Restructuring Opportunities and Risk Considerations for Government Contractors

Cutbacks in government spending during the last few years have caused companies to reevaluate their business methods in order to maintain profitability despite reductions in the overall business base. The solutions to this problem are simple when viewed at a high level: increase revenue or reduce cost. As revenue raisers are becoming scarcer and companies increasingly try to figure out how to be stronger, lighter, faster, and more agile with fewer resources, the idea of restructuring materializes as a leading candidate for corporate change. Many companies who have launched into this arena have experienced firsthand the operational, financial, and regulatory complexities surrounding restructuring. Companies that provide products and services to support the US government and protect the war-fighter face an even greater challenge than other companies due to the burden of government contract regulation incremental to the typical business environment. This paper lays out some of the key considerations and pitfalls for government contractors looking to explore reorganization as one of many possible responses to the changing economic environment.
Restructuring Plan and Business Case

All investments should be well planned — and a restructuring is no different. Given the number of operational and financial variables as well as internal and external stakeholders that must be considered, a restructuring plan can be complicated. Government contractors will have the added complexity of having their plan evaluated by the government. The government’s evaluation will heavily scrutinize the estimated costs that will be the expected outgrowth of the operational transformation. They will also evaluate the cost impacts to existing programs. A major challenge for the contractor is to align a business case done using commercial tools and methods, such as time studies and the present valuation of future cash flows, with a government accounting translation of the reorganization, which should consider forward pricing rates as a starting point. The business case justification for reorganization can make or break the government’s acceptance of the restructuring plan, and a business case that considers both the government and commercial views of the world will help the business anticipate operational as well as government accounting roadblocks.

Government Communication

As a result of this GAO audit report, executing an effective communication plan with the government is more than just hitting the required timelines for cost impact study submission and disclosure statement updates. Any management decision regarding a material acquisition should be considered disclosable, if not from a financial statement perspective than from a Truth in Negotiations Act (TINA) perspective, particularly since the view of materiality applied to financial statements is much different than that applied to government contract pricing.

Companies must be careful to be internally and externally consistent with messaging regarding any restructuring studies or decisions, as the period immediately preceding a restructuring announcement is likely to be closely scrutinized. This will occur so that the government can determine if the company failed to timely disclose knowledge of events material to the pricing of contracts. This risk can be managed both internally and externally. Internally, company messaging to employees should be as clear as possible to avoid rumor or miscommunication. Externally, management must closely and candidly monitor the progress of any restructuring studies, and disclosures should be considered when management feels that a decision has been made, even if the precise impact of a restructuring decision won’t be estimable for some time. This is a somewhat higher standard for disclosure than for statutory accounting guidelines, which require disclosure only when impacts are probable, estimable, and material to the financial statements.

It should be noted too that knowledge anywhere within the organization is deemed TINA knowledge. Typically, corporate-level decisions are communicated on a timeframe that best benefits the company. However, where the government is involved, decisions must be disclosed to the government if they are expected to materially affect pricing. In some cases, this could drive disclosures to be made at a corporate administrative contracting officer (CACO) or divisional administrative contracting officer (DACO) level, even before the local business units are informed.

Finally, and practically, in addition to heightened regulatory scrutiny that comes with an organizational announcement, any company who has the government as a significant customer runs the risk of damaging the relationship with the government if a restructuring announcement is sprung as a complete surprise. The government, sometimes conveniently and primarily when it benefits itself,
views itself as an investor in the contractor and not simply a customer. As a result, it wants to have an idea of future impacts to contract negotiations and forward pricing levels. This is a fair viewpoint in some cases because, unlike typical commercial relationships, the customer doesn’t directly participate in the downside of increased administrative cost, whereas the government, through its cost type and negotiated firm-fixed price (FFP) contracts, can be impacted directly and significantly as a result of company decisions. It is for this reason that maintaining a positive relationship with government oversight and tactfully softening the ground for any major decision is a good idea, so long as it can be done in a professional manner that also considers the well-being of the company, its investors, and its employees.

At the same time, companies shouldn’t share too much information. Providing lofty estimates of savings or of operational synergies can put companies under pressure to make unwise operational and financial decisions in order to meet promises. Any of these decisions made under duress can run contrary to the point of restructuring. This is consistent with the earlier point about the value of a well-conceived business case.

Establishment of Shared Service Centers

Companies are increasingly moving to the central delivery models made possible through the use of internal and external shared services organizations. Accounting, human resources, treasury, compliance, information technology, and procurement are only a few of the support functions that industry is elevating for greater management control and greater efficiency of internal service delivery.

At first pass, the ability to reduce headcount and accomplish the same services seems like a winner; however, these benefits must be weighed against the costs and complications of establishing shared services. Where will the costs of shared service delivery be accumulated? What are the best metrics on which to pattern the methods of output or consumption of the services? Will the cost spent on service delivery infrastructure outweigh the cost reduced at the business unit level? Are the needs of the businesses in each functional area similar enough to be satisfied with a common shared service model, or are practices so unique that the benefit of centralizing the support will be lost? At what location should the shared service centers be established (foreign versus domestic) and what are the implications for government audit oversight?

Vertical Supply Chain Integration

- Another popular idea in restructuring is to purchase a supplier under the rational that the integrator can better manage the supply chain and more cost-effectively procure parts, components, and subassemblies used in the end product. The challenges here include regulatory issues and the ability to adequately forecast post-acquisition business volumes for the acquired entity.
- From a regulatory perspective, contracts must now be restructured to consider a related-party involvement for certain costs. What were previously subcontracts can now be managed as internal purchase orders.
- There are significant financial ramifications for this as well. For example, if an acquisition is integrated into a prime contractor’s organization, the prime must factor in the reduction in contract revenue for the inability to pyramid profit and, in some cases, General and Administrative cost (G&A) on transferred parts and labor. The anticipated revenue of the acquired supplier must also be scrutinized as competitors who previously sourced components from the pre-acquisition entity may decide to go elsewhere rather than risk their performance on a competitor who may not have the motivation to work in their best interest. The reduction in the third-party business of the acquired entity can result in a reduced base over which to allocate indirect costs and can result in fewer viable suppliers in the marketplace, leading to the inflation of component prices.
- Additionally, an anticipated increase in profitability due to having greater control over the supply chain can be accompanied by added risk. The effect of program and contract terminations may now be magnified as the prime contractor may now own a greater share of the total program delivery. This is contrary to the benefit of diversification of risk through a broadening of product and service offerings that most companies will rely on as a benefit of an acquisition.
Status of Business System Approvals

Business system approvals are invaluable to the health of the business. The rule at Defense Federal Acquisition Regulation (DFAR) (252) 242-7005 Contractor Business Systems covers the following systems:

- Accounting
- Earned-value management
- Estimating
- Material management and accounting
- Property management
- Purchasing

Essentially, this rule enables the contracting officer (CO) to withhold up to 5% of payments on contracts if one or more significant deficiencies are found in a single business system, and up to 10% of payments on contracts if multiple systems are deemed to be significantly deficient. Significantly deficient is defined as a:

*shortcoming in the system that materially affects the ability of officials of the Department of Defense to rely upon information produced by the system that is needed for management purposes.*

It is clear that unapproved systems indicate the government’s perception of increased risk inherent in a contractor’s systems. The gross case of failure to comply with DFAR system adequacy requirements can result in withheld payments, but the worst case does not necessarily need to play out for system approvals to have real impacts. For example, in its April 15, 2009 memo titled *Audit Guidance on Approving and Rescinding Contractor’s Authorization to Participate in the Direct Bill Program for Major Contractors*, the Defense Contract Audit Agency (DCAA) makes the direct connection between significant changes to the accounting system increasing risk in the billing system. Because DCAA has authority under the DFAR to authorize direct submission of invoices where it has deemed the contractor’s billing system to be adequate, failure to make DCAA comfortable with accounting and billing system changes can result in revocation of direct billing privileges. This can result in additional red tape for invoicing, which can translate to slower incoming cash flow.

Careful consideration must be paid to the status of business system approvals, anticipated changes to key systems that have approvals, and a tactful campaign of communication with the government regarding the restructuring change environment in order to mitigate impacts to business system approvals caused by the government’s perception of risk due to lack of communication.

Consolidation of the Indirect Rate Structure

Any restructuring will likely require the combining of rate pools. Different businesses inevitably incur similar types of indirect cost, and a restructuring provides the opportunity to combine these pools. In many cases, combined indirect cost pools facilitate the rationalization of indirect “fixed” support costs over a stable or growing base of direct costs. If the pools and bases are similar enough, contractors may be able to combine rate pools and bases without making a cost accounting change. A change is defined in the Cost Accounting Standards (CAS) as a change in cost measurement, allocation, or assignment to periods. If two engineering overhead pools are combined, both with similar indirect cost contents, and both allocated over engineering direct labor bases, no change in measurement or allocation has occurred. If both businesses maintain the same timing of assignment of costs to pools, then no accounting period constraint has been violated. As a result, no change in accounting method has occurred.

However, if the pools or bases are not the same, for example one business unit G&A pool allocated on a total cost input base and another allocated on a value-added base, a cost impact will occur for the CAS-covered contracts of at least one of the legacy business units. The cost impacts can result in lost opportunity cost in the way of reduced contract prices and lost out-of-pocket cost in the way of billing adjustments to existing contracts.

Even without a cost accounting change, combining two similar pool/base combinations can result in significant cost effects of the combination through the creation of winners and losers. Combining pools and bases that result in widely disparate rates will mathematically result in a combined rate somewhere in between the two individual rates. Depending upon the magnitude of the costs and the distance between the individual rates, the resulting rate could create significant cost fluctuations on legacy contracts as well as possible competitive pressures on pricing of future contracts. This can have a detrimental effect to existing contracts as well as to contract pursuits, especially in cases where contract prices are fixed or capped and margins are thin.
Administration of Cost Accounting Standards through a restructuring requires significant effort. In addition to development of a new compliant cost accounting structure, the impacts to CAS-covered contracts and subcontracts must be considered. Cost impacts resulting from accounting changes must be estimated and, if material, need to be settled with the government. A common mistake here involves the definition of an accounting change. Companies often mislabel changes in estimates for changes in the measurement, allocation, or assignment of cost to periods. Failing to adequately identify those restructuring changes that result in true cost accounting changes can cause companies to incorrectly estimate the liability to the government for cost accounting change impacts. An overestimate could result in the company making unnecessary compensatory actions. An understatement of cost accounting change liability could result in both a faulty restructuring plan and unanticipated liability for the company, particularly in the cases where the understatement is not noticed until a later accounting period when no reserve still exists. The latter is a risk given the delayed timing of cost impact proposal audits. Government audit resources are scarce, increasing the time to a completed audit. As a result, the likelihood is that any restructuring plan and impact liability estimate will not be fully audited while the restructuring is ongoing.

Another restructuring pitfall is the failure to coordinate corporate-level accounting practices and changes with those occurring at the business unit levels. For example, if a change in systems or metrics at the corporate level results in an impact to a business unit’s practical ability to account for the cost in the same way as before the restructuring, a constructive change will have occurred. This will force the business unit to consider the impact liability that can affect the anticipated bottom line benefit of the restructuring.

Federal Acquisition Regulation (FAR) Part 30 defines the analysis that must be performed when cost accounting changes occur. Companies must carefully plan this analysis both for safe approval of their business plan by the government and to reduce adverse impacts to contracts and financial statements caused by poor estimates of CAS impact liability.

**Internal versus External Restructuring**

Government contractors considering a restructuring must deal with the issue of cost allowability. Key to the question of restructuring cost allowability is the type of restructuring: internal or external. External restructuring is a concept introduced in response to concerns that costs resulting from elective corporate restructurings would increase the price on government contracts.

Internal restructuring involves a significant and nonrecurring change in legal, management, and/or cost accounting structure that does not stem from a business combination. Contractors operating on CAS-covered contracts typically are responsible for analyzing and settling any cost impacts resulting from restructuring. These impacts should be considered when performing a cost/benefit analysis for the restructuring decision. Because companies can sometimes fail to consider that the government will take back the “savings” occurring on existing contracts backlog in the settlement of cost impacts, they may overstate the estimated bottom line benefits of reorganization.

On the other hand, an external restructuring is one driven from need to integrate an acquisition and reorganize operations to accommodate new capabilities, assets, and employees. There is a window of three years from the date of the triggering acquisition to initiate an external restructuring plan. An external restructuring can result in the allowance of restructuring costs and the waiver of cost impact obligations if the contractor can demonstrate a planned savings of $2 for every $1 spent in restructuring. DFAR 231.205-70 defines restructuring costs as:

- costs, including both direct and indirect, of restructuring activities and restructuring activities as:
  - nonroutine, nonrecurring, or extraordinary activities to combine facilities, operations, or workforce, in order to eliminate redundant capabilities, improve future operations, and reduce overall costs and explains the requirements and benefits of external restructuring.

Although the size of the acquisition that triggers the restructuring is a consideration, the more important issues surround the restructuring plan. The plan must clearly define the company rational for restructuring and must also lay out anticipated steps and timeline to fully execute the restructuring. Finally, a demonstration of the savings, typically on an annual basis for some reasonable duration into the future, is needed. Failed attempts at external restructuring can often be
tied back to a company’s inability to demonstrate to the customer the strategic value of the reorganization or an inability to achieve the $2 for $1 cost savings. Failure to adequately develop and communicate this plan can result in the restructuring being classified as internal, leaving the contractor to bear the burden of restructuring costs and contract cost impacts. This can make or break the value proposition of a proposed restructuring, so a well-rationalized and documented plan is an imperative that can also discipline the company into making an informed restructuring decision.

**Impact**

Restructuring can be a successful solution to deal with current economic conditions, but should not be entered into lightly. A restructuring should not occur entirely because of pressure from the government customer. It should instead occur in the context of the government’s business and the regulatory environment as the purposeful follow through of a well-conceived plan to increase competitiveness while maintaining the quality of service delivery. The issues discussed above are only a few of the factors that complicate a company’s pathway to reorganization. However, companies whose restructuring plan and business case address methods of streamlining, simplicity, and driving efficiency while considering relevant regulations, can not only minimize risk but can also reduce business interruptions that occur through failures to engage the government at the appropriate points throughout the change management process.
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