

A full year ago, in July 2010, we [reported](#) that Northrop Grumman had issued a press release in which it announced that it planned to “winddown” shipbuilding at its Avondale, Louisiana shipyard, close two other Louisiana shipyards, and “consolidate” shipbuilding operations between its Louisiana and Mississippi shipyards. We reported Northrop Grumman’s statement that—

The consolidation will reduce future costs, increase efficiency, and address shipbuilding overcapacity. ... The company also anticipates that it will incur substantial restructuring and facilities shutdown-related costs including, but not limited to, severance, relocation expense, and asset write-downs. These costs are expected to be allowable expenses under government accounting standards and recoverable in future years under the company's contracts. The company estimates that these restructuring costs will be more than offset by future savings expected to be generated by the consolidation.

At the time, we openly questioned whether the Pentagon would go along with NGC’s plan to pass back its restructuring costs as “allowable expenses”.

A few months later, we noted that NGC had dropped its plans to sell the shipbuilding business, and would instead “spin-off” its maritime business into a new company with separate management. Indeed, that’s what happened and [Huntington Ingalls Industries, Inc.](#) —located in Newport News, Virginia—was born.

Recently, [Bloomberg](#) reported that DCAA was having trouble buying NGC’s math.

It reported that—

The Pentagon’s audit agency has concluded it can’t verify Northrop Grumman Corp. (NOC)’s assertion that divesting its shipbuilding business and shutting one of its three yards will save the U.S. as much as \$600 million.

Written by Nick Sanders  
Thursday, 14 July 2011 00:00

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The Defense Contract Audit Agency in a Feb. 1 audit also concluded that Northrop's claim for \$310 million in federal reimbursement to close the Avondale, Louisiana shipyard is 'unsupported,' according to a summary.

In what summary did the Bloomberg journalists find this fascinating tidbit of information? According to the article, it was located in an Appendix of the DOD Inspector General's recently published [Semi-Annual Report](#) to Congress. With that hint, we headed over to Appendix G of the SAR and found a brief recap of DCAA Audit Report No. 01751-2010G17900010, in which the DOD IG reported, "The audit of the contractor's internal restructuring proposal resulted in \$23.5 million of questioned costs relating to proposed labor, severance pay, incentive bonuses, and relocation expenses. Another \$284.5 million of proposed costs and the entire \$600 million proposed gross savings are considered unsupported."

Bloomberg followed-up with the U.S. Navy and reported—

'Ninety-two percent of the claimed shutdown costs were unsupported because the contractor could not provide sufficient evidence of its underlying assumptions,' said Navy Commander Kathleen Kesler, an agency spokeswoman, in an e-mail. 'Because these assumptions are integral to the savings computations, the resulting savings calculation could not be adequately evaluated.' ... Huntington and the Navy have not reached agreement on the 'allowability of proposed restructure costs,' Navy spokeswoman Captain Catherine Mueller said in an e-mail.

Readers may remember that, in the early 1990's (during Clinton-era defense industry consolidation), the Pentagon announced that it would pay for "restructuring costs" in order to encourage contractors (notably Lockheed and Martin Marietta) to merge with each other. In order to make the otherwise unallowable restructuring costs allowable, a DOD Contracting Officer had to determine that the business combination would result in overall reduced cost to DOD—or that the combination would preserve a critical defense capability.

In 1994, Congress passed a law that required additional hurdles to be jumped in order to make contractor restructuring costs allowable. These Congressionally mandated hurdles included:

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The projections of restructuring savings had to be based on “audited cost data”.

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A senior DOD official had to certify that the projected savings would result in overall reduced costs to DOD.

More hurdles were added by Congress in 1996, including requiring that projected savings had to be at least twice the amount of allowed restructuring costs (unless a critical defense capability was being persevered, in which case savings simply had to exceed costs). All the foregoing requirements were made permanent in 1997.

GAO has issued several audit reports related to claimed DOD savings from contractor combinations. However, its results have not been as quantitatively precise as it would have liked. In one report, GAO stated—

Determining the precise impact of restructuring on specific contract prices requires isolating the impact of these activities from nonrestructuring-related factors, such as changes in business volume, quantities purchased, and accounting practices. DOD, selected business segments, and we were generally not able to isolate the effects of restructuring from those of other factors.

Moreover, GAO noted that, “The regulations do not require contractors to propose or demonstrate savings on individual contracts or use any particular method or approach in estimating restructuring savings.” Because of the varied approaches in estimating restructuring savings taken by the contractors it reviewed, GAO recommended that DCAA tighten its audit guidance related to contractor proposals. GAO reported that DOD nonconcurred with that recommendation.

Quite obviously, we have not seen the NGC proposal(s) related to its business restructuring. That said, we have little doubt that such a murky area as projecting shutdown costs and future contract savings would fare poorly in a DCAA audit that was conducted in the current—shall we say?—difficult environment. We expect that it would be difficult for NGC to submit an “adequate” proposal, and we expect that it would be difficult for DCAA to reach a

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GAGAS-compliant conclusion regardless of how NGC supported its costs.

Normally, we would expect DCMA to move ahead in negotiating with NGC even with an adverse DCAA audit report—and, apparently, NGC expected the same thing. The Bloomberg article reported—

‘We are working with the Navy and DCAA on the specifics of the restructuring proposal,’ William Glenn, a spokesman for Huntington, said in an e-mail. ‘The cost estimates submitted as well as the savings projections will be further supported through the negotiation process.’

The Navy’s Mueller and Huntington’s Glenn said the company is following Pentagon’s acquisition rules in applying for reimbursement of the shutdown costs.

Unfortunately for DCMA, Huntington Ingalls, and NGC, Congress mandated that the costs have to be audited by DCAA. That requirement is going to throw a monkey-wrench into the works—or so it seems to us.