

GAO

Testimony



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Deferment Actions Associated  
With the A-12 Aircraft

Statement of  
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Before the  
Legislation and National Security  
Subcommittee  
Committee on Government Operations  
House of Representatives



Mr. Chairman and Members of the Subcommittee:

We are pleased to appear before the Legislation and National Security Subcommittee of the House Committee on Government Operations. Our testimony today is in response to your request to us at your hearing on April 11, 1991. That hearing addressed the Navy's default termination of the A-12 contract on January 7, 1991, and the subsequent agreement on February 5, 1991, to defer repayment of \$1.35 billion by the contractor team of McDonnell Douglas and General Dynamics until litigation over the termination is resolved or a negotiated settlement is reached.

At the hearing, Department of Defense (DOD) officials used the term "analysis" in describing their activities leading to the decision to grant the deferment. For example, the Director of Defense Procurement stated that a thorough analysis had been performed before making the deferment decision. You asked us to evaluate the analysis performed, data used, and the reasonableness of the deferment decision regardless of the kind of analysis DOD had before it when it made the deferment decision.

#### BACKGROUND

On January 7, 1991, the Navy terminated the A-12 full-scale development contract for default. On February 5, 1991, it issued a demand letter to the team of contractors for repayment of \$1.35 billion in progress payments for which no completed items had been accepted by the government. On the same day, at the team's request, the Navy--with DOD approval--agreed to defer the repayment until litigation over the termination is resolved in court or a negotiated settlement is reached.

According to Federal Acquisition Regulation section 32.613, the government may defer the collection of debts it is owed. Deferments pending the disposition of an appeal may be granted to small businesses and financially weak contractors with a

reasonable balance of the need for government security against loss and of undue hardship on the contractor. The regulation also provides that if the contractor has appealed the debt under the procedures of the disputes clause of the contract, the information supplied by the contractor with its request for deferment may be limited to an explanation of the contractor's financial condition. On the other hand, if there is no appeal pending or action filed under the disputes clause of the contract, the following information about the contractor should be submitted with the request for deferment:

- its financial condition,
- its contract backlog,
- its projected cash receipts and requirements,
- the feasibility of immediate payment of the debt, and
- the probable effect on the contractor's operations of immediate payment in full.

This information, once supplied, is to be promptly reviewed to determine whether it is adequate to grant a deferment. If the information is inadequate, the government may request the contractor to furnish the needed information. Although the existence of a contractor appeal of the debt does not of itself require the government to suspend or delay collection action, consideration is to be given to whether deferment of the debt collection is advisable to avoid possible over-collection.

In its February 5, 1991, demand letter, the Navy advised the A-12's team of contractors that it could submit a request for deferment of collection if immediate payment was not practical or if the amount was disputed. On the same day, February 5, the team requested the

deferral of payment, stating that immediate payment of the demanded amount was not practical and the amount was disputed. The team also stated that while it had not yet filed a notice of appeal, it intended to do so.<sup>1</sup> The Navy and the team signed the deferral agreement on February 5, 1991.

According to the Navy contracting officer, the team had advised the government before it issued its demand letter that the issuance of such a letter and the resulting reaction of the credit markets would cause financial hardship. Therefore, coordinated action was taken to execute the demand letter, the request for deferment, and the deferment agreement on the same day.

The deferral agreement provides that the government will take no action to enforce collection pending (1) a decision by the Armed Services Board of Contract Appeals or the Claims Court on the team's appeal or (2) a negotiated settlement between the government and the team. The deferral agreement also provides for the payment of interest at the time of repayment. The interest rate is established by the Secretary of the Treasury, as provided in section 12 of the Contracts Disputes Act. The rate as of February 5, 1991, was 8-3/8 percent, and will be reviewed every 6 months. The agreement will remain in full force until it is reviewed on December 1, 1992, and annually thereafter.

Because McDonnell Douglas's financial condition was known to be weaker than General Dynamics, DOD limited its efforts to McDonnell Douglas. The data available for DOD's consideration was almost exclusively on McDonnell Douglas's financial condition. Because we were asked to review the information considered by DOD, we limited

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<sup>1</sup>On June 7, 1991, the team filed a 78-page complaint with the U.S. Claims Court. The team's appeal requests that debt of \$1.35 billion be reduced to zero and that the Court increase the contract target price by an additional \$1.4 billion. The team is also requesting recovery of termination costs which are not yet determined.

our review to the information on McDonnell Douglas and did not review information on General Dynamics. As indicated at the hearings, DOD did not consider alternatives to granting a full deferment to both contractors.

#### RESULTS IN BRIEF

There is some evidence that DOD officials did follow a deliberative process in deciding to grant a deferment. However, documentation showing what was discussed during this process is not available. There is also no documentation available that indicates why data was used in a particular manner, nor is there a formal document or written decision paper prepared supporting the deferment decision.

According to DOD officials, DOD's deferment decision was based on information from the Defense Contract Audit Agency (DCAA) and the government's Corporate Administrative Contracting Officer (CACO) indicating that McDonnell Douglas was in a weak financial condition and on numerous discussions between services and DOD officials. In addition, the financial data package provided by McDonnell Douglas on January 24, 1991, and referred to at the April hearings, accompanied its request for significant advance payments in addition to the deferment. Once the information was provided, DOD focused much of its attention on the request for advance payments.

Although DOD did not prepare a documented analysis of McDonnell Douglas's financial data, we believe that the decision to grant the deferment appears reasonable. Although we did not perform a financial analysis, a variety of factors indicate that McDonnell Douglas was in a financially weak condition and could not immediately repay the amount demanded.

## DOD "ANALYSIS" UNDOCUMENTED

During hearings on April 9 and 11, 1991, DOD witnesses stated that they had thoroughly analyzed what would have happened if a deferment was not granted. The DOD officials told us that the deliberative process of meetings and a January 31, 1991, briefing to the services' acquisition executives and comptrollers supported their decision. The DOD witnesses believe that an analysis was performed but agree that it was not formalized through documentation and that the majority of the analysis for the financial package submitted by McDonnell Douglas was focused on the request for advance payments.

## DATA AVAILABLE FOR DOD'S "ANALYSIS"

DOD believed that General Dynamics could repay its share of the debt, but that if the government demanded immediate repayment, General Dynamics would be less capable of supporting current operations. DOD officials stated that both contractors are jointly and severally liable for the entire amount of \$1.35 billion. Even if one contractor was able to pay its share, it would still be liable for the remaining amount if the other contractor could not pay its share. Consequently, because McDonnell Douglas's financial condition was believed to be weaker than that of General Dynamics, DOD limited its attention to McDonnell Douglas and did not consider any alternatives but to grant the deferment to both companies. DOD personnel told us that they based the deferment decision on early information indicating that McDonnell Douglas was in a weak financial condition and on discussions at numerous meetings on the need for a deferment.

## Early Information Alerted DOD to Potential Problems

Beginning in August 1990, the government's CACO alerted DOD officials to McDonnell Douglas's weakened financial condition. At

that time, the CACO believed that McDonnell Douglas had adequate credit to sustain current operations. The CACO also reported to DOD officials on the actions the contractor was taking to improve its operations. CACO memos dated August 20, 1990, and September 4, 1990, described a series of actions McDonnell Douglas had taken to conserve cash, improve credit arrangements, and strengthen its financial position. These memos indicated that McDonnell Douglas's debt had been downgraded in May 1990; it was put on "credit watch" in June 1990 by Moody's and Standard & Poor's credit rating services; and the company's debt was again downgraded in July 1990 by Moody's Investor Service. This early information set the stage for DOD's favorable consideration of the deferment.

DCAA in its September 13, 1990, audit report stated that, in its opinion, the then-current financial capability of McDonnell Douglas was weak when compared with industry standards. However, DCAA did not believe that continued performance on government contracts was endangered. The audit report was prepared in response to a request from the CACO to determine whether potentially adverse financial conditions existed that could affect performance on government contracts. DCAA reviewed McDonnell Douglas's financial statements, cash flow projections, and other documentation. DCAA also computed ratios that are generally accepted as indicators of a firm's financial condition. DCAA recommended that the CACO make arrangements for monthly financial briefings to examine McDonnell Douglas's financial condition.

DOD's principal analyst-- the Director for Cost, Pricing, and Finance, Office of the Deputy Assistant Secretary of Defense (Procurement)--told us that it was generally known that McDonnell Douglas was already in a weak financial condition before the termination and that this awareness came from the early DCAA audits and the CACO memoranda mentioned above. Thus, DOD officials believed that a deferment would be required because McDonnell Douglas could not repay its share of the amount demanded.

### Financial Condition Addressed in Meetings and Briefings

DOD personnel told us that there were numerous meetings concerning McDonnell Douglas's financial condition beginning in the fall of 1990. Some of these meetings involved Air Force status reports to Office of the Secretary of Defense personnel on the C-17 aircraft program. In addition, the DOD principal analyst held discussions with the Navy and had numerous telephone conversations with the CACO. The CACO confirmed that he had numerous conversations with the principal analyst and that he was convinced that granting of a deferment was necessary.

The Deputy Chief of Staff for Financial Management and Comptroller, Air Force Systems Command, confirmed that during the briefings on the status of the C-17 aircraft program, McDonnell Douglas's cash flow data was presented. DOD officials responsible for the A-12 deferment were present at these briefings. The Deputy Chief explained that he compared McDonnell Douglas's monthly debt forecasts to actual monthly debt and found that the forecasts were within plus or minus five percent. He said that his analysis was limited to the corporate cash flow and was not an analysis of McDonnell Douglas's overall financial condition and that his effort was intended to improve efficiency on the C-17 program.

### Financial Data Submitted With Request For Deferral

On January 16, 1991, McDonnell Douglas met with the Navy contracting officer and gave the Navy the following documents:

- a draft letter requesting a deferral and indicating that the company anticipated that the deferral would take place in January 1991,



-- a draft deferment agreement referring to the same January 1991 date, and

-- a financial data package.

We confirmed with Navy officials that this data was given to them. Concerning the January 1991 date, the Navy officials said that the contractors wanted the deferment as soon as possible.

McDonnell Douglas also gave the CACO a copy of its January 11, 1991, debt forecast on January 22, 1991. This forecast showed that McDonnell Douglas would be in a negative cash flow position during 1991. The CACO sent a memorandum to the Defense Logistics Agency headquarters the next day, January 23, 1991, alerting officials to this information and stating that an infusion of cash would be necessary. The CACO assumed that McDonnell Douglas could not issue new debt instruments or obtain a new bank loan and had insufficient cash. The CACO considered having the debt forecast audited by DCAA, but McDonnell Douglas told the CACO that its debt forecast was a repetitive document routinely used by corporate management. The CACO therefore decided to accept the forecast without audit.

#### Additional Financial Assistance Requested

A day later, on January 24, 1991, the Chief Executive Officer of McDonnell Douglas met with the Under Secretary of Defense for Acquisition and presented a letter requesting advance payments for a number of DOD programs. This was in addition to the request for deferral on the A-12 program. The Chief Executive Officer also presented a financial data package similar to the package presented to the Navy on January 16, 1991.

The DOD principal analyst stated that McDonnell Douglas's January 24, 1991, financial data package was intended to support its

request for significant advance payments, not the deferment. Therefore, after January 24, 1991, DOD focused its attention on the request for advance payments.

According to DOD officials after January 24, 1991, DOD was not making a single decision focusing only on the granting of a deferment, but was also being asked to consider providing additional financial assistance to McDonnell Douglas. In a January 28, 1991, memorandum the Under Secretary for Acquisition stipulated those actions to be taken by the military services before he would brief the Deputy Secretary of Defense. The services, for example, were to provide their perspectives on the near- and long-term requirements for continued performance by McDonnell Douglas and on the probable impact if the corporation should go into Chapter 11 bankruptcy. Other officials were directed to document McDonnell Douglas's financial needs, determine which programs should be used as sources for advance payments, and determine the legality of any recommended option.

#### Banks' Concerns Over Possible Denial of Deferment

At the April hearings, DOD's Director of Defense Procurement said that McDonnell Douglas had told her that its banks could view DOD's denial of the deferment as a material adverse change and withdraw their lines of credit. In a January 29, 1991, memo to her, McDonnell Douglas's Senior Vice President for Finance provided a letter from McDonnell Douglas's Treasurer, which stated that certain of key banks were concerned that the termination of the A-12 might have resulted in a material adverse change in McDonnell Douglas' financial condition. If the banks invoked the material adverse change provisions in revolving credit agreements, the company could not borrow any additional amounts under those agreements.

We asked the McDonnell Douglas's Senior Vice President for Finance whether there was any documentation from the banks regarding the withdrawal of their lines of credit. He told us that the agent bank had told him verbally that three member banks had expressed their concern. He said the three banks were persuaded to wait before they took action.

Additional Financial Information Provided

On January 25, 1991, DOD's principal analyst asked McDonnell Douglas to respond to 22 questions. McDonnell Douglas responded in writing on January 26 and 29, 1991. Answering these questions involved providing additional information on a variety of subjects dealing with the company's financial condition, including federal income tax liabilities, its dividend policy, commercial sales projections, and liabilities and debts to subcontractors. The information was to provide data not contained in the financial data package McDonnell Douglas provided on January 24, 1991.

The Director for Defense Procurement briefed the services' acquisition executives and comptrollers on January 31, 1991. The tentative conclusions shown in the briefing charts were the following:

- McDonnell Douglas bankruptcy would not be in DOD's best interest;
- McDonnell Douglas could not afford to repay the A-12 debt,
- McDonnell Douglas needed additional short-term financing, and
- McDonnell Douglas's financial problems would be a continuing concern.

In addition, the Director presented the financial data McDonnell Douglas had provided on January 24, 1991, unchanged but reformatted. This was the briefing the DOD witnesses were referring to at the April 11 hearing.

#### Financial Review Continued After the Deferment Decision

As indicated earlier, McDonnell Douglas requested advance payments on January 24, 1991. On February 7, 1991, 2 days after the deferment agreement was signed, the CACO, McDonnell Douglas officials, and personnel from the services and the Office of the Secretary of Defense met to review the financial data submitted by McDonnell Douglas. The Director of Defense Procurement told McDonnell Douglas officials that if the advance payments were approved, they would have to explain how any remaining cash shortfall would be resolved.

In materials prepared on February 4, for a meeting between the Under Secretary of Defense for Acquisition and McDonnell Douglas, there is evidence that DOD wanted a better understanding of McDonnell Douglas's cash flow needs and further assurance that additional payments would solve the company's problems. DOD did not request a DCAA audit of the data submitted by McDonnell Douglas until February 12, 1991, after the deferment decision was made. The purpose of the audit was to determine if cash flow projections were consistent with the assumptions made by McDonnell Douglas and to comment on the accuracy of previous cash flow projections.

A decision on additional advance payments was set forth in a March 20, 1991, letter addressed to the Chief Executive Officer of McDonnell Douglas and signed by the Under Secretary for Acquisition. The letter suggested four areas in which the company could take action to improve its cash flow. On April 1, 1991, during a visit to McDonnell Douglas's corporate headquarters in St.

Louis by the Under Secretary of Defense for Acquisition and the Director of Defense Procurement, McDonnell Douglas withdrew its request.

#### REASONABLENESS OF DOD DEFERMENT DECISION

There is no documented analysis demonstrating that DOD made a detailed evaluation of McDonnell Douglas's data before making its deferment decision, but it did have a great deal of pertinent information. We believe that the decision to grant the deferment was reasonable for the following reasons.

- The DCAA September 13, 1990, audit report contained financial status indicators suggesting that McDonnell Douglas was in a weak financial position, even though contract performance was not endangered. DCAA calculated a number of ratios that showed a trend of declining financial well-being. For example, the ratio of total debt to net worth increased from 38 cents of debt for every dollar of net worth in 1986 to 92 cents of debt for every dollar of net worth in 1990.
- McDonnell Douglas's data, which was not subjected to any verification, shows that it would be in a negative cash flow position during 1991. This is consistent with McDonnell Douglas's projection of a negative cash flow from operations during calendar year 1991 as published in the corporation's annual report to the stockholders for calendar year 1990.
- McDonnell Douglas told DOD that its financial condition made obtaining additional credit from its banks or the securities market unlikely. Furthermore, McDonnell Douglas's debt rating had been down graded by Standard & Poors and Moody's Investment Service twice.

- The government's CACO in a January 23, 1991, memorandum expressed concern about McDonnell Douglas's negative cash flow position. The CACO suggested that the contractor would have to take drastic action to remedy its cash flow problem. The data that is the basis for the CACO's memorandum was not subjected to independent verification.
  
- McDonnell Douglas was already taking a variety of actions to improve its weakened financial condition. It had instituted a cost reduction and cash conservation effort with a goal of saving between \$700 million and \$1 billion. It sold some assets and identified other assets for possible sale.
  
- McDonnell Douglas's annual report stated that the continuing negative cash flow from operations was primarily the result of increased investment in its commercial aircraft work. In addition to the cash needed to support the increase in commercial work, McDonnell Douglas is experiencing difficulties in performing concurrently on major government fixed-price development contracts. According to the Air Force, McDonnell Douglas could experience a loss on the Air Force C-17 aircraft program and additional losses on the Navy's T-45 aircraft program.
  
- The McDonnell Douglas Senior Vice President For Finance summarized the company's financial position when he testified under oath that to have paid the government the disputed amount would have been extremely difficult, seriously strained the company's financial capability, and jeopardized continued performance of other government contracts.
  
- McDonnell Douglas is responsible for a variety of major weapon systems that could have been and may well still be adversely affected if it is unable to continue performing.

- The loss of a major defense contractor like McDonnell Douglas could adversely affect the U. S. defense industrial base.
- The Persian Gulf War was ongoing when the deferment decision was made, and DOD was concerned that McDonnell Douglas's continued support of the war effort would be interrupted.

Finally, the contractor team disputed the amount owed and has filed its appeal with the Claims Court to convert the termination for default to a termination for convenience. If the court rules in favor of the team, it will not have to repay the deferred amount.

#### IMPLICATIONS OF MCDONNELL DOUGLAS'S FINANCIAL PROBLEMS

The short- and longer-term implications of McDonnell Douglas's financial problems on government programs require DOD's and the Congress's continuing attention for several years.

DOD did not deny McDonnell Douglas's request for advance payments; rather, McDonnell Douglas withdrew its request. If McDonnell Douglas encounters further financial difficulties, it could renew its request for financial assistance. McDonnell Douglas is also experiencing cost problems on the T-45 aircraft program and the C-17 aircraft program.

#### T-45 Navy Aircraft Program

In its T-45 aircraft program, McDonnell Douglas is currently working off a \$45 million overpayment of progress payments. When the overpayment was identified, the Navy suspended further progress payments until McDonnell Douglas made up the difference with continued work on the contract. Furthermore, McDonnell Douglas is engaged in a dispute with its principal subcontractors, British Aerospace and Rolls Royce, over the costs of work performed and the

amount paid for such work. The parties in dispute are awaiting the results of audits performed by the British government's audit office. This T-45 contract is resulting in a negative cash flow.

C-17 Air Force Aircraft Program

McDonnell Douglas could lose substantial amounts on the C-17 aircraft program. In addition, we were told there were still unresolved problems with this program. For example, the first flight milestone in June 1991 was not met and scheduled delivery of the first production aircraft in December 1991 may not be met. Because of these and other performance shortcomings, an Air Force official told us that serious consideration is being given to modifying the C-17 contract.

Mr. Chairman, that concludes our prepared remarks. We will be happy to answer any questions.

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