

Statement of
Dr. Kevin Stein, President and Chief Executive Officer
TransDigm Group Incorporated
Before the Committee on Oversight and Reform, U.S. House of Representatives
Hearing on January 19, 2022

Chairwoman Maloney, Ranking Member Comer, and distinguished Members of the Committee:

Thank you for the opportunity to appear before you to discuss TransDigm's business model and its work with the DoD. I am joined by the company's Chairman and founder, Nick Howley.

The DoD's Office of the Inspector General (DoD IG) completed an audit in December of 2021 in which they reviewed 155 firm-fixed-price contracts awarded to TransDigm businesses. They also evaluated TransDigm's business model, which focuses primarily on the commercial aerospace industry. This is the second audit in two years, and the third audit completed on TransDigm businesses since 2006. In fact, the contracts selected and reviewed in this most recent audit were from the same general timeframe as the last audit—2017 to 2019—and predate the 2019 hearing before this Committee.

Throughout this latest audit, TransDigm engaged in an open and transparent exchange with the DoD IG, providing complete access to financial and corporate data, thousands of pages of documentation, regular meetings to provide answers to questions, and tours at many of our manufacturing facilities throughout the United States where they witnessed our research, development, and production and spoke to our employees. The IG team commended us for our continuous cooperation and recognized our hard work to make sure they had whatever information they needed.

After over two years of review and thousands of documents produced, the recently released audit came to the same conclusion as the previous two: that TransDigm businesses followed all applicable laws and policies in their fixed-price contracts with the DoD. In fact, the DoD IG team expressed numerous times that it is their conclusion that TransDigm has done nothing wrong and that their goal is simply to induce procurement policy changes.

Since the last time we appeared before this committee in 2019, TransDigm has instituted many initiatives to improve communication and transparency with the DoD. First and foremost, we worked with DoD's Defense Pricing and Contracting and the Defense Logistics Agency to establish a Working Group to identify and address acquisition and pricing issues. We did so because we value the DoD as our customer and we feel that the Working Group and the high level relationships we have cultivated at DoD have been helpful in addressing various issues over the last two years. That Working Group began after the 2019 hearing with acting Director Mr. Kim Herrington and continues with Mr. John Tenaglia, who is a witness here today. Secondly, we have

proactively been providing more information to DoD since the last hearing to facilitate the DoD's determination of price reasonableness. Third, we have proactively been offering volume discounts to DoD. Finally, we have hired independent experts to evaluate our business practices and to train our employees on the statutory and policy requirements related to DoD procurement. These efforts have come at additional costs to our businesses, but we believe it has improved procurements over the past two years.

TDG BACKGROUND

I would like to provide some background on TransDigm. TransDigm is an American manufacturing company, headquartered in Cleveland, Ohio. We have over 60 manufacturing facilities all over the United States, as well as facilities outside the United States. TransDigm provides good paying jobs and excellent benefits to over 13,000 employees, most of whom are in the United States and many of whom are union members. Our manufacturing facilities are in over 20 States, including New York, New Jersey, California, Ohio, Illinois, Kansas, Florida, Arizona, Washington, North Carolina, South Carolina, and Texas. We are a leading designer, producer, and supplier of highly engineered aircraft components. In an era when the domestic supply chain remains vulnerable and the Federal Government is spending billions of dollars to incentivize companies to bring key manufacturing back to the United States, TransDigm's businesses continue to domestically produce quality, highly engineered products within the United States that are essential to keeping America strong.

TransDigm's 46 operating units are wholly owned subsidiaries of TransDigm, but each is independently run by its own local management team and they are treated as autonomous, stand-alone businesses. These operating units set their own prices and maintain their own accounting policies and procedures.

I would also like to say a few words about what TransDigm is not. TransDigm is not primarily a defense contractor. TransDigm's direct contracts with the DoD represent a small fraction of TransDigm's revenue. In fact, during the period of this audit (2017-2019), TransDigm's direct sales to the US government comprised about 6% of our sales. The defense contracts for TransDigm businesses are almost exclusively through firm-fixed-price contracts in which the contractor takes the risk of cost fluctuations such as inflation. I will say that again. We have firm-fixed-price contracts in which we take the risk of cost overruns; we rarely receive cost-plus fixed-fee contracts where the contractor receives a fixed profit on costs and the government bears all risk of increased costs. We are predominantly a commercial aerospace company, servicing commercial air travel, and while we value our relationship with the Department of Defense, it is not our primary source of revenue. This point is important for two reasons.

First, the notion that we seek out business acquisitions to raise prices on the DoD is simply untrue. We look for quality businesses that produce highly engineered, proprietary aerospace parts. In fact, in recent years, we have avoided potential

acquisitions that have a large percentage of government sales because of the substantial costs and challenges associated with federal contracts.

Secondly, because TransDigm is predominantly a commercial aerospace company, in almost all cases, we pay for the research and development costs for our products. Unlike many traditional defense contractors, who receive cost-reimbursable contracts and funding for their R&D, TransDigm shoulders all of the risk, delays, raw material cost fluctuations, inflation, and other potential losses associated with developing its products. We also take the risk that, after developing a product, the Department of Defense will elect not to buy from us or will buy in such low quantities that we risk losing money and disrupt our commercial production just to deliver the few parts requested. This point is best illustrated by the audit report, which states that 61 of the 107 spare parts evaluated under this audit "did not have enough procurement history data...to perform an analysis." The report states that in many cases, DOD went more than five years between procurements. This is not a sustainable customer practice for any manufacturer.

TransDigm's actions during the COVID pandemic reinforce that we are different than traditional defense contractors. Like everyone in the commercial aerospace industry, the pandemic has had a substantial effect on our businesses. But while many defense contractors requested and received COVID relief funds for costs incurred as a result of the pandemic, TransDigm did not, and could not, because the vast majority of our federal contracts are firm-fixed-price contracts where we have taken the risk up front and are ineligible for such cost adjustments after award. This is yet another illustration of how firm-fixed price contracts benefit the federal government, shifting the risk and expense to the contractor.

The Department of Defense Inspector General's Audit Report

I would like to now turn to the DoD IG's most recent audit report. We value the extraordinarily important role of the Inspector General and we have supported their work throughout this process. And we appreciate that the DoD IG again acknowledged that TransDigm businesses followed all applicable laws and policies in their fixed-price contracts with the Department of Defense. However, we are deeply concerned with the fundamental legal and accounting errors contained in this report, which we communicated to the DoD IG and their General Counsel's office. I will limit my comments to three points, and I am happy to expand upon our concerns during the question-and-answer period.

First, we provided complete cost information for the parts reviewed in this audit. However, the IG excluded nearly \$10 million in federal taxes and interest arbitrarily. The DoD IG's explanation for excluding these costs, which make up more than half of what they allege to be "excess profits", is not clear. The report expressly acknowledges they applied FAR provisions that are inapplicable to the firm-fixed price contracts in the audit. But the report remarkably says that their exclusion should not be interpreted to mean that DoD should exclude interest and taxes in price calculations for

fixed-price contracts. This is not the only occasion that IG creates arbitrary standards and applies them only to TransDigm and blatantly states that it is doing so.

Second, the DoD IG Report creates a 15% profit standard for firm-fixed price contracts that does not exist in law or policy. The DoD IG Report readily acknowledges that the FAR does not contain a profit threshold for fixed price contracts, so they used a standard that is applicable to a completely different type of contract in which the government, not the contractor, takes the risk of cost overruns. The report itself goes on to specifically state:

"We are not stating that 15 percent should be used as a benchmark when negotiating firm-fixed price contracts. We...reiterate that nothing in this report states, or should be interpreted to mean, that the DoD OIG advocates a 15 percent profit ceiling or any other specified profit ceiling on fixed price contracts."

So, DoD IG expressly acknowledges that the standard they used for this report was unique and should not apply to other DoD contracts.

The ignoring of tax and interest costs and this arbitrary 15% profit standard are central to why we are here today. The IG report created these arbitrary standards and then determined that anything over 15% was "excess profit"—not for all companies but only for TransDigm. However, the report itself contains an extraordinary admission that even the DoD IG doesn't support the standard they used for TransDigm's audit. This was central to the 2019 report, as well, and I highlighted the arbitrary standard during my testimony then, and yet this IG report contains the same major legal error.

Third, most of TransDigm's sales to the DoD are for products derived from commercial aerospace parts used on commercial aircraft. This point was lost in the DoD IG's report, which failed to acknowledge the volumes of technical data TransDigm provided showing that the great majority of audited parts have commercial equivalents and that on average the DoD received a 25% discount to the commercial price of those parts. That point bears repeating: on average, DoD purchased the parts in this audit at a 25% discount to the commercial equivalent. The FAR requires DoD to evaluate commercial comparable pricing first and only then consider cost. The Report incorrectly claims that there is no way to evaluate price on "sole source" parts. But most airplane parts can be found on multiple platforms and are made by multiple companies, even when a part is "sole-source" on a particular platform. So DoD can compare our products with others available in the market to see that the prices are fair and reasonable. That is exactly what the DoD did on 126 of the audited contracts when they established price reasonableness based on available data and exactly what Congress intended with the Federal Acquisition Streamlining Act and subsequent laws--to shift the risk away from the government to the commercial marketplace and take advantage of the efficiencies associated with commercial-style buying. In so doing, the government's traditional focus on cost analysis was replaced with a focus on price analysis. In other words, the main question is not how much it costs the manufacturer to produce the item, but whether the federal government is getting a fair and reasonable price. The DoD

IG's audit does not evaluate what the price of the parts should be but instead erroneously asks, did the company make more than 15% profit on its negotiated firm-fixed price contracts.

By using these arbitrary standards and ignoring reams of information we provided in support of the reasonableness of the prices, the DoD IG was able to come up with inflammatory profit percentages that make for a good headline but ignore the basic facts about how profit is calculated, or the out-of-pocket costs involved in creating and producing products.

As a final matter, in our invitation to testify before this Committee, we were asked whether we will voluntarily pay the amount deemed "excessive profit" in the IG report. We have received some letters from the DoD requesting voluntary payments of some of the funds, and we anticipate more letters in the coming days. Once we receive them, we will evaluate each request, along with the underlying calculations used to arrive at the amounts. We look forward to working with the DoD to come to a resolution on this matter and to establish a plan for going forward. However, we remain deeply concerned with the arbitrary standards set forth in this report. The policy the DoD IG invented for the purpose of this report will disincentive businesses from accepting a firm-fixed price contract with the government when they can instead shift risk to the government through cost-reimbursement contracts used by the IG as the benchmark for this audit.

Thank you, and I look forward to your questions.