inherently difficult, the reports should, in our view, attempt to accurately depict the impact of restructuring to the extent possible. Finally, several business combinations have recently announced their intent to restructure, including Raytheon and Boeing. Our discussions with DCAA, Defense Contract Management Command (DCMC), and contractor officials indicated that better guidance as to what constitutes restructuring-related savings would assist in these efforts. Consequently, we believe augmenting the existing criteria with a discussion of the various factors that auditors should consider in evaluating savings is a reasonable request.

DOD's comments are reprinted in appendix I.

Scope and Methodology

To determine the amount and nature of restructuring costs, we requested the cognizant DCMC office to provide updated restructuring-related cost and savings information for each of the business combinations in our review. We analyzed this information to determine the amount of restructuring costs incurred for workforce reductions and to identify the costs associated with services provided to assist laid-off workers find reemployment. We did not, however, independently verify the information provided.

In assessing restructuring savings relative to the restructuring costs paid by DOD, we relied on the information contained in DOD's November 22, 1997, report to Congress. We did examine, however, the methodology DCAA used to estimate the amount of restructuring costs paid by DOD and the amount of estimated savings at selected units of business combinations at which we conducted work.

To determine the budgetary implications of restructuring savings, we compared DOD's share of certified restructuring savings to DOD's actual or projected budgets for the period over which the savings were expected to be realized. We discussed how DOD uses projected restructuring savings in formulating its budget requests with officials from the Office of the Under Secretary of Defense (Comptroller/Chief Financial Officer). We also discussed how projected restructuring savings were used by the Air Force's Titan IV and B-2 program offices in formulating their budget requests.

Finally, we discussed various aspects of the restructuring costs and savings with officials from the business combinations, DOD, DCMC, and DCAA.

We performed our review between December 1997 and March 1998 in accordance with generally accepted government auditing standards.

We are sending copies of this report to appropriate congressional committees; the Secretary of Defense; the Commander, DCMC; and the Director, DCAA. We will also provide copies to other committees and Members of Congress upon request.

Please contact me at (202) 512-4841 if you or your staff have any questions concerning this report. The major contributors to this report are listed in appendix II.

David E. Cooper
Associate Director
Defense Acquisitions Issues

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Abbreviations

AMRAAM	advanced medium range air-to-air missile
DCAA	Defense Contract Audit Agency
DCMC	Defense Contract Management Command
DOD	Department of Defense
UDLP	United Defense Limited Partnership

Comments From the Department of Defense

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

OFFICE OF THE UNDER SECRETARY OF DEFENSE

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ACQUISITION AND TECHNOLOGY

March 26, 1998

DP/CPF

Mr. David E. Cooper
Associate Director, Defense Acquisitions Issues
National Security and International
Affairs Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Cooper:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report "DEFENSE INDUSTRY RESTRUCTURING: Updated Cost and Savings Information," dated March 20, 1998 (GAO Code 707322/OSD Case 1569).

The DoD nonconcurs with the GAO recommendation and selected finding of the draft report. Our detailed comments are provided in the enclosure.

Thank you for providing us the opportunity to comment on the draft report.

Sincerely,

Eleanor Spector

Eleanor R. Spector
Director, Defense Procurement

Enclosure

GAO DRAFT REPORT
"DEFENSE INDUSTRY RESTRUCTURING:
Updated Cost and Savings Information"
(GAO Code 707322/OSD Case 1569)

* * * * *

DOD COMMENT
ON SELECTED GAO FINDING

FINDING: The GAO stated that not all of DoD's reported savings may be directly attributable to restructuring. Based on its review of one of the certified business combinations, the GAO found that $489 million of the savings accepted by DoD was attributed to increased operational efficiency resulting from the adoption of various business practices across one segment's units. The GAO cited an acknowledgment from contractor officials that many of the improvements and their associated savings could have been implemented without restructuring. The GAO also noted that guidance was issued by the Department of Justice (DOJ) and Federal Trade Commission (FTC) concerning the types of savings they consider germane to their reviews of proposed mergers and acquisitions. In general, these agencies consider only those savings that are specific to the merger and that are unlikely to be accomplished in the absence of the merger. Their guidance indicates that efficiencies such as those relating to management improvements are less likely to be specifically related to mergers. The GAO concluded that DoD should adopt a similar approach to better depict the impact of restructuring activities. (p. 11-13/Draft Report)

Now on pp. 7-9.

See comment 1.

DOD COMMENT: Nonconcur. The GAO finding is based on an issue identified at one business segment. There is no evidence that classifying these savings and their associated costs differently (i.e., as other than restructuring savings and costs) would have resulted in not meeting the 2 to 1 savings to cost ratio required for business combinations occurring after September 30, 1996. Even if DoD had refused to accept the $489 million in restructuring savings identified by the GAO as questionable, the savings to cost ratio at the business segment would have been 4.4 to 1.

In reviewing contractor restructuring proposals associated with business combinations, DoD is most concerned with two issues: ensuring the savings associated with restructuring activities will exceed the costs by the required 2 to 1 ratio, and ensuring the restructuring costs and savings are factored into forward pricing rates and contractor estimating systems as quickly as possible so that the net savings are priced into new contracts. When a contractor can demonstrate that savings will significantly exceed

ENCLOSURE

costs, there is usually no valid reason for DoD to argue over whether the savings could have been accomplished without restructuring. Restructuring costs are allowed as long as the 2 to 1 test is met, and the contractor does not benefit from demonstrating a larger savings amount. However, if DoD refuses to accept savings as restructuring savings, then the associated costs are not considered to be restructuring costs, and are not subject to the audit, review, certification, and delayed cost recovery requirements (i.e., over a three to five year period) imposed on restructuring costs. Instead, the costs would be fully allowable in the year incurred.

See comment 2.

The guidance issued by the DOJ and the FTC is designed to ensure that the efficiencies claimed by the contractor are only those savings likely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects. We do not consider the DOJ/FTC guidance to be relevant for contract cost allowability and pricing matters.

See comment 3.

GAO DRAFT REPORT
"DEFENSE INDUSTRY RESTRUCTURING:
Updated Cost and Savings Information"
(GAO Code 707322/OSD Case 1569)

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DOD COMMENT
ON GAO RECOMMENDATION

RECOMMENDATION: The GAO recommended that the Secretary of Defense direct the Director, Defense Contract Audit Agency (DCAA), to clarify DCAA's guidance on evaluating restructuring savings. In particular, the guidance should discuss how to evaluate proposed savings based on activities that were ongoing or planned prior to restructuring or that could have been achieved absent restructuring, such as those achievable by management improvements. (p. 19/Draft Report)

Now on p. 13.

DOD COMMENT: Nonconcur. We believe that existing guidance on evaluating contractor restructuring costs and savings is adequate and ensures that the requirements of 10 USC 2325, as amended, are properly implemented. We believe the current guidance serves the best interests of the Department and ensures that net savings are priced into new contracts as quickly as possible. Since the type of refinement proposed by the GAO would not appear to affect the allowability of costs, we believe it would not be a prudent use of our resources to implement this recommendation. In the one case identified as questionable by the GAO, if DoD had refused to accept $489 million in restructuring savings, the savings to cost ratio at the business segment would still have been 4.4 to 1, which substantially exceeds the 2 to 1 ratio required for business combinations occurring after September 30, 1996, and the costs incurred to generate the savings would have been fully allowable.

The following are our comments on the Department of Defense's (DOD) letter dated March 26, 1998:

GAO Comments

1. Questions regarding the treatment of proposed restructuring savings have arisen during other certifications. We illustrated it at one business segment because of the large amount of savings there and the concerns expressed by the Defense Contract Audit Agency (DCAA), Defense Contract Management Command (DCMC), and contractor officials regarding the need for additional guidance. However, we did not intend to imply that certification of the overall business combination—which had to demonstrate only that DOD's share of projected savings exceeded its projected share of costs—was improper.

It should be noted that the issue as to what constitutes restructuring-related savings is not limited to the certification process, but also plays a role in DOD's report to Congress on realized savings. For example, based in part on our work at this business segment, DCAA officials rejected $66 million in savings the contractor claimed on one program. While DCAA rejected more than $124 million overall at this location, DCAA officials told us the absence of clear criteria precluded them from questioning additional amounts of the claimed savings.

2. We would agree that any costs associated with activities that are not directly related to restructuring should not be subject to the certification process, but rather should be reviewed under normal auditing practices. As with savings, eliminating costs that are not restructuring-related would provide a more accurate depiction of restructuring activities.

3. We did not intend to suggest that DOD should adopt the joint guidance issued by the Department of Justice and the Federal Trade Commission per se, but rather we used the joint guidance to illustrate an approach that DCAA should consider in revising its guidance. We have revised the text accordingly.

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