EXTERNAL RESTRUCTURING

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TOPICS FOR TODAY

- **Back to basics**
- **It’s not your father’s XRP**
- **The elephant in the room**
- **Open Discussion**

BACK TO BASICS

EXTERNAL RESTRUCTURING - BACKGROUND

- **Applicability**
  - External Restructuring applicable to Business Combinations defined when the assets or operations of companies not previously under common control are combined
  - Direct and indirect costs of external restructuring activities in excess of $2.5 million allocated to DoD contracts
  - Costs must be allowable in accordance with FAR Part 31 and DFARS Part 31
  - Companies have the option of submitting an **external restructuring proposal** in accordance with guidelines for external restructuring activities that are subject to, and meet the requirements of, 10 United States Code (USC) 2325
- **External restructuring benefits**
  - Cost Impact Exemption - FAR 30.602(e) and 9903.201-8
    - The contract price and cost adjustment requirements are not applicable to compliant cost accounting practice changes directly associated with external restructuring activities that are subject to and meet the requirements of 10 U.S.C. 2325; disclosure of the practice changes still required
  - Assignment Period – CAS 406-61
    - Restructuring costs may be accumulated as a deferred cost, and subsequently amortized, over a period during which the benefits of restructuring are expected to accrue, but not to exceed 5 years

EXTERNAL RESTRUCTURING ACTIVITIES

Must meet the definition of External Restructuring Activities - DFARS 231.205-70(b)

- External Restructuring Activities:
  - Occur after business combination (i.e. common ownership or control)
  - Direct outgrowth of business combination
  - Normally initiated within 3 years of business combination
    - Efforts that are non-routine, non-recurring, and extraordinary,
    - To combine facilities, operation, and workforce,
    - To eliminate redundant capabilities, improve future operation, and reduce overall costs
- External restructuring activities may include:
  - Consolidation of CHQ to realize synergies
  - Elimination of Facilitates
  - IT Integration/Application Rationalization
  - Additional Value Capture Initiatives that qualify for XRP

CONSIDERATIONS:

1) One-time, non-recurring activity; and

2) Would otherwise not have been incurred

EXTERNAL RESTRUCTURING – COSTS

External restructuring costs mean the costs associated with external restructuring activities

- **May include:**
  - Severance paid during workforce reductions
  - Movement of personal & equipment due to facility consolidations
  - Lease termination costs for heritage facilities being consolidated
  - IT Integration costs including certain h/w & software costs
  - Third-party costs for activities that qualify as external restructuring activities
  - Dedicated Integration Management Office labor (generally post-close)

- **Do not include or more difficult to sustain:**
  - Activities occurring after a business combination that affect the operations of only one of the companies not previously under common ownership or control
  - Routine or ongoing repositioning and redeployment of a contractor's productive facilities or workforce (e.g., normal plant rearrangement or employee relocation)
  - Other routine or ordinary activities charged as indirect costs that would otherwise have been incurred (e.g., planning and analysis, contract administration and oversight, or recurring financial and administrative support)
  - Otherwise unallowable costs

EXTERNAL RESTRUCTURING –SAVINGS

External restructuring savings mean the savings associated with external restructuring activities

- **May include:**
  - Salary avoidance as a result of workforce reductions
  - Facilities lease and operating cost avoidance
  - Elimination of certain IT costs resulting from consolidation and moving to common systems

- **Do not include or more difficult to sustain:**
  - Direct cost reductions
  - Benefit harmonization
  - Facility reductions where only one company is impacts
  - Pre-close actions

ALLOWABILITY OF EXTERNAL RESTRUCTURING COSTS

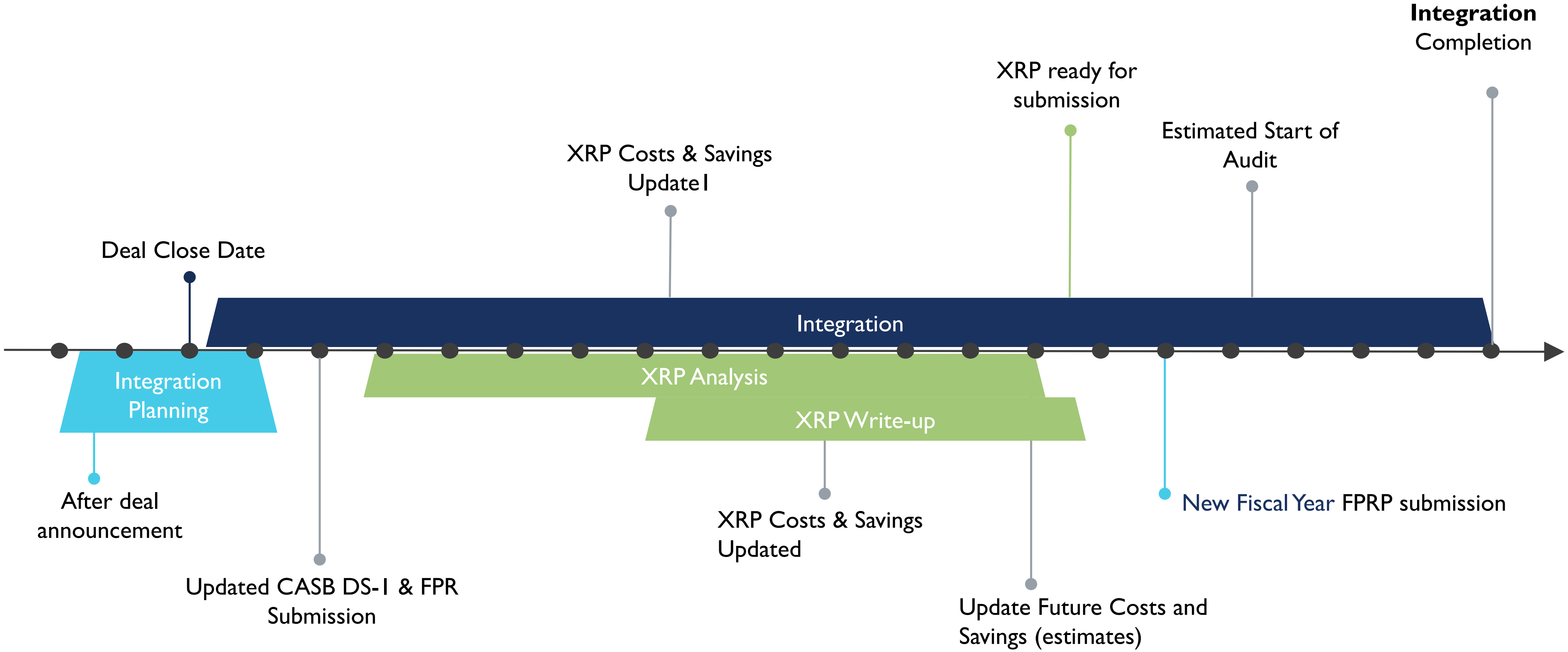
10 U.S.C. 2325(a) Limitation on Payment

- Secretary of Defense may not pay restructuring costs unless written determination that either:
  - Savings exceed costs by at least 2:1; or
  - Savings exceed costs and preservation of critical capability would otherwise by lost to DoD

DFARS 231.205-70(c) Cost Limitation

- Restructuring costs are allowed if:
  - Costs are allowable in accordance with FAR Part 31 and DFARS Part 231
  - An audit of costs and savings is performed and reviewed by the ACO
  - ACO negotiates and advance agreement
  - USD (AT&L) or Director DCMA, depending upon the amount of restructuring costs, determines audited savings exceed costs by a factor of 2:1 or preservation of critical capability would otherwise by lost to DoD
- Otherwise, costs are non-reimbursable as restructuring

EXAMPLE EXTERNAL RESTRUCTURING TIMELINE



DFARS RESTRUCTURING VS. GAAP INTEGRATION

DFARS & CAS (Gov't cost accounting) and GAAP (financial reporting) definitions differ

- **Integration Costs (GAAP)**
  - Costs are generally related to activities that allow the company to perform as an integrated organization
  - Restructuring costs are generally a subset of integration costs
- **Examples of integration costs not included as DFARS restructuring**
  - Rebranding activity including changing signs, stationary, websites, etc.
  - Moving to common policies
  - Business process improvements to allow the combined companies to perform more efficiently
  - Some activities related to defining/forming unified team and "to be" state **prior** to date of merger/acquisition
- **Cost Allowability**
  - Generally allowable for gov't costing purposes only in the year incurred (i.e., not eligible for amortization to future periods)
  - Note - company can voluntarily withhold from rates (i.e., charge to non-billable account/project)

IT'S NOT YOUR FATHER'S XRP

PREPARING AN EXTERNAL RESTRUCTURING PROPOSAL

Refer to DFARS 231.205-70(d) and PGI 231.205-70(d) – ACO Procedures

- Segregate restructuring costs
- Suspend external restructuring costs from billing and settlements until DoD makes determination of projected restructure savings
- Require contractor plan showing net present value of costs and savings
  - Adequately supported proposal to establish reasonableness of costs and projections
  - Breakout by year by cost element with basis of estimate rationale for accumulation, amortization, and methods of allocation
  - DoD participation rate or "share" of projected costs and savings
  - Separately identify from internal restructuring costs, if any
  - Determine restructuring activities and objectives

PREPARING AN EXTERNAL RESTRUCTURING PROPOSAL (CON'T)

External Restructuring Proposal Considerations

- Identify restructuring projects and tasks
- Establish anticipated period of performance
- Develop cost and savings summary – NPV/DoD share
- Develop detailed cost and savings Basis of Estimates (BOEs)
- Determine cost accounting structure/practice changes of combined business

Other consideration during proposal preparation…

- Align your cost accounting, cost identification, and cost allocation practices to allow for the tracking of external restructuring costs in a consistent manner to which they were estimated in the proposal.
- Be prepared to revise your forward pricing rates to reflect the inclusion of external restructuring savings and cost, provide dedicated resources to support the government audit, and consider the approach for messaging the external restructuring cost impacts to government customers.
- Be prepared to revise your Cost Accounting Standards Disclosure Statement(s), or develop additional disclosure statements, and include documentation to support cost accounting practice changes resulting from external restructuring activities as being exempt from cost impact calculations

THE ELEPHANT IN THE ROOM

DCMA GUIDANCE TO ACO'S

ACO's Determination Letter of Adequacy and Compliance on an Amended or Revised Disclosure Statement Submission with a Cost Accounting Practice Change(s) Submitted in Connection with External Restructuring

- In accordance with FAR 30.604(b)(1)(i), **a General Dollar Magnitude Cost Impact Proposal (GDM) is required** for a (*each*) unilateral cost accounting practice change. [Contractor] has asserted that:
  - all (*or identify the specific changes*) cost accounting practice changes in this disclosure statement revision are directly related to the [*name the two entities*] external restructuring;
  - the restructuring satisfies the 2:1 savings test required by DFARS 231.205-70; and
  - 48 CFR 9903.201-8 exempts it from submission of a GDM(s).
- **48 CFR 9903.201-8 exempts the transaction from contract price and cost adjustment provisions** as stated, if and when it is determined that all requirements of 10 U.S.C. 2325 have been met. At least until that determination is made, the transaction is subject to all the requirements of the CAS clauses in your contracts. In addition, the information included in a GDM proposal is required in order to evaluate the assertion of 2:1 savings. Should [a qualifying restructuring proposal not be submitted, *(delete if inapplicable)* or] the Government's review of the external restructuring proposal conclude that the required 2:1 savings has not been met, contract price and cost adjustments based on our review of these GDMs may be processed accordingly. Therefore, GDMs for all cost accounting practice change(s) in Disclosure Statement Item(s) (*identify the specific changes by item number, such as Item 2.5.0, Item 4.2.0, etc.*) is (*are*) requested by [date].
- The GDMs should be prepared as described in FAR 30.604(d),(e) and (h).

APPLICABLE REGULATIONS & GUIDANCE

DFARS 231.205-70: DEFINITIONS

- **Business combination** means a transaction whereby assets or operations of <u>two or more companies not previously under common ownership or control are combined</u>, whether by merger, acquisition, or sale/purchase of assets.

- **External restructuring** activities means restructuring activities <u>occurring after a business combination that affect the operations of companies not previously under common ownership or control</u>. They do not include restructuring activities occurring after a business combination that affect the operations of only one of the companies not previously under common ownership or control, or, when there has been no business combination, restructuring activities undertaken within one company. External restructuring activities are a direct outgrowth of a business combination. They normally will be initiated within 3 years of the business combination.

DFARS 231.205-70: DEFINITIONS (CONTINUED)

- **Restructuring activities** means nonroutine, nonrecurring, or extraordinary activities to combine facilities, operations, or workforce, in order to eliminate redundant capabilities, improve future operations, and reduce overall costs. Restructuring activities do not include routine or ongoing repositioning's and redeployments of a contractor's productive facilities or workforce (e.g., normal plant rearrangement or employee relocation), nor do they include other routine or ordinary activities charged as indirect costs that would otherwise have been incurred (e.g., planning and analysis, contract administration and oversight, or recurring financial and administrative support).

- **Restructuring costs** means the costs, including both direct and indirect, of restructuring activities. Restructuring costs that may be allowed include, but are not limited to, severance pay for employees, early retirement incentive payments for employees, employee retraining costs, relocation expense for retained employees, and relocation and rearrangement of plant and equipment. For purposes of this definition, if restructuring costs associated with external restructuring activities allocated to DoD contracts are less than $2.5 million, the costs shall not be subject to the audit, review, and determination requirements of paragraph (c)(4) of this subsection; instead, the normal rules for determining cost allowability in accordance with FAR part 31 shall apply.

DFARS 231.205-70: DEFINITIONS (CONTINUED)

- **Restructuring savings** means cost reductions, including both direct and indirect cost reductions, that result from restructuring activities. Reassignments of cost to future periods are not restructuring savings.

DFARS 231.205-70: LIMITATIONS ON COST ALLOWABILITY

- Restructuring costs associated with external restructuring activities shall not be allowed unless -
  - Such costs are allowable in accordance with FAR part 31 and DFARS part 231;
  - An audit of projected restructuring costs and restructuring savings is performed;
  - The cognizant administrative contracting officer (ACO) reviews the audit report and the projected costs and projected savings, and negotiates an advance agreement in accordance with this subsection; and
  - The official designated in this subsection determines in writing that the audited projected savings, on a present value basis, for DoD resulting from the restructuring will exceed either -
    - The costs allowed by a factor of at least two to one; or
    - The costs allowed, and the business combination will result in the preservation of a critical capability that might otherwise be lost to DoD.
    - If the amount of restructuring costs is expected to exceed $25 million over a 5-year period, the designated official is the Under Secretary of Defense (Acquisition, Technology, and Logistics) or the Principal Deputy. This authority may not be delegated below the level of an Assistant Secretary of Defense.
    - For all other cases, the designated official is the Director of the Defense Contract Management Agency. The Director may not delegate this authority.

DFARS 231.205-70: ACO RESPONSIBILITIES

- As soon as it is known that the contractor will incur restructuring costs for external restructuring activities, the cognizant ACO shall follow the procedures at PGI 231.205-70(d). Information needed to obtain a determination:
  - The novation agreement (if one is required);
  - The contractor's restructuring proposal;
  - The proposed advance agreement;
  - The audit report; and
  - Any other pertinent information.
  - The cognizant ACO's recommendation must clearly indicate one of the following:
    - The audited projected savings for DoD will exceed the costs allowed by a factor of at least two to one on a present value basis.
    - The business combination will result in the preservation of a critical capability that might otherwise be lost to DoD, and the audited projected savings for DoD will exceed the costs allowed on a present value basis.

DFARS 231.205-70: CO RESPONSIBILITIES

- The contracting officer, in consultation with the cognizant ACO, should consider including a repricing clause in noncompetitive fixed-price contracts that are negotiated during the period between -
  - The time a business combination is announced; and
  - The time the contractor's forward pricing rates are adjusted to reflect the impact of restructuring.
- The decision to use a repricing clause will depend upon the particular circumstances involved, including -
  - When the restructuring will take place;
  - When restructuring savings will begin to be realized;
  - The contract performance period;
  - Whether the contracting parties are able to make a reasonable estimate of the impact of restructuring on the contract; and
  - The size of the potential dollar impact of restructuring on the contract.
- If the contracting officer decides to use a repricing clause, the clause must provide for a downward-only price adjustment to ensure that DoD receives its appropriate share of restructuring net savings.

CAS 9903.201-8: COMPLIANT COST ACCOUNTING CHANGES

- Compliant cost accounting changes due to external restructuring activities:
  - The contract price and cost adjustment requirements of this part 9903 are not applicable to compliant cost accounting practice changes directly associated with external restructuring activities that are subject to and meet the requirements of 10 U.S.C. 2325 [as adopted in DFARS 231.205-70].

OTHER PRIMARY GUIDANCE

- 10 U.S.C 2325: Restructuring Costs
- PGI 231.205-70: External Restructuring Costs
- DCMA Instruction 132: Novation, Change-of-Name, and Business Combination (Restructuring) Agreements
- DCAA Selected Area of Cost Guidebook: FAR 31.205 Cost Principles, Chapter 63 – Restructuring Costs

EXTERNAL RESTRUCTURING COSTS & SAVINGS

EXTERNAL RESTRUCTURING COSTS (EXAMPLES)

- **Restructuring costs** means the costs, including both direct and indirect, of restructuring activities. Restructuring costs that may be allowed include, but are not limited to, severance pay for employees, early retirement incentive payments for employees, employee retraining costs, relocation expense for retained employees, and relocation and rearrangement of plant and equipment…cont.
- Employee Related Costs:
  - Early retirement incentives or severance;
  - Relocation;
  - Recruitment;
  - Training;
  - Bonuses;
  - Pension;
  - Organizational restructuring.

EXTERNAL RESTRUCTURING COSTS (EXAMPLES - CONTINUED)

- Facilities Related Costs
  - Facility consolidation in whole or part;
  - Asset relocation;
  - Gain/loss on sale or disposition of assets;
  - Environmental remediation.

- IT/Systems Costs
  - Consolidation of systems, e.g. accounting, payroll, etc.

- Cost Accounting Practices
  - Consolidation of Disclosure Statements (compliant cost accounting changes directly associated with external restructuring are exempt from cost impacts per CAS 9903.201-8)

EXTERNAL RESTRUCTURING SAVINGS (EXAMPLES)

- **Restructuring savings** means cost reductions, including both direct and indirect cost reductions, that result from restructuring activities. Reassignments of cost to future periods are not restructuring savings.

- To be considered, the Government will evaluate whether savings are "directly associated" with external restructuring activities:
  - Future cost savings from external restructuring activities such as:
    - Workforce reduction;
    - Facility consolidation;
    - IT system consolidation;
    - Elimination of any redundant capabilities;
    - Overall improvement of operations that will reduce costs;
    - Translates to savings on future Government contracts, existing flexibly priced contracts, or firm-fixed price contracts yet to be negotiated.
- While not required, the Government will look for evidence to support contractor assertions of direct cost "savings" through changes to estimating practices on new proposals and/or actual program cost reductions.

OTHER ITEMS FOR CONSIDERATION

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- A management decision to restructure is information that should be disclosed as cost and pricing data.
- Projected external restructuring costs can be included in forward pricing if projected savings are also included.
- Actual external restructuring costs must be withheld from billings to Government customers until all steps and approvals have been completed. The costs are effectively non-billable until the Restructuring Advance Agreement is approved.
- Maintain good records on all decision making rationale, charging guidance, cost records, applicable policies and procedures, savings rationale, etc. as the entire process could take several years to complete.

OTHER ITEMS FOR CONSIDERATION (CONTINUED)

- Ensure conformance to all aspects of FAR Part 31, particularly on areas of cost that warrant careful consideration:
  - Retention pay, severance, retirement incentives, etc.: FAR 31.205-6;
  - Relocation: FAR 31.205-35 and FAR 31.205-46;
  - Recruitment: FAR 31.205-34;
  - Idle facilities and idle capacity: FAR 31.205-17;
  - Assets: FAR 31.205-16 and FAR 31.205-52;
  - Organization costs: FAR 31.205-27;
  - Goodwill: FAR 31.205-49.
- Maintain proper coding of costs and amortization as applicable, e.g. direct vs. indirect vs. capital, etc.

CURRENT ISSUES & CHALLENGES

CURRENT ISSUES & CHALLENGES

- **Contract Reopeners**
- The contracting officer, in consultation with the cognizant ACO, should consider including a repricing clause in noncompetitive fixed-price contracts that are negotiated during the period between -
  - The time a business combination is announced; and
  - The time the contractor's forward pricing rates are adjusted to reflect the impact of restructuring.

- The Government may attempt a more expansive use of reopeners beyond the defined criteria;
- Reopeners are subject to negotiation;
- Ensure controls are in place to review any proposed reopeners by the Government;
- Ensure reopeners are not accepted if they fall outside of the defined criteria.

CURRENT ISSUES & CHALLENGES (CONTINUED)

- **Compliant Cost Accounting Practice Changes**
- The contract price and cost adjustment requirements of this part 9903 <u>are not applicable to compliant cost accounting practice changes directly associated with external restructuring activities</u> that are subject to and meet the requirements of 10 U.S.C. 2325 [as adopted in DFARS 231.205-70].

- The Government is pushing for cost impact analysis on compliant cost accounting changes that are directly associated with external restructuring.
- There seems to be a push for cost impact analysis to be included in the external restructuring 2:1 savings ratio.
- CAS regulation explicitly exonerates the contract price and cost adjustment requirements on compliant cost accounting practice changes that are directly associated with external restructuring activities;
- Neither CAS, FAR, or DFARS requires that cost impact analysis be performed, nor included in the 2:1 savings ratio.

QUESTIONS