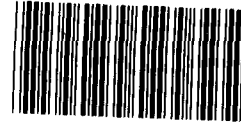




United States  
General Accounting Office  
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National Security and  
International Affairs Division  
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February 5, 1993



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The Honorable John Conyers, Jr.  
Chairman, Committee on  
Government Operations  
House of Representatives

The Honorable Ronald V. Dellums  
Chairman, Committee on  
Armed Services  
House of Representatives

The Honorable John Glenn  
Chairman, Committee on  
Governmental Affairs  
United States Senate

The Honorable Sam Nunn  
Chairman, Committee on  
Armed Services  
United States Senate

Section 2324 of title 10 U.S.C. requires us to evaluate and report on substantive changes to the Department of Defense's (DOD) regulations concerning allowable costs on certain defense contracts. The purpose of this letter is to report on recent regulatory changes.

The regulatory changes are published in the Federal Register as revisions to the Federal Acquisition Regulation (FAR) and the Department of Defense Federal Acquisition Regulation Supplement (DFARS). On November 12, 1992, a final DFARS rule incorporating prohibitions regarding severance pay to foreign nationals was published in the Federal Register. The prohibitions were required by the defense authorization acts for fiscal year 1989 and fiscal years 1990 and 1991, and were codified in section 2324, title 10, U.S.C., which governs allowable costs on defense contracts.

GAO/NSIAD-93-132R FAR Cost Principles Revisions

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RESULTS IN BRIEF

The language of the final DFARS rule closely parallels that of the legislation and appears to be consistent with congressional intent. The regulation defines circumstances under which severance pay is unallowable for reimbursement on defense contracts.

However, the National Defense Authorization Act for Fiscal Year 1993 revised the rules concerning severance pay for foreign nationals in section 2324, title 10 U.S.C. The revision provides for waivers of the prohibitions on severance pay to foreign nationals when such payments are generally required by the host country's laws or a collective bargaining agreement, the contractor has taken (or has established plans to take) steps to minimize the amounts to be paid to foreign nationals, and nonpayment would adversely affect programs providing significant support services for armed forces members. This provision is effective for costs incurred on or after October 1, 1991. The new DFARS rule must again be revised to reflect this recent change, as well as two other related changes.

BACKGROUND

Prior to March 1989, the FAR cost principles did not treat severance pay for foreign nationals differently than severance pay for U.S. citizens. In general, severance pay was allowable if required by law; an employer-employee agreement; an established policy that was, in effect, an implied agreement by the contractor; or circumstances of the specific employment. In addition, severance pay had to meet certain general allowability criteria, depending on whether the cost was normal turnover severance pay or abnormal or mass severance pay.

However, section 322 of the National Defense Authorization Act for Fiscal Year 1989 restricted the allowability of severance costs paid to foreign nationals working on service contracts outside the United States. According to the law, payments could not exceed amounts paid under the prevailing practice for similar service by the same industry in the United States. This provision took effect in March 1989.

Section 311 of the National Defense Authorization Act for Fiscal Years 1990 and 1991 further restricted severance pay to foreign nationals, making such costs unallowable if termination of their employment results from a request by the host country to close or curtail activities at a U.S. military facility in that country. The prohibition did not apply if the closing or curtailment was pursuant to an agreement entered into with that country prior to November 29, 1989, the effective date of the prohibition. Both prohibitions were placed in 10 U.S.C. section 2324, which governs allowable costs on defense contracts.

The prohibitions were initially prompted by severance pay for termination of Japanese nationals working in DOD's overseas banking system. According to hearings on the proposed legislation held by the House Committee on Armed Services, at that time, it was the custom of Japanese companies that an employee was considered to be hired for life. Severance pay was set accordingly. When the U.S. contractor who had hired about 140 Japanese nationals to work in DOD's Japanese banking offices lost the contract, the employees were terminated. DOD was responsible for the severance payments, according to the contract. The payments averaged about \$200,000 per person, for a total of \$28 million. In an effort to prevent further occurrences of what were considered excessive severance payments, Congress restricted allowable severance pay for foreign nationals to amounts not exceeding what employees providing similar services in the same industry in the United States would be paid.

Questions were also raised about the severance pay due other foreign nationals in the event that certain overseas military bases were closed at the request of the host country. For example, the Philippines government had indicated it might not renew leases on U.S. bases.<sup>1</sup> There was a possibility that U.S. ship repair facilities might be

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<sup>1</sup>Military Base Closures: U.S. Financial Obligations in the Philippines (GAO/NSIAD-92-51, Jan. 22, 1992).

curtailed. In addition, Greece<sup>2</sup> and Spain had requested the withdrawal of U.S. forces from certain bases in their countries. As a result, Congress added a second restriction to the law, making severance pay to foreign nationals unallowable if their termination was the result of curtailment of activities at, or closing of, a U.S. military facility at the request of the host country.

Two interim rules have been published implementing the provisions of these laws in the FAR, which is applicable to executive agency acquisition, both defense and civilian. In addition, section 346 of the National Defense Authorization Act for Fiscal Years 1992 and 1993 provided that the Secretary of Defense could waive the severance pay restrictions for banking institutions when such payments are required by a law generally applicable to businesses in the host country and the contractor has taken (or has established plans to take) steps to minimize the amounts to be paid to foreign nationals.

The FAR revisions are prepared and issued through the coordinated action of the Civilian Agency Acquisition Council and the Defense Acquisition Regulations (DAR) Council. The DFARS is prepared and issued by the DAR Council to supplement the FAR and is applicable only to DOD. Since publishing the interim rules, the two Councils have concluded that because the prohibitions were legislated in defense authorization acts and prompted by situations involving U.S. military facilities overseas, the prohibitions were meant to apply only to the defense department, not governmentwide. Therefore, the DAR Council has now placed the prohibitions in the DFARS. On December 21, 1992, a final rule removing the prohibitions from the FAR was published in the Federal Register.

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<sup>2</sup>Severance Pay: DOD Not Exempt From Paying Benefits to Greek Employees (GAO/NSIAD-91-223, July 22, 1991).

DFARS RULE CONSISTENT WITH INTENT OF THE DEFENSE  
AUTHORIZATION ACTS FOR FY 1989 AND FYS 1990 AND 1991

The language of the DFARS rule closely parallels that of the legislation and appears to be consistent with congressional intent. The regulation defines circumstances under which severance pay is unallowable for reimbursement on defense contracts.

However, although the new DFARS final rule reflects the restrictions called for by the authorization acts for fiscal year 1989 and fiscal years 1990 and 1991, it must be revised again to reflect section 1352 of the National Defense Authorization Act for Fiscal Year 1993. This section provides that the head of an agency may waive the prohibitions on severance pay to foreign nationals when such payments are generally required by the host country's laws or a collective bargaining agreement, the contractor has taken (or has established plans to take) steps to minimize the amounts to be paid to foreign nationals, and nonpayment would adversely affect programs providing significant support services for armed forces members. It is effective for costs incurred on or after October 1, 1991. The 1989 and 1990 and 1991 restrictions had previously been amended to permit waiver of the prohibitions for banking institutions under somewhat similar conditions.

The 1993 act also prohibited payment of severance pay to foreign nationals employed by DOD in the Philippines or reimbursement to contractors for severance payments to foreign nationals when discontinuation of employment resulted from termination of basing rights of the U.S. military in the Philippines. Further, the act repealed the exception to section 311 of the National Defense Authorization Act for Fiscal Years 1990 and 1991, which stated that its prohibitions did not apply if the closing or curtailment was pursuant to an agreement entered into with the host country prior to November 29, 1989.

The DAR Council is currently preparing a DFARS rule to implement the provision for waivers. According to a DOD official, it will also address the other changes made by the 1993 act.

Severance Pay Prohibitions Difficult to Implement

The fiscal year 1993 provision for waivers was intended to alleviate problems that have been encountered in enforcing the severance pay restrictions. For example, as stated in our July 1991 report, severance pay to foreign nationals employed overseas is frequently set by host country law or an agreement between the two countries. If a contractor refused to make severance payments required by law or agreement, the contractor could be sued in the host country's courts. In addition, since the amount of severance pay required was often far in excess of a contract's profit, DOD officials said that contractors were refusing to accept overseas contracts unless a waiver to the prohibitions was obtained.

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This letter was prepared under the direction of Paul F. Math, Director, Acquisition Policy, Technology, and Competitiveness Issues, who may be reached on (202) 275-4587 if you or your staff have any questions. Other contributors to this letter were Charles W. Thompson and Carol S. Markson.



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