
Tightening the Budget Belt:

Managing Contracts and Profitability in Light of Government Spending Reductions



What is sequestration?

On August 2, 2011, President Obama signed into law the Budget Control Act of 2011 (BCA), which increased the nation's debt limit but also imposed a series of measures to limit spending and decrease the nation's overall debt. The BCA increased the debt ceiling by \$400 billion in August 2011 and concurrently required the federal government to make \$1.2 trillion in spending cuts over the next decade.

The BCA created the Joint Select Committee on Deficit Reduction, also known as the 'Supercommittee'. The Supercommittee was charged with issuing a deficit reduction recommendation by November 23, 2011. The recommendation was expected to increase revenue through tax reform and military spending cuts, as well as reform entitlement programs, including Medicare, Medicaid, and Social Security. The Supercommittee's recommendation was to be put to a simple majority vote by Congress by December 23, 2011, with the vote not subject to any amendments. The structure of the process was to guarantee a pure majority vote within both chambers of Congress.

On November 23, 2011, the Supercommittee announced that it would not be able to reach a deficit reduction deal, and, according to the BCA, lack of a Supercommittee recommendation by the November deadline triggered sequestration — \$1.2 trillion in automatic cuts over 10 years, beginning January 2, 2013. BCA gives the Office of Management and Budget (OMB) execution authority to carry out sequestration. Sequestration budget reduction triggers are to be split evenly between defense and non-defense spending.

Although the near term effects of sequestration-type budget cuts are uncertain, some form of budget reductions will most certainly occur. The contracting environment will become more challenging and competitive, as contractors are forced to show how they are now more lean, efficient, and focused on accountability.

What can contractors expect?

Budget reductions will affect both discretionary spending (i.e., programs funded through annual appropriations bills) as well as mandatory spending (i.e., entitlement spending established through law). It is anticipated, based on the BCA, that sequestration will require annual budget reductions of approximately 9.4% and 8.2%, respectively, for non-exempt discretionary defense spending and discretionary non-defense budget line items. Additionally, non-exempt mandatory spending and defense mandatory spending will see reductions to the tune of 7.6% and 10%, respectively.¹ Certain mandatory spend entitlement programs, such as Social Security and Medicaid, and programs administered by the Department of Veterans Affairs, will be exempt from sequestration. Medicare cuts will be limited to 2% annually.

It's important to note that by sequestration, budget line items will be cut indiscriminately. The automatic across-the-board budget cut effects of sequestration are anticipated to be so significant and disruptive that many hope that Congress and the President will reach a decision to take a more meaningful budgeting approach prior to January 2013. Or, perhaps an interim solution will be reached, effectively deferring the date of sequestration to provide additional time for agreement on a more thoughtful approach, once the new 113th Congress is in session.

¹ OMB Report Pursuant to the Sequestration Transparency Act of 2012 (P.L. 112-155), page 1.

Budget cuts/ budget reallocation

In September 2012, the OMB gave a rough estimate on how sequestration will be applied to budget line items (i.e., existing government funded programs, projects, and activities).² Government agencies are expected to begin to execute the mapping of OMB-directed line item reductions. There is much work to be done considering that any single budget line item may affect thousands of contracts. Although outlining a need for flexibility for the Department of Defense (DOD) to meet critical military readiness capability, the OMB's estimate includes reductions in areas such as shipbuilding, military construction, and aircraft procurement. Though specific programs are not identified by the OMB, the report indicates a reduction in more than 80 discrete defense department appropriations accounts, including research and development spending.

Non-defense reductions are also expected to be significant. Within non-defense departments and agencies, \$43.5 billion is identified to be removed as a uniform percentage reduction to sequestration-eligible accounts. In addition to the \$11 billion sequestration of Medicare, other notable reductions include cuts to Health and Human Services, \$7.2 billion;³ Department of Homeland Security, \$4.1 billion; Department of Energy, \$2.4 billion; Department of State, \$2.6 billion; and Department of Transportation, \$2.2 billion.⁴

Increased competition and price pressure on negotiated contracts

Naturally, the competitive environment during a time of declining budgets will create a more challenging business landscape for government contractors, including a likely increase in bid protest activity as competing contractors position themselves to obtain the highest share of anticipated lower volumes of government spending.

Contractors may notice more requests for justification and documentation during procurements, as well as scrutiny of sole source procurements and exceptions to full disclosure of cost or pricing data. For example, to stretch the taxpayer dollar, it appears that the government will press for more details on costs, instead of relying on market-based pricing.

Although overall spending levels will decline, discretionary defense spending will still be guided by the military's assessment of emerging threats. Contracting organizations will need to be agile to adapt to evolving military strategy in order to respond to the requirements for the next generation technologies and weapon systems. Similarly, for non-defense discretionary spending, contractors will need to focus on the government's high-priority issues, including emerging needs in healthcare and energy.

Effective management of independent research and development (IR&D) dollars can be a competitive advantage, especially during periods of prolonged budget reduction efforts in both defense and non-defense programs. Other important considerations for contractors include dedicated teams that define strategy and maintain flexibility in order to respond to opportunities.

Companies engaging in merger and acquisition activity will have to carefully consider targets by assessing the viability of programs and potential sustainment of backlog.

Contract reductions and government reliance on fixed-price contracting

Spending cuts can occur in many ways, including reductions of new contract awards, de-scoping of existing contracts, and even program terminations. The recent OMB release notes that unobligated balances from prior years are subject to sequestration and confirms that contractors can expect procurement delays. Although the government has stated its preference to avoid contract termination procedures, full or partial contract terminations for convenience may occur, as well as a lower tolerance for situations that could justify a termination for default.

² OMB Report Pursuant to the Sequestration Transparency Act of 2012 (P.L. 112-155).

³ The \$7.2 billion listed is the amount required for sequestration from HHS net of the mandatory 2% \$11.1 billion dollar budget reduction to Medicare in the Centers for Medicare and Medicaid Services portion of the HHS budget.

⁴ Ibid. Note 2

Contractors can expect agencies to favor contracting methodologies that create more predictable spending patterns, at least in the near term, particularly through increased reliance on fixed-price contracts.

Increased audits/investigations

Contractors can expect government agencies such as the Defense Contract Management Agency (DCMA) to more actively pursue cost recovery initiatives. Budget pressures have introduced a new sense of urgency for the DCMA to continue clearing its large backlog of dormant contract claims. Contractors will continue to see increased activity from the Defense Contract Audit Agency (DCAA). The government has already begun to demand greater contractor accountability through its should-cost audit approach, which typically results in suggested cutbacks and a need for greater efficiency.

How can contractors prepare?

As agencies target programs for reduction, contractors should monitor changes in funding appropriations, customer communications, and trade publications, which can signal planned program cuts. Contractors should consider establishing a spending reduction response plan, by focusing on tactical issues such as those addressed in the following section.

Organizational design, cost control, and cost recovery

Higher overhead rates, which result from reductions in business volume, may not be recoverable under existing contracts and can threaten a contractor's competitive position. Along with cost reduction initiatives, contractors should revisit their organizational structures and cost allocation methods. Considerations in this area include:

- **Redesign of cost allocations** — After years of growth, cost allocation methods can become outdated. Changes in the nature of the business, labor skills, assets, management, support services, use of subcontractors, and other factors drive the need to reassess costing models. In a downturn, it is especially important to review costing methods to assess whether revisions are needed so that contact costs better reflect the consumption of resources. Overhead pools should be designed to allow for management accountability. The needs of customers should be considered in evaluating whether changes in the classification of direct and indirect costs are required. As budgets tighten, customers will be focused on understanding the components of the prices they receive in order to avoid paying for unnecessary or inefficient contractor costs.
- **Effects on cost recovery** — In addition to funding, which may be reduced through program cuts, contractors should consider the potential effects on their ability to recover costs across the spectrum of programs, even those that may not experience deep cuts. For example, increases in indirect rates may occur through the reduction of contract volumes at a level faster than indirect pools can be rationalized. If the indirect rates on continuing contracts increase beyond contractually established rate ceilings or cost thresholds, contractors could find themselves unable to recover their full fixed costs of supporting the business (G&A) and performance operations (overhead costs). Another possibility to consider would be the existence in the indirect pools of unallowable costs that were driven off of sequestration activities. These could include costs for restructuring and idle facilities costs incurred in contractors' reactions to sequestration. Additionally, reductions in business volume lead to special one-time costs such as large-scale severance, relocations, idle facilities, and other restructuring items. Contractors need to pay close attention to the rules concerning cost recovery. For example, mass severance is considered on a case-by-case basis; idle facilities are normally allowed for one year; and restructuring costs have special limitations on defense contracts.
- **Business process effectiveness** — Many indirect functions, including accounting, government compliance, contract administration, and engineering support, can benefit from an analysis of the activities performed by functional resources with the intent to identify opportunities for efficiencies and process improvement. An independent way to evaluate the effectiveness of support functions is to benchmark performance metrics against others in an industry or peer group. Examples of useful benchmarking metrics include functional headcount and functional cost per capita.

- **Implementation of shared services and supply chain analysis** — Shared services will require organizations to satisfy internal service delivery at reduced cost. Typical candidate functions for shared service redesign to take better advantage of volume purchasing opportunities include finance and treasury, human resources and benefits management, and strategic purchasing arrangements. Similar to functional analysis, a supply chain analysis can assist contractors in identifying inefficiencies and hidden expense in existing processes to source material, manage inventory, and manufacture product. Supply chain rationalization can help diagnose root causes of cost inefficiencies and create additional cost-competitiveness by identifying process efficiencies and by using strategic purchase planning to boost buying power.
- **Business unit restructuring** — As markets change, there is a need to evaluate whether the organizational structure is best designed to execute the strategy for the future. Business units should be designed around common products or services. However, to minimize the volatility of indirect rates, product and service lines may need to be consolidated. Consolidating product and service lines can allow for better leverage of management, independent research and development, and bid and proposal expense. Special purpose segments may still be needed to accommodate unique markets or customer requirements.

Each of these initiatives should be carefully considered based on the contractor's own business strategy. The compliance implications of making business changes should also be considered. For example, an organizational restructuring can lead to cost accounting practice changes. The government is protected against paying increased costs for such changes unless the changes are viewed as desirable. The government may require a demonstration of the savings before accepting a change as desirable.

Contract and claims management

As agencies streamline their missions with reduced funding, contractors may find elements of their backlog at risk of reduced scoping or termination. With funding uncertainty, contractors should be prepared to file requests for equitable adjustment for contract changes. In an environment where the pursuit of claims is expected to increase, it may be prudent to accelerate the claims process to secure the available funds as early as possible. However, there may be a trade-off between an early settlement and an equitable settlement.

Contractors should also be aware of the higher potential for out-of-scope work as agencies place higher demands on contractors. A sound claims management process can help protect profits where the government bears the responsibility for cost growth.

Systems and contract compliance

Whether you are a large or small organization, providers of goods and services to the government are generally subject to complex regulations. With the government's focus on compliance at all levels, a strong compliance record can sometimes create a competitive advantage for contractors. An example of this is contained within the developing small business rules, where companies that have high-quality compliance controls for small business plan fulfillment may qualify for positive evaluation factors in contract awards. Compliance with the requirements under the DFARS business systems rule will help to protect the cash flow on government contracts, as government audits that identify significant system deficiencies are subject to payment withholds and additional scrutiny. Contractors with significant deficiencies may be more heavily targeted by the government for cost recovery initiatives.

WARN Act compliance

Under the requirements of the Worker Adjustment and Retraining Notification (WARN) Act, larger private sector employers with more than 100 full-time employees are required by law to give notice of impending plant closings or layoffs. In July 2012, the Department of Labor (DOL) released a memo to federal contractors stating that it was 'neither necessary nor appropriate' to issue WARN Act notices to employees, even within the uncertain

environment created by potential sequestration.⁵ If WARN Act notices were required, the timing of issue would have needed to precede the November 6, 2012 Presidential election, as the Act would ostensibly require employee notice 60 days prior to the January 2, 2013 sequestration trigger. In September 2012, the Office of Management and Budget informed contractors that they would be compensated for legal costs incurred, regardless of the outcome of the litigation, in the event that mass layoffs do occur as a result of contract cancellations under sequestration.⁶

The White House has received further inquiry from some contractors and their legal representatives seeking to understand the administration's authority and legal basis for the guidance it issued saying sequestration did not require WARN Act notices to be issued. It should be noted, however, that legal costs incurred in defense of a violation of the WARN Act would most likely be challenged in the normal course of an audit, if the contractor is found to be in violation of the Act. Contractors will need to continue to follow this issue and the White House position closely to manage the potential risks of foreseeable legal liability.

Managing despite uncertainty

Even if sequestration does not take effect on January 2, 2013, budget cuts in the near future will almost certainly occur. Contractors with a well-balanced focus on restructuring their operations and navigating the government claims process, while also assessing their procedures for cost control and regulatory compliance, can be best positioned to manage the uncertain environment.

⁵ Department of Labor Training and Employment Guidance Letter No. 3-12

⁶ OMB Memo M-12-19 Subject Guidance on Allowable Contracting Costs Associated with the Worker Adjustment and Retraining Notification (WARN) Act

A special acknowledgment to the authors of this piece:

Bill Scally
(617) 530-5643
[william.b.scally@us.pwc.com](mailto:wiliam.b.scally@us.pwc.com)

Richard Meene
(646) 471-7346
richard.j.meene@us.pwc.com

To discuss how this subject may affect your business, please contact:

James Bucrek
Principal
(312) 298-3907
james.bucrek@us.pwc.com

Philip Koos
Partner
(646) 471-2454
philip.koos@us.pwc.com

John May
Partner
(617) 530-5340
john.m.may@us.pwc.com

James Thomas
Partner
(703) 918-3050
james.w.thomas@us.pwc.com