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Steven A. Meyerowitz

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What You Need to Know About Mergers and Acquisitions Involving Government Contractors and Their Suppliers

By John W. Chierichella and Keith R. Szeliga*

This article highlights the categories of costs that commonly arise in connection with government contracts mergers and acquisitions and addresses how they are treated under the applicable regulations. It also discusses the relevance of novation agreements and changes to cost accounting practices.

Mergers and acquisitions create additional costs and complex accounting issues for government contractors. There are fees for accounting, legal, and business consultants. There may be restructuring costs associated with combining business operations. Segments may be closed and retirement plans may be terminated. Golden handcuffs and golden parachutes are also common. Assets may be revalued, goodwill may be created, and there may be changes in cost accounting practices.

ACCOUNTING FOR THE COST OF BUSINESS COMBINATIONS UNDER GOVERNMENT CONTRACTS

The regulations applicable to the allowability and allocability of costs under government contracts include specific requirements regarding the treatment of costs that are likely to arise from mergers and acquisitions. The requirements are scattered throughout the Federal Acquisition Regulation ("FAR") Cost Principles and the Cost Accounting Standards ("CAS"). Some are complex. Others are impenetrable. Government auditors are instructed and trained to scrutinize these costs with a critical eye. Perceived noncompliance can result in consequences ranging from disallowance of costs to False Claims Act investigations, which are both disruptive and expensive, even if they do not result in liability. Accordingly, compliance is critical.

This article highlights the categories of costs that commonly arise in connection with government contracts mergers and acquisitions and addresses

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how they are treated under the applicable regulations. It also addresses the relevance of novation agreements and changes to cost accounting practices.

APPLICABLE REGULATIONS

The Cost Principles govern the allowability of costs. They reflect policy decisions regarding the categories of costs the government will, or will not, pay under a government contract. The Cost Principles are used to determine whether costs will be reimbursed under flexibly priced government contracts and modifications and whether they will be included in the cost-buildup for fixed-price contracts for which the government requires cost or pricing data.

CAS governs the allocation of costs to indirect cost pools and contracts, as well as the assignment of costs to cost accounting periods. There are multiple thresholds and exemptions for CAS coverage. The bottom line, however, is that a contractor is likely to be subject to some form of CAS coverage if (a) it is a large business and (b) it has at least one $7.5 million contract for non-commercial items that is flexibly priced or for which it was required to submit cost or pricing data.

SPECIFIC CATEGORIES OF COSTS

- *Depreciation*: For non-government contracts purposes, assets may be written-up or written-down to fair market value following an acquisition. A write-up occurs when the book value of an asset is increased because its carrying value is less than the fair market value. Conversely, a write-down occurs when the book value of an asset is decreased because its carrying value is higher than the fair market value. A write-up would increase the value of an asset that can be depreciated and, thus, the amount of costs ultimately allocated to contracts. For government contracts purposes, however, the buyer generally cannot write-up or write-down the value of assets acquired in a business combination unless those assets did not generate depreciation expense in the prior cost accounting period.[1] This rule effectively limits allowable depreciation for government contracts purposes to the seller's net book value of an asset, regardless of its current fair market value.
- *Goodwill*: Goodwill is an intangible asset that arises when the purchase price of a company exceeds the sum of the identifiable individual assets acquired less the liabilities assumed. The goodwill premium takes into account factors such as the company's brand, customer base, employee relations, intellectual property, and other intangible factors. If the value

[1] FAR 31.205-52; CAS 404-50(d)(1).

of a company's goodwill falls, a write-down or write-off may be available for other than government contracts purposes. For government contracts purposes, however, any cost for amortization, expensing, write-off, or write-down of goodwill is expressly unallowable.[2] This means that, if an investment does not pay off, and the value of a company's goodwill decreases following an acquisition, the government will not bear any portion of this cost.

- *Organization Costs*: The Cost Principles identify as expressly unallowable all costs associated with planning or executing the organization or reorganization of a business (specifically including mergers and acquisitions), resisting or planning to resist such an organization or reorganization, and raising capital.[3] Examples of unallowable costs include incorporation fees as well as costs incurred for attorneys, accountants, brokers, promoters and organizers, management consultants, and investment counselors. Such costs are unallowable whether the work is performed by employees or outside consultants. In fact, Defense Contract Audit Agency ("DCAA") guidance specifically instructs auditors to review the records of activities performed by any in-house business planning group, acquisition and divestiture committee, and by the corporate legal and accounting departments to ensure that a company has tracked and treated as unallowable all such work performed by these individuals. It is important to distinguish unallowable organizational costs from long-range economic planning costs, which are allowable.[4] The FAR defines "economic planning costs" to include the costs of general long-range management and planning concerned with the future development of the business, which can include the need for strategic mergers, acquisitions, or investments. The line between allowable economic planning costs and unallowable organization costs is murky at best. One common approach is for contractors to account for costs associated with the consideration of multiple potential targets as economic planning costs but to begin treating the costs as unallowable organization costs once the contractor has zeroed in on a particular target. Defining when that occurs, however, is not always easy. For example, is the line crossed when a contractor identifies the target internally? When the contractor engages a consultant to evaluate that target? When the contractor approaches

[2] FAR 31.205-49.

[3] FAR 31.205-27(a).

[4] FAR 31.205-12.

that target? When the contractor enters into a letter of intent with the target? The regulations do not answer this critical question, and the outcome depends on the facts and circumstances of each particular case.

- *Interest and Financing*: Most deals require financing. Interest on borrowings, however, is an expressly unallowable cost.[5] Legal and professional fees associated with obtaining financing are likewise unallowable.
- *Golden Parachutes/Handcuffs*: Golden parachute and golden handcuff payments are expressly unallowable.[6] Golden parachutes are special compensation, in excess of normal severance, paid to employees if their employment terminates following a change in ownership or control. Golden handcuffs are payments to employees under plans introduced in connection with a change in ownership or control pursuant to which the employees receive special compensation contingent upon remaining with the contractor for a specified period of time. Golden handcuffs must be distinguished from increases in compensation, following a change in control, that are not linked to remaining with the company for a specific timeframe. This latter category of compensation is not subject to the golden handcuffs rule.
- *Pension Costs*: Mergers and acquisitions can lead to the closing of segments, the termination of pension plans and/or the curtailment of benefits. If any of these events occur, and if the plan assets exceed its actuarial liabilities, the government may be entitled to a credit for its equitable share of the overfunding.[7] Conversely, when the liabilities of the plan exceed the assets, a charge to government contracts may result. The rules defining the events that trigger a reversion of plan assets, and how to calculate the government's share of any credit or debit, are extraordinarily complex, and beyond the scope of this article. For present purposes, it is sufficient to note that these adjustments, particularly the credits to the government, can be significant and should be factored into the purchase price of the target.
- *Restructuring Costs*: Business combinations frequently result in restructuring activities—onroutine, nonrecurring, or extraordinary activities to combine facilities, operations, or workforce to eliminate redundant

[5] FAR 31.205-20.

[6] FAR 31.205-6(l).

[7] FAR 52.215-15; CAS 413-50(c)(12).

capabilities, improve future operations, and reduce overall costs.[8] Examples of restructuring costs include severance pay, early retirement incentives, employee retraining, relocation expense, relocation and rearrangement of plant and equipment, and other related costs.[9] Restructuring costs may be amortized over a period not to exceed five years.[10] Under Department of Defense contracts, however, restructuring costs resulting from business combinations (i.e., external restructuring costs), are unallowable unless the contractor can establish, and the cognizant DoD official determines, that the audited projected savings from the restructuring will either (1) exceed the restructuring costs by a factor of two or (2) exceed the costs allowed, and DoD determines that the business combination will result in the preservation of a critical capability that DoD otherwise might lose.[11] Importantly, this limitation on the allowability of restructuring costs does not apply to internal restructuring costs (e.g., where the restructuring occurs within an entity that has been under common control) and also does not apply to contracts with civilian agencies.

RELEVANCE OF NOVATION AGREEMENT

The standard novation agreement provides that "[t]he Government is not obligated to pay or reimburse, or otherwise give effect to, any costs, taxes, or other expenses, or any related increases, directly or indirectly arising out of or resulting from" the transfer of assets.[12] This provision is not limited to professional services, taxes, and corporate expenses directly related to the change in ownership. Rather, for novated contracts, the government is not obligated to pay *any* increase in contract costs that would otherwise not have occurred.

The provision rendering cost increases unallowable has been interpreted to apply not only to the total cost of performance—but to each individual element of cost. For example, the government could disallow cost increases resulting from a higher overhead rate, even if those costs were more than offset by a decrease in the applicable general and administrative expense ("G&A") rate. The net result is that a contractor may be able to recover lower costs from the government, even if its own costs increase.

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[8] CAS 406-61(b); DFARS 231.205-70(b)(2).

[9] CAS 406-61(b); DFARS 231.205-70(b)(4).

[10] CAS 406-61().

[11] DFARS 231.205-70(b)(4).

[12] FAR 42.1204(i), (b)(7).

CHANGES IN COST ACCOUNTING PRACTICES

Different companies have different cost accounting methods and techniques, referred to as cost accounting practices. When two companies merge, one generally changes its cost accounting practices to be consistent with the other. A change in cost accounting practices occurs when there is a change in the method or technique for allocation of cost to cost objectives, assignment of costs to cost accounting periods, or measurement of cost.[13] Examples of changes to cost accounting practices involving the allocation of costs to cost objectives include changes in the methods or techniques for determining whether a cost is allocated directly or indirectly, determining the composition of cost pools, determining the selection of the allocation base over which costs are allocated, or determining the composition of the allocation base.[14]

Changes to cost accounting practices can result in more or less costs being allocated to particular contracts. Accordingly, there are detailed procedural requirements governing changes in cost accounting practices and the treatment of the resulting cost impact to government contracts.[15] The contractor must notify the contracting officer in advance of implementing any change. The contractor is also required to submit a general dollar magnitude ("GDM") proposal that provides an estimated overall impact of the change and to assist the contracting officer in determining whether individual contract adjustments will be necessary. In most cases, the contractor will subsequently be required to submit a detailed cost impact statement ("DCI") that quantifies the impact of the changed cost accounting practice on a contract-by-contract basis.

The contractor is then required to agree to an adjustment based on the cost impact to each contract. The goal of this exercise is to ensure that the government does not pay any more, or any less, than it would if there had not been a change in the cost accounting practice.

Because changes in cost accounting practices can result in liability to the government, it is important to identify three common scenarios that are *not* considered changes to cost accounting practices.

First, changes in the size and composition of cost pools are not changes in cost accounting practices. So long as both entities use the same pool and the same base to allocate a particular type of cost, combining the pools does not create a change in a cost.

Second, the initial adoption of a cost accounting practice is not a change in

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[13] 48 C.F.R. §§ 9903.302-1; 9903.302-1.

[14] 48 C.F.R. §§ 9903.302-1(c).

[15] *See generally* FAR 52.230-6.

a cost accounting practice.[16] If, for example, Company A has a disclosed practice of amortizing restructuring costs and Company B does not have any disclosed practice with respect to restructuring costs, Company B's adoption of the practice of amortizing restructuring costs would not constitute a change in a cost accounting practice.

Third, revising a cost accounting practice for a cost that previously had previously been immaterial is not a change in cost accounting practice.[17] Whether or not a cost was previously material depends on the facts and circumstances. Contractors should be forewarned, however, that a government auditor's perspective on what constitutes a material cost is likely to be far broader than their own.

COMPETITIVE ANALYSIS

An acquisition can have a significant impact on a contractor's direct and indirect cost rates, and, thus the most probable cost of performing a government contract. Transactions consummated during competitive acquisitions can complicate the government's cost analysis, resulting in disadvantageous cost realism evaluations when the financial impacts of the deal cannot be predicted with accuracy or confidence. Accordingly, it is important to consider the timing of significant corporate transactions vis-a-vis major competitions as well as potential strategies, such as rate caps, to mitigate the risk of an upward cost realism adjustment.

CONCLUSION

The regulations applicable to the accounting treatment of government contracts mergers and acquisitions are complex. When in doubt, let two simple rules be your guide:

1. If a cost would not have been incurred but for a merger or acquisition, it is probably unallowable.
2. If you think it is allowable, be certain—because your decision will be scrutinized by DCAA.

These guidelines will go a long way to keeping you out of trouble.

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[16] 48 C.F.R. §§ 9903.302-2(a).

[17] 48 C.F.R. §§ 9903.302-2(a).