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IMPACTS OF DECLINING BUDGETS AND DEFENSE MERGERS ON THE DEPARTMENT OF DEFENSE

BY

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The views expressed in this academic research paper are those of the author and do not necessarily reflect the official policy or position of the U.S. Government, the Department of Defense, or any of its agencies.

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ABSTRACT

AUTHOR: Joe E. Conley

TITLE: Impacts of Declining Budgets and Defense Mergers on the Department of Defense

FORMAT: Fellowship Research Project

DATE: 09 April 2002 PAGES: 35 CLASSIFICATION: Unclassified

After the end of the Cold War, defense contractors were forced to merge and restructure operations due to declining defense budgets. Moreover, contractors convinced the Department of Defense that it is in the government's best interest to pay restructuring costs. Senior industry executives stated that the potential savings would far exceed the costs of consolidation for the Department of Defense. In 2001, twelve years since the Cold War, we continue to see mergers and restructuring costs charged to the Department of Defense. This paper will examine the impacts of declining defense budgets and defense mergers on the Department of Defense. It will focus primarily on the areas of declining defense spending, overhead costs, and industry restructuring activities.

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IMPACTS OF DECLINING BUDGETS AND DEFENSE MERGERS ON THE DEPARTMENT OF DEFENSE

After the end of the Cold War, defense contractors were forced to merge and restructure operations due to a declining defense budgets. Moreover, contractors convinced the Department of Defense that it was in the government's best interest to pay for these mergers and their restructuring activities. Contractors stated that the potential savings from restructuring would far exceed the cost of consolidation for the Department of Defense. In 2001, twelve years since the Cold War, one continues to see mergers and restructuring costs charged to the Department of Defense. This paper will examine the effects of the post-Cold War defense budgets on industry mergers over the past twelve years. It will focus primarily on the areas of the declining defense spending, overhead costs, and industry restructuring activities.

The collapse of the Soviet Union ended the Cold War and the United States emerged as the world's only true superpower. Many Americans had hoped and prayed for this revelation for years. However, this news was devastating for the national defense industry. The end of the Cold War brought an environment of declining defense budgets that dramatically affected the size and structure of the United States defense industry. Declining budgets caused sharp reductions in expenditures for military procurement, which caused enormous cuts in the number and size of weapons programs. The decrease in defense spending, declining sales, and excess capacity forced many defense companies to consolidate in order to remain competitive and financially viable.[1]

The overall United States defense budget had decreased from a peak of $390 billion in 1985 to $250 billion in 1997, with another projected cut of $50 billion by year 2000. A decline of this magnitude was crippling to an industry that had invested heavily in plants and infrastructure based on the expectation that the defense budget would remain high due to the communist threat. This investment in the defense industry and the demand for weapons and military systems led quickly to overcapacity among defense contractors.[2] This overcapacity contributed to excess overhead and higher costs for United States military programs.

CONGRESS CONCERNED OVER DEFENSE DOWNSIZING

Congress has always maintained that it wants a strong defense industrial base. Concerned with the downward defense trend, they directed the Secretary of Defense and the General Accounting Office to report on the ability of industry to support the United States national security objectives.[3] Congress wanted to know the impact of the recent decline in defense expenditures on individual business units of major defense contractors, which included: sales and employment levels, their spending on Independent Research and Development (IR&D) and Bid Proposal (BP) preparation, capital improvements, and facilities. Responding to Congress' request, the General Accounting Office selected six of the top ten defense contractors in 1993 to conduct its study. The contractors were General Dynamics, General Motors, Lockheed, Martin Marietta, McDonnell Douglas, and United Technologies. These contractors were selected because they engaged primarily in defense work and comprised an important part of their corporations' total government sales.[4]

DEFENSE EXPENDITURES

Since the World War II drawdown, defense spending has experienced three peaks associated with the Korean War, the Vietnam War, and the Reagan administration military buildup. In fiscal year 1989, defense expenditures reached the highest peacetime level since World War II, exceeding defense spending at the peak of the Korean War and almost matching spending during the Vietnam War. Defense expenditures in fiscal year 1989 were $354.1 billion, but had declined to $274.5 billion by fiscal year 1994, a reduction of $79.6 billion or 22% The Clinton administration projected defense expenditures of $ 224.5 billion in fiscal year 2000, which represented a $129.6 billion, or a 37% decline in defense expenditures after the end of World War II.[5] As one can see, the post-Cold War decline in spending is significant. However, unlike pre-Cold War drawdowns, defense contractors view the current decline in defense expenditures as permanent, not cyclical.[6] Therefore, this decline in defense spending will impact future contractors' sales tremendously.

DECLINE IN CONTRACTORS BUSINESS SALES

According to defense contractors, the decline in defense spending since the late 1980s had radically affected their defense business sales. When the General Accounting Office compared the contractors' peak sales years of 1985 with sales in 1993 and projected sales for 2001, they found that the contractors' sales posture had decreases ranging from 21% to 54% through 1993 and that the business units were estimating decreases ranging from 50% to 73% through 2001. The average projected decline in sales for the businesses was about 55%.[7] When any business sales position is cut in half, one either gets out of the business or aggressively finds ways to reduce spending. Many smaller contractors got out of defense work altogether and made the transition into the commercial markets. Defense contractors have taken and are continuing to take aggressive actions in the areas of employee cutback, IR&D and BP, capital investments, and facilities to reduce spending as a result of the post Cold War sale declines.[8]

CUTBACK IN EMPLOYEES

The contractors made huge reductions in the number of employees since their peak employment years of the late 1980s. Through 1993, the business units' workforce reductions range from 30% to 76%. Through the latest projected year of 2001, the business units' estimated reductions ranged between 44% to 79%. The downward employment trend at these six contractors' facilities is consistent with the finding of other studies on the defense industry workforce. Defense related employment had declined from about 3.7 million workers in 1987 to about 2.7 million workers in 1993, which represents a 26 percent employment decline of the period. During that period between 1987 and 1993, the twenty leading defense contractors had experienced an average employment reduction of 22 percent. One report estimated that defense employment would decline by 803,000 jobs from 1992 to1997.[9]

DECLINES IN IR&D AND BP EXPENDITURES

The Department of Defense policy recognizes the IR&D and BP as a cost that increases the technology base and the number of contractors able to compete for government contracts. The terms IR&D and BP are unique to government contracting. The IR&D consists of contractor research and development efforts not performed under contract or grant and not required for the preparation of a specific bid or proposal, either government or commercial. The IR&D is funded and managed at the contractor's discretion from contractor-controlled resources. There are four types of IR&D: basic research, applied research, development, and systems concept formulation studies. The BP comprises contractor efforts related to preparing, submitting, and supporting bids and proposals, either government or commercial. Both administrative and technical efforts are included in the BP. The nature of the work in the IR&D and BP is sometimes the same. The difference is the intent to use the BP efforts to obtain a specific contract.[10]

Similar to the reductions in employment levels, the six contractors had made substantial cuts in their IR&D and BP expenditures. Between their peak spending years and 1993, these business units had reduced the IR&D and BP expenditures ranging from 31 percent to 71 percent and ranging from 41% to 84 % through the latest projected year of 2001. Studies have shown a correlation between the level of the defense expenditures and the amount contractors spent on the IR&D. When large production runs were the rule, many companies willingly invested their own funds in the IR&D because they could reasonably expect to recover their investment.[11]

To determine whether the level of sales affected these contractors' IR&D and BP investments, the General Accounting Office compared the change in the business units spending levels for the IR&D and BP with changes in their sales. They found that within four of the six business units, the change in the IR&D and BP expenditures generally correlated to their sales volume. Because of concerns that the quantity and quality of the IR&D would decline as budget cuts forced the defense industry to limit overhead costs, the Congress made substantial legislative revisions to the IR&D program in fiscal years 1991 and 1992 to encourage defense contractors to continue the IR&D activities. Even with these revisions, defense contractors have continued to cut their IR&D and BP expenditures, as defense sales declined.[12]

REDUCTION IN CAPITAL EXPENDITURES

The Department of Defense has always encouraged contractors to invest in cost-reducing facilities and equipment, which enable the government to procure weapon systems at the lowest possible price. However, given that interest is an unallowable cost, there is not a strong incentive for contractors to invest in capital equipment, especially during a time of declining sales. Such investments normally require very large outlays of cash.[13] Contractors significantly cut their capital expenditure from their peak spending levels in the 1980s. Business units had made reductions through 1993, ranging from 52% to 92%, and estimated reductions from 55% to 85% through the 2002 projected year. Business units projected an average reduction of 76% in their capital expenditures. Similar to the IR&D and BP expenditures, changes in capital expenditures at some business units correlated to their sales volume.[14]

REDUCTION IN FACILITIES

Measured from their peak years, five of the business units had reduced square footage by as much as 35% through 1993, and projected reduction ranging from 6% to 43%, or an average of 26% through the year 2001. The units projected most of these reductions in their leased space. According to the Defense Contract Management Command records, defense contractors have significantly reduced the size of their facilities through such actions as vacating and selling buildings, and terminating leases.[15]

The post-Cold War budgets decline had a domino effect on the defense industry. The Department of Defense cut spending and/or canceled contracts, contractors' sale base eroded, contractors laid-off employees, and overhead rates increased. Let's suppose one is a defense contractor and landed a $100 billion contract for a highly technological missile system. One would aggressively go out and invest money in top-of-the-line engineers, support personnel, facilities, and plant equipment. For the next fiscal year, Congress reduced the program funding by $50 billion. In addition, your business received a partial contract termination from the contracting officer for $25 billion. Now under these conditions, can one afford to sustain operations at current levels? No, one would be forced to lay-off employees, close facilities, decrease spending, and spread the overhead to other government programs.

DEFENSE SPENDING EFFECTS ON OVERHEAD COSTS AND INDUSTRY INITIATIVES TO CONTROL OVERHEAD

The Defense industry takes initiatives to control overhead costs. First, there are many terms used interchangeably in industry that have the same meaning as overhead such as burden, loading, add-on, management, and factory expense. Many people in industry and government commonly use the term "overhead" to mean indirect cost. Therefore, let's define a key term such as "cost objective" which is a function, organization subdivision, contract, or other work unit for which cost data is desired and for which a provision is made to accumulate and measure the cost of processes, products and jobs.[16] A "final cost objective" is allocated to both direct and indirect costs, and is in the contractor's accumulation system. For the author's purpose, a final cost objective is a specific contract.[17] "Indirect costs" are any costs not directly identified with a single, final cost objective, but identified with two or more cost objectives.[18] "Direct cost" is any cost that can be identified specifically with a particular final cost objective.[19] "Overhead rates" are used for allocating overhead costs, for estimating and costing jobs completed prior to the end of the year when actual costs are known.

In 1994 Senior Department of Defense officials expressed concern that contractors overhead rates could increase procurement costs due to the decline in the Department of Defense spending. The Department of Defense estimated that overhead costs on the average represented about one-third of the contract price.[20] Overhead costs are different from contractor to contractor and from industry to industry. Again, costs are typically classified as overhead, if they are not directly assignable to a specific contract but support a company's total business to include those facilities, equipment, administrative and general office support, computer operation, managers' salaries, and security.[21]

Defense contractors were also very concerned about increasing overhead rates. However, as stated earlier, there had been a severe deterioration in the contractors' business base, which naturally caused a significant increase in overhead rates. Contract terminations and major quantity reductions affect overhead costs significantly, and the remaining contracts were forced to absorb the additional overhead costs. Defense contractors were fully aware that overhead costs must be reduced in order for them to stay in business and satisfy their stockholders.

Contractors responded to reducing overhead by decreasing the number of indirect employees, cutting employee health care benefits, consolidating facilities, and reducing IR&D and BP expenditures. The Defense Contract Management Agency, which is the Department of Defense's organization responsible for overseeing contractor overhead costs, collected this data. Contractors across the industry have taken aggressive steps to reduce overhead costs to remain competitive in an environment of declining sales. In an effort to reduce overhead costs, many contractors targeted top overhead cost drivers such as indirect labor, fringe benefits, facilities, and assessed other areas of their overhead operation to identify additional cost opportunities. The cost reduction measures taken by contractor business units and corporate headquarters resulted in significant reductions in overhead costs.[22]

However, in many cases, despite the aggressive efforts by industry, overhead costs were not declining as rapidly as their sales business base; therefore, overhead rates continued to increase. For example, a program officer is currently paying the contractor $1.50 in overhead cost on a contract, and Congress decides to cut major programs that are performed at the contractor's plant due to funding shortfalls and future budgets projections.
This action will force the contractor to raise his overhead rate by 25% to cover cost. One will now pay the contractor $1.88 in overhead cost. At first glance, a 25% increase may not seem like much, but when one is working with multi-billion dollar programs, it is an enormous amount of money. The tough question is, who is going to pay for the increase?

The future budget outlook was dim. The Department of Defense, and ultimately the taxpayer, could not continue to bear the cost for increased overhead and excess capacity in the defense industry. The Department of Defense took drastic measures. Senior Department of Defense officials informed industry executives that the declining defense budgets would drive many of them out of business, if they did not consolidate and restructure their business operations.[23]

The effect of the Department of Defense's warning was immediate and dramatic. The defense industry responded with merger-mania by restructuring and consolidating their organizations. In the author's opinion, this was a watershed event in the defense industry. Through mergers and acquisitions, the defense industry as a whole has gone from about twenty major defense contractors to four within the last decade. In some areas, there are only two large contractors representing the industry. The Department of Defense played an important role in the process. This paper will now shift its focus to discuss restructuring in the defense industry.

DEFENSE INDUSTRY CONSOLIDATION AND RESTRUCTURE

As a result of reduced defense spending, the Department of Defense encouraged the defense industry to restructure and consolidate in 1993. Deputy Secretary of Defense William Perry started the process with his famous "last supper" speech to industry executives.[24] He laid out the bleak military budgetary outlook at this meeting and urged industry leaders to combine into a few large companies to eliminate the costly overcapacity problem. However, senior industry executives voiced their concerns, stating that there were few incentives to consolidate and to reduce excess capacity and facilities, which raised overhead charges on defense contracts. In fact, they said that it was in the best interest of the Department of Defense to pay contractors to consolidate because the potential savings would exceed the consolidation costs to the Department of Defense.[25]

This issue of reimbursing contractors for costs related to mergers and acquisitions is a subject of controversy and heated debate. Prior to July 1993, the Department of Defense had a policy of not permitting defense contractors to charge restructuring costs that were from one contractor to another contractor, a result of a business combination. The rationale for the policy was that the government should not pay increased contract costs that were incurred only because the contractor decided to combine with another firm. In July 1993, the Department of Defense changed its policy. The change allowed contractors to charge the government for restructuring costs if the Federal Acquisition Regulation permitted the costs, and a contracting officer determined that the business combination would reduce overall costs to the government or preserve a critical defense capability.[26]

Congress was concerned that the policy change would cause the government to pay unallowable restructuring costs to contractors. Therefore, Congress enacted Section 818 of the National Defense Authorization Act for Fiscal Year 1995, which restricts Department of Defense payment to contractors for costs associated with business combinations. The act prohibits the payment of restructuring costs associated with closing facilities and eliminating jobs, until a senior Department of Defense official certifies that the projected savings from the restructuring activity have been audited. Therefore, to comply with Section 818 requirements, the Department of Defense issued interim regulations on restructuring costs effective in December 1994.[27]

This law was needed because the Department of Defense regulations were unclear and did not require certain costs associated with a business combination to be certified. The Department of Defense regulations defined two types of restructuring actions: internal and external. Internal activities are those occurring after a business combination merger and involve the facilities or workforce of only one of the companies in the merger. These costs were not subject to the certification requirement. External activities are those occurring after a business combination and involve facilities or workforce from both companies in the merger. These costs were subject to the certification requirement. However, Section 818 makes no distinction between internal or external activities. If the restructuring costs are associated with the business combination, they must be certified.[28]

THE FIRST TEST FOR THE RESTRUCTURING COSTS AND SAVINGS REGULATIONS

In accordance with Section 818 requirements, the General Accounting Office reviewed the implementation of the Department of Defense's restructuring regulations in 1995. Its task was to determine whether the certification process was carried out in accordance with the interim regulations and whether restructuring had resulted in lower contract prices. The General Accounting Office selected the United Defense, Limited Partnership business combination between FMC Corporation's Ground System Division and Harsco Corporation's Combat Systems Division. This was an excellent business combination to test, because procurement funding for tracked vehicles had decreased by 86% between 1983 and 1994 and United Defense had the first and only restructuring proposal certified as of May 1995. The FMC and Harsco manufactured tracked vehicles for the Army and clearly there was not enough funding to sustain two large corporations. Therefore, to survive in the market, they formed a partnership to eliminate excess capacity and staffing. The contractor began restructuring its operations by combining the two divisions, moving the final assembly, and the test of most product lines from California to Pennsylvania.[29]

The Department of Defense's actions in reviewing and certifying the contractor's business combinations complied with the interim regulations. The contractor submitted the proposal. The Defense Contract Audit Agency reviewed the proposal and a senior Department of Defense official certified that the restructuring should result in a reduction in costs on government contracts. However, the projected net cost reduction was less than 15% of the estimated savings that the contractor initially projected when the partnership was proposed two years earlier.[30]

Several factors account for the difference between the original estimate and the revised estimate. The initial estimate was based on reductions in specific elements of cost, including overhead, manufacturing, and material. Furthermore, it included savings from improved facility use, which would result from potential increases in foreign military sales. However, when the contractor understood that Section 818 and the Department of Defense implementing regulations only required that the contractor demonstrate that restructuring should result in reduced cost, the contractor chose to base its revised estimate solely on elements of cost related to workforce reductions.[31] This was an example of how interpreting the restructuring regulations were viewed differently by government and industry personnel.

RESTRUCTURING ACTIVITIES REDUCED CONTRACT PRICE

Remember that the General Accounting Office's other task was to determine if restructuring activities would reduce contract prices. After completing restructuring, the Department of Defense awarded United Defense a contract that was comparable to the contract awarded before restructuring. They found that United Defense's restructuring efforts did contribute to a reduction in the unit price, but the precise amount of savings resulting from the restructuring could not be determined. Tank-Automotive and Armaments Command (Buying Activity) compared the unit price of a follow-on contract that included restructuring to the price of the initial contract that did not include restructuring. According to the buying activity, the unit price of the follow-on contract was eleven percent lower than the initial cost price, not adjusting for inflation. The buying activity analysis was based on the basic contract of 172 vehicles.

However, according to United Defense, the follow on unit price was sixteen percent lower, adjusting for inflation. The United Defense analysis was based on the basic contract plus an option for a total of 272 vehicles.[32] The General Accounting Office's analysis indicated that the savings could range from eight to sixteen percent. As shown by these three sets of estimates, there was difficulty in determining the precise amount of savings from restructuring. The savings vary depending on the differences in the estimates of the numbers of remanufactured vehicles and the inflation rate used to adjust the unit price of the initial contract. Even though the savings were eight, eleven, or sixteen percent, it appeared that there was a need for a better understanding and agreement by all parties on the data being analyzed for restructuring.[33]

Although the Department of Defense interim regulations basically complied with Section 818 in applying restructuring costs and savings, there appears to be confusion on the part of the government and industry personnel in dealing with restructuring issues. Whenever one change a long-standing policy that affects costs in large organizations like the Department of Defense and the defense industry, there are going to be growing pains. However, providing clear guidance and proper training can minimize these challenges.

United Defense, a tracked combat vehicle manufacturer, was the first business combination to undergo the Department of Defense certification process with its interim regulations on restructuring costs and savings. Therefore, it would be beneficial to look also at a business combination in a totally different business segment to determine if there are similar findings.

The General Accounting Office reviewed Martin Marietta's acquisition of General Electric Aerospace in 1995. Its objectives were to determine whether the certification process was carried out in accordance with the regulations, whether the savings were in line with original estimates, and if the restructuring resulted in lower contract prices. They found that the restructuring results were similar to those at United Defense. The contractor submitted the restructuring proposals for projects to be audited, a senior Department of Defense official certified that the projects should result in an overall cost reduction on the Department of Defense contracts and savings were less than originally projected.[34]

Martin Marietta Corporation entered into formal discussions with General Electric in October 1992 to acquire its aerospace and other business operations. The acquisition was effective April 1993, and this alliance combined two of the nation's leading aerospace research and development organizations.[35] Martin Marietta Corporation submitted proposals showing restructuring savings would result in a net reduction of projected overhead costs. However, restructuring savings from eight certified projects were less than its initial estimates. Before certification, the contractor projected that for every dollar the government pays in restructuring costs; it would receive $5.24 in savings. After certification, the contractor projected that for every dollar in restructuring costs the government was projected to receive savings of $2.57, which represents about forty-nine percent of the contractor's original projection. Clearly the projected savings are lower than initially estimated.[36]

Contractors normally did not put in the same level of detail in determining restructuring savings proposals as they did for restructuring costs proposals. They provided the government a rough order of magnitude estimate initially, and then revised the projected savings when they prepared the detailed proposals. The government should establish procedures to ensure that the contractors provide more realistic estimates up-front in the restructuring process. The government is taking more risks at this stage of the process. It should be remembered that a senior Department of Defense official must certify that the restructuring activity will provide savings to the government. If the contractors provide pie in the sky estimates, there is a chance that the government can engage in a restructuring activity that does not produce the appropriate savings.

The history of the Martin Marietta certified projects, together with the fact that the United Defense restructuring achieved savings less than 15% of the original estimate, validate the point that certified savings have been considerably less than initially estimated. These results are also consistent with the Federal Trade Commission Staff's conclusion that mergers do not consistently produce the predicted efficiencies.[37] Although the restructuring savings are less than originally estimated, the contractor's projected overhead costs are lower. The reduced overhead costs should lower future overhead rates, thereby reducing the contract price. When the buying activities use the lower rates, the Department of Defense contract prices will be lower than they would have been if restructuring had not occurred. Even though the Department of Defense has been receiving projected costs savings on previous restructuring activities, the savings were always less that initially projected.[38]

WORKFORCE COST REDUCTION AT FIVE BUSINESS COMBINATIONS

Restructuring costs cover a wide range of expenses, such as personnel relocations, severance pay, early retirement incentives, equipment relocations, plant rearrangements, and facility closures. Section 8115 of the Fiscal Year 1997 Department of Defense Appropriation Act requires an annual report to Congress on restructuring costs associated with workforce reductions and funds, used to help laid-off workers find new employment. To accomplish this effort, the General Accounting Office focused on five defense contractor business combinations: Hughes Aircraft Company acquisition of General Dynamics Corporation's Missile Operations, Untied Defense Limited Partnership between FMC Corporation and Harsco Corporation, Martin Marietta Corporation acquisition of General Electric, Northrop Corporation acquisition of Grumman Corporation and Vought Aircraft Company to form Northrop Grumman Corporation, and the merger of the Lockheed Corporation and the Martin Marietta Corporation to form Lockheed Martin Corporation.[39] At the time of the review, these five business combinations had spent about $849 million on disposal and relocation of facilities and equipment, consolidation of operations and systems, employee relocations, and workforce reductions. Of the $849 million, the business combinations spent about $89 million on workforce reductions, which consisted of severance pay, temporary continuation of health benefits, and outplacement services. About 15,000 workers had left the companies at the time of this review.[40]

In addition to those services provided for restructuring costs by the Department of Defense to assists laid off workers, the Department of Labor provided $48 million in grants made either directly to the contractors or to locations where workers were laid off as a result of the business combinations or normal downsizing. Moreover, there were at least 163 federally funded programs and funding streams that provided employment training assistance, of which nine were targeted specifically for laid-off workers. However, the Department of Labor, the business combinations, and other federal grant programs did not maintain records showing how many workers using these services were terminated as a result of the business combinations. Therefore, it is almost impossible to determine who used the programs and the effectiveness of services.[41]

The Defense Contract Audit Agency estimated that, as of September 1996, the Department of Defense had reimbursed these business combinations about $179 million toward its share of the $849 million that the business combinations had incurred from restructuring activities. The Defense Contract Audit Agency also estimated that the Department of Defense realized restructuring savings totaling $347 million during the same timeframe. Therefore, for every dollar the Department of Defense paid in restructuring costs, it realized a savings of $1.93. Furthermore, industry officials quickly pointed out that these savings only cover the September 1996 period and do not reflect savings that may be realized in future periods. It should also be noted that the estimates do not reflect any additional costs that may be incurred in future periods.[42]

COMPARING RESTRUCTURING COSTS AND ESTIMATED SAVINGS

Defense contractors are required to maintain accounting records showing the actual amount and nature of costs charged to government contracts. These costs are generally billed to the government contracts during the same time they are incurred. As stated earlier, Section 818's prohibition against payment of restructuring costs until certification of net savings, creates a requirement for the contractor to segregate restructuring costs on their accounting records, and also excludes these costs from any billings, final contract price settlements, and overhead settlements until the certification is made by the Department of Defense. After certification, the contractor is then permitted to begin charging restructuring costs to government contracts.[43]

Restructuring savings, on the other hand, are not recorded in a contractor's accounting records. Therefore, neither the amount nor the nature of the savings can be determined by reviewing the accounting records. Consequently, savings are estimated. For example, Northrop Grumman estimated a savings of about $215 million spread over five years for closing the Grumman corporate headquarters. $100 million of that amount represents labor and fringe costs that would have been avoided over the five-year period by laying-off approximately 250 workers. These savings are, therefore, an estimate of cost avoidance over the five-years for the additional people that would have been needed had the headquarters not been closed. Savings from restructuring activities are generally in the form of future cost savings.[44] The initial estimate of restructuring savings is simple in concept because it makes the critical assumption that everything, except for the restructuring, is the same for the business combination as before.

Because things are never the same, it is difficult to precisely identify actual savings several years after the initial estimate is prepared. Other factors affecting costs include changes in the rate of inflation, fluctuation in the business base, and how subsequent reorganizations could impact the amount of savings.[45]

It is amazing the headlines "Department of Defense Pays Industry Restructuring Costs for Mergers - The fleecing of America" were not heard on 60 Minutes. If the decision were up to Marcus Corbin, it probably would have been on 60 Minutes. In his article "Payoff for Layoff: Much More Than A Sound Bite," Mr. Corbin said:

> "Unfortunately, Augustine makes his case by ignoring the fundamental issue: whether government funding is needed to gain the purported benefits of the policy. Nor, in the end, is he convincing that this huge, newly merged corporation will provide benefits to the government in the long run.[46] It is easy enough for a contractor to claim that there are savings, but a lot more independent proof is required. Defense contractors will have to counter decades of scandals that exposed frequent overcharging of the government. In fact, it is extremely difficult to demonstrate savings, since prices charged over time are determined by many factors." [47]

In his article, Corbin is referring to Norm Augustine, Chief Executive Officer of Lockheed Martin. Mr. Augustine is one of four defense industries' Chief Executive Officers who asked for the policy change. Many people in and out of the government and Congress agree with Mr. Corbin's position and others do not. It really depends on which side of the issue one stands.

BUDGETARY IMPACTS ON RESTRUCTURING SAVINGS AND WORKFORCE REDUCTION

Section 8092 of the Department of Defense Appropriation Act for 1998 required the General Accounting Office to report by April 1998 on restructuring costs of defense contractors involved in business combinations since 1993. The legislation required that an analysis of the specific costs associated with workforce reduction, the service provided to workers affected by business combinations, and the savings reached from the business combinations relative to the restructuring costs paid by the Department of Defense.[48]

Through December 1997, the Department of Defense issued nine certifications for restructuring proposals associated with six business combinations and another six proposals were in various stages of review. Future proposed business combinations included Raytheon's acquisition of Texas Instruments and Hughes Electronics, and Boeing's acquisition of McDonnell Douglas.[49] The business combinations estimated they had spent $1.2 billion at the time of this 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 the $1.2 billion, the business combinations spent about $ 115 million on expenses related to workforce reduction. Severance pay constituted the majority of these expenses, with lesser amounts provided for temporary health benefits and outplacement services. Outplacement services included career transition workshops, résumé development, career counseling services, job listings, and information on state and federal programs. Overall, about 18,000 workers or positions were to be eliminated as a result of restructuring activities. The Department of Defense estimated it would realize a net benefit of about $3.3 billion from certified restructuring activities. As of August 1997, it had realized a net savings of only about $1.9 billion.[50]

However, 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 business combinations, often spread over a five-year period. These savings constituted less than one percent of the Department of Defense's research and procurement budgets over the period for which the savings were projected. The Department of Defense normally does not consider restructuring savings when formulating its budget request. On one occasion, however, they did consider reducing Air Force and Navy missile programs by the anticipated restructuring savings. The military services maintained that the projected savings were needed to fund other program needs.[51] The Department of Defense agreed with the military services and did not reduce the funding on the programs.

INSUFFICIENT GUIDANCE FOR AUDITING RESTRUCTURING PROPOSALS

The Defense Contract Audit Agency's guidance on auditing restructuring proposals may not provide sufficient criteria to ensure that the proposed savings are directly due to restructuring. The guidance discusses in great detail factors to consider in evaluating proposed costs, but it provides far less guidance on evaluating savings. Relative to evaluating projected savings, the guidance indicates that contractors restructuring efforts are intended to result in a business combination's facilities, operations, and workforce that eliminates redundant capabilities, improves future operations, and reduces overall costs. The guidance also states that it is the contractor's responsibility to establish and support the reasonableness of the baseline to measure restructuring savings, but indicates that various techniques can be used to do so. Furthermore, the guidance requires 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.[52]

This broad framework may result in accepting proposed savings that are not directly attributable to restructuring. For example, the General Accounting Office attempted to isolate the effects of Lockheed Martin's Space and Strategic Missiles sector's restructuring activities from non-restructuring activities. Of the savings accepted by the Department of Defense for certification purposes, about $489 million was attributed to the increase in operational efficiencies at one location through the adoption of improved business practices.[53]

Lockheed officials acknowledged that some of the improvements and associated savings could have been implemented without restructuring, thereby revealing that the organization had various efforts to improve its operational efficiency already underway or planned prior to restructuring. However, the contractor believed that the business combinations provided the means to overcome organizational and culture barriers that otherwise would have hindered their improvement efforts.[54] The $489 million in savings were clearly overstated. This was confirmed by the contractor's statement that some improvements were underway and could have been implemented without restructuring.

As stated before, caution should be exercised when interpreting the reported savings. It is inherently difficult to precisely identify the amount of actual savings realized through restructuring activities several years after the initial estimate. Again, it is not feasible to completely isolate the effects of restructuring from other factors, such as fluctuation in a contractor's business base, changes in the inflation rate, accounting system changes, subsequent reorganization, and unexpected events, which may impact the contractor's cost of operations. For example, Contractor X and merges with Contractor Y in an effort to reduce excess capacity and overhead cost. One develops and submits a restructuring proposal to the government, which reflects a five billion dollar savings over five years. However, in year two, the stock market crashes, and the contractor's stock prices fall drastically. There is no way that the government will receive its full share of projected savings from this business combination.

RESTRUCTURING COSTS PAID – SAVINGS LOST

Section 804 of the National Authorization Act for Fiscal Year 1998 required the General Accounting Office to provide updated information on restructuring costs paid and savings realized by the Department of Defense. They focused the review on six business combinations in which the Department of Defense had certified as of September 1998.[55] The Department of Defense projected that its share of restructuring savings would amount to $4.1 billion and that its share of restructuring costs would amount to $856 million, which represents a net savings of $3.3 million. Restructuring savings come from both direct costs and indirect costs. (Remember, indirect costs are often referred to as overhead costs and include expense that benefits all contracts at a contractor's facility.) The contractors recover these overhead costs through the forward pricing rate, which are rates negotiated between the government and the contractor to use in pricing future contracts. When restructuring activities reduce indirect costs, the Department of Defense realizes savings through lower overhead charges to the contracts.[56]

However, the time it takes for restructuring savings to be included in a contract price can be considerable. It takes an average of about twenty-one months from the announcement of the acquisition or merger to the time the contractor shows the savings in reduced overhead rates. During this period, contracting officers awarded hundreds of fixed price contracts or contract modifications totaling millions of dollars. Despite repeated recommendations from the Defense Contract Audit Agency and the Defense Contract Management Agency, buying activities rarely included adjustment clauses for savings in fixed price contracts awarded during the contractor-restructuring phase. This is an area where the Department of Defense needs strong, clear, and direct guidance from its top policy makers to all its contracting officers. The government is currently losing millions of dollars by not immediately adjusting the contract price downward after restructuring savings are determined. Without timely contract adjustment, the Department of Defense will not recoup its entire restructuring savings.[57]

The Department of Defense procuring contracting officers give various reasons for not using adjustment clauses. Two of the reasons are: the desires of the contracting officer to have a contract with no loose ends, and concerns that the use of the clause will cause an excessive administrative burden in renegotiating contract price adjustments. Another factor, which appeared to influence the use of adjustment clauses, is the level of contractor resistance.[58] Properly applying adjustment clauses can result in substantial savings to government. In one case where the clause was used, the government reduced the contract price by $1.8 million. Unless the Department of Defense takes the necessary steps to standardize the use of adjustment clauses in its fixed price contracts with companies forming business combinations, it risks losing substantial savings resulting from contractor restructuring.[59]

It appears that government does a better job addressing the contractors' risk by allowing restructuring costs to be included in their overhead rates before certification, provided that the contract includes downward adjustment clauses to remove restructuring costs if the combinations were not certified. The government does not take the same care in addressing its own risk by not standardizing the use of adjustment clauses. The government's current policy leaves the use of adjustment clauses to the discretion of its contracting officers, and many are not taking advantage of its use and savings.

The author concurs with the General Accounting Office recommendation that the Department of Defense should require all of its contracting officers to use the adjustment clause to claim savings on noncompetitive fixed price contracts. If the contracting officers decide not to use the clause, they must provide a written justification in the contract file as to why the clause was not used.[60] The risks are too high and there is too much money at stake to leave a critical decision of whether or not to use the adjustment clause to the discretion of individual contracting officers.

CONCLUSION

What were the total impacts of post Cold War budget reductions and merger-mania on the Department of Defense? To be completely honest, the holistic effects are not really known and probably won't be for some time. It is likely that until the Department of Defense and the industrial base are stressed and tested from a prolonged regional conflict, the government may not ever find out the true impacts of the last twelve years of diminished budgets and industry consolidations. However, the government does know from lessons learned that it cannot continue to treat industry partners like a water faucet, turning them on and off at will. Also, the defense industry partners can no longer take advantage of their prime customers by providing over-priced cost proposals in an effort to make up for lagging sales and to boost profit positions.

The Department of Defense and Industry must do a better job of proactively working together as an effective, integrated team. This team needs to develop the most effective ways to sustain and maintain a healthy industry base while providing high quality and reasonably priced military systems. If the current business practices are not improved, the domino effect of the past will continue. The last twelve years have shown that when the Department of Defense substantially reduces its procurement budgets, the effects on industry, and ultimately on the Department of Defense itself, are disastrous. Defense industry's declining sales posture was depleted to a point where it could not sustain operations at optimum levels. This caused excess capacity along with panic and uncertainty for many contractors in industry, and they responded in different ways. Some lost confidence in the defense industry and left the business altogether. Those contractors that stayed in the business took drastic but unavoidable measures. They decreased costs by laying-off valuable and dedicated employees, and stopped investing in capital investments, IR&D and BP, facilities, and equipment. These measures did not only degrade the health of the defense industry, but they crippled the Department of Defense by driving up overhead costs on critical weapon systems. The Department of Defense encouraged industry executives to merge and restructure their operations in an effort to reduce overhead cost. To assist industry in this effort, the Department of Defense paid for restructuring costs and realized costs savings in the form of lower contract prices on weapon systems. However, to realize its fair share of savings from industry's restructuring activities, the author recommends that the Department of Defense establish clear policy that require all of its contracting officers to use the adjustment clause to claim savings on noncompetitive fixed price contracts. If the contracting officers decide not to use the clause, they must provide a written justification in the contract file as to why the clause was not used. The risks are too high and there is too much money at stake to leave a critical decision of whether or not to use the adjustment clause to the discretion of individual contracting officers.

Word Count = 7,314

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