SELECTED AREAS OF COST

Chapter 63 - EXTERNAL RESTRUCTURING COSTS

Authoritative Sources

- DFARS 231.205-70 External Restructuring Costs
- PGI 231.205-70(d), External Restructuring Costs
- FAR 31.205-6(l), Compensation Incidental to Business Acquisitions
- FAR 31.205-27, Organization Costs
- DFARS 231.205-6(f)(1), Compensation for Personal Services-Restructure
- 48 CFR 9904-406 (CAS 406) Cost Accounting Period

This chapter provides supplemental guidance on the external restructuring costs allowability requirements of DFARS 231.205-70; Procedures and ACO responsibilities at PGI 231.205-70(d); and auditing the contractor's external restructuring proposal and incurred costs.

This chapter addresses the following topics:

Introduction

Contractors frequently consolidate and restructure to reduce operating costs and thereby reduce contract costs. Unique requirements have been established governing the evaluation and approval of costs related to restructuring activities resulting from business combinations.

63-1 Legislation and Regulations (Return)

General Audit Guidelines

Since August 1994, various legislation was enacted to restrict the reimbursement of restructuring costs associated with a business combination. For business combinations occurring after September 30, 1996, legislation requires that for external restructuring costs to be allowable, the projected savings must either:

- exceed allowable costs by a factor of two to one, **or**
- exceed allowable costs and the business combination will result in the preservation of a critical capability that might otherwise be lost to the Department.

DFARS 231.205-70 prescribes policies and procedures regarding a contractor's external restructuring costs. Several steps are required before external restructuring costs may be reimbursed. The procedural steps relating to the Government's responsibilities are provided in the DFARS resource companion guide, Procedures, Guidance, and Information (PGI), at PGI 231.205-70.

(1) The first step for the cognizant ACO is to promptly novate contracts when required. The novation agreement must include the provision at DFARS 242.1204(ii) which allows increased costs on flexibly priced novated contracts for restructuring, provided that the transferee demonstrates that the restructuring will reduce overall costs for DoD (and the National Aeronautics and Space Administration (NASA) when there is a mix of DoD and NASA contracts). DoD will not treat a shifting of costs from DoD contracts to NASA contracts as an overall cost reduction for DoD. Restructuring costs are not allowed until execution of the advance agreement required by DFARS 231.205-70(c)(3).

(2) The cognizant ACO must take other steps before external restructuring costs may be either reimbursed on the flexibly priced contracts that were awarded after the business combination or included in the price of future fixed-price contracts. These steps are outlined at PGI 231.205-70(d) and include requirements for the ACO to obtain an adequate restructuring proposal, which must be audited.

(3) The advance agreement will not be executed until the Under Secretary of Defense for Acquisition and Sustainment (USD A&S) or for external restructuring costs less than $25 million over a 5 year period, the Director DCMA, determines in writing that projections of future cost savings from the business combination

are based on audited cost data and should either (a) exceed allowable restructuring costs by a factor of two to one on a present value basis, or (b) exceed allowable costs on a present value basis and the business combination will result in the preservation of a critical capability that might otherwise be lost to DoD. Until the determination is obtained, the contractor must segregate restructuring costs and suspend those costs from billings, final contract price settlements, and overhead settlements, as noted at PGI 231.205-70(d)(ii).

(4) The audit, ACO review, and USD (A&S) or Director DCMA determination requirements of DFARS 231.205-70 apply only to external restructuring activities that:

(a) occur after a business combination,

(b) affect the operations of companies not previously under common ownership or control,

(c) are initiated within three years of the business combination, and

(d) result in costs allocated to DoD contracts of $2.5 million or more.

The phrase “initiated within three years” means that a restructuring decision was made within three years of the business combination. Each of these four conditions must be met for DFARS 231.205-70 to apply.

(5) Testing for the $2.5 million materiality threshold should be based on the best information currently available. A decision that the threshold is not met should not be reversed in the future if conditions change (e.g., actual business mix differs from projected business mix) and actual DoD reimbursement exceeds $2.5 million. The materiality threshold applies to all external restructuring activities associated with a business combination. It is not to be applied project by project or segment by segment. A general dollar magnitude estimate should be sufficient to determine if the $2.5 million threshold is met.

63-2 Contents of External Restructuring Proposals (Return)

General Audit Guidelines

The proposals for external restructuring costs, as noted at DFARS PGI 231.205-70(d)(iii), must show projected external restructuring costs and savings by year and by cost element. Data supporting the projections and the methods by which restructuring costs will be allocated must also be included.

The following basic elements should be part of any external restructuring proposal and its supporting data:

- An outline of proposed external restructuring actions, anticipated time span for accomplishing proposed actions, and the affected locations.

- A summary of proposed external restructuring costs and savings, by year and by cost element, that includes the present value of the DoD share of projected costs and savings.
- Points of contact for obtaining clarification or additional information.
- A description of how external restructuring costs will be accumulated and amortized (if restructuring costs will be accounted for as a deferred charge), and the methods by which external restructuring costs will be allocated. External restructuring costs should be identified separately from internal reorganization costs, if any.
- A plan for updating forward pricing rates to reflect the impact of projected external restructuring savings. External restructuring costs may also be reflected in the forward pricing rates provided the contracts priced with the rates include a downward price adjustment clause to remove restructuring costs should the written determination required by DFARS 231.205-70(c)(4)(i) not be obtained.
- Supporting data sufficient to establish the reasonableness of the external restructuring cost and savings projections.

63-3 Coordinated Audit Approach (Return)

General Audit Guidelines

To accomplish effective and timely audits of contractor external restructuring proposals at multi-segment contractors, it is important that the DCAA Contract Audit Directorate (CAD) maintain effective communications with all affected DCAA offices throughout the review process. If a CAD POC has not been assigned to a multidivisional contractor, the regional director cognizant of the corporate home office will designate a Corporate Home Office Auditor (CHOA) or Group Audit Coordinator (GAC), as applicable. The DCAA CAD program, for major multi-segment contractors and other specific groups of contractors, is described in CAM 15-200.

63-4 Purpose and Scope of Audit (Return)

General Audit Guidelines

The purpose of the contractor's external restructuring proposal audit is to verify that savings projected from the external restructuring for DoD contracts will exceed the allowable external restructuring costs by a factor of two to one on a present value basis or that the savings will exceed the allowable costs and the business combination will result in the preservation of a critical capability that might otherwise be lost to DoD. Specifically, the audit should determine that:

- The contractor’s classification of costs as external restructuring costs is proper.
- The projected external restructuring costs are allowable, reasonable, and allocable to Government contracts.

- The projected external restructuring savings represent reasonable estimates of future cost reductions that will accrue to the Government resulting from the contractor's restructuring activities.
- The external restructuring savings will exceed external restructuring costs on a present value basis.
- Savings resulting from the external restructuring will exceed costs allowed by a factor of at least two to one; or exceed allowable costs and the business combination will result in the preservation of a critical capability that might otherwise be lost to the Department.

63-5 Evaluation of Projected Costs (Return)

62-5.1 Definition of Restructuring Costs

Restructuring that is a direct outgrowth of a business combination is termed "external restructuring." External restructuring costs are defined in DFARS 231.205-70(b)(4) as the costs, both direct and indirect, of restructuring activities. A restructuring activity is defined as:

- A nonroutine, nonrecurring, or extraordinary activity to combine facilities, operations, or workforce, in order to eliminate redundant capabilities, improve future operations, and to reduce overall costs.
- It is not a routine or ongoing repositioning and redeployment of a contractor's productive facilities or workforce (e.g., normal plant rearrangement or employee relocation).
- It is not other routine or ordinary activities charged as an indirect costs that would otherwise have been incurred (e.g., planning and analysis, contract administration and oversight, or recurring financial and administrative support).

63-5.2 Evaluation of Employee Related Costs

- Employee Termination Costs. Employee termination costs such as early retirement incentive or severance payments may be incurred to effect reductions in the contractor's workforce as part of external restructuring efforts. The auditor should review any proposed employee termination costs to determine if the expense is allowable under FAR 31.205-6, *Compensation for personal services* (see Selected Areas of Cost Guidebook, Chapter 10, *Compensation for Personal Services*).

- Retention Pay. The cost of a plan introduced in connection with a change in ownership through which employees receive special compensation that is contingent upon the employee remaining with the contractor for a specified period of time is unallowable under FAR 31.205-6(l), *Compensation incidental to business acquisitions*. This cost principle is typically applicable to "golden handcuff" arrangements with key executives upon a business combination. It should not be applied to plans that provide additional dismissal wages to employees who remain with the contractor until their employment is involuntarily terminated (e.g., until a plant is closed). The allowability of such dismissal wages should be determined under FAR 31.205-6(g), *Severance pay*.

- Employee Relocation Costs. Employee relocation costs may be incurred when a contractor's external restructuring activities involve the consolidation of facilities or functions from different geographic locations. The auditor should review any proposed relocation costs to determine if allowable under FAR 31.205-35, *Relocation costs* and FAR 31.205-46, *Travel costs* (see Selected Areas of Cost Guidebook, Chapter 61, *Relocation Costs*, and 72, *Travel Costs*).

- Recruitment Costs. Recruitment costs may be incurred to hire employees at new or expanded contractor locations resulting from a contractor's external restructuring activities. The auditor should review any proposed recruitment costs to determine if allowable under FAR 31.205-34, *Recruitment costs* (see CAM 6-408 and Selected Areas of Cost Guidebook, Chapter 60, *Recruitment Costs*).

- Employee Training. Employee training costs may be incurred to train employees on new or modified practices resulting from a contractor's external restructuring activities. The auditor should review any proposed training costs to determine if allowable under FAR 31.205-44, *Training and education costs* (see Selected Areas of Cost Guidebook, Chapter 71, *Training and Education Costs*).

- Bonuses. Costs for bonuses or other payments in excess of the employee's normal salary that are part of external restructuring costs associated with a business combination are unallowable under DoD contracts per DFARS 231.205-6(f)(1). This DFARS limitation does not apply to severance and early retirement incentive payments. Reasonable payments for these types of costs are allowable subject to the provisions in FAR 31.205-6(g), Severance Pay, and (j)(6), Early Retirement Incentives. (see Selected Areas of Cost Guidebook, Chapter 7, *Bonuses and Incentive Compensation.* .

- Pension and Post Retirement Health Benefit Costs**.** After a business combination, a contractor may have employees who are covered by multiple pension and post-retirement health benefit plans. As a result, the contractor may decide to modify the existing plans to provide for comparable benefits or to merge the plans together into a single plan covering all employees. The cost of implementing these changes and any associated increases in pension and post-retirement health benefit costs do not meet the DFARS definition of restructuring costs. Depending upon their nature and extent, other changes and their associated cost increases may not meet the definition of restructuring costs (see DFARS 231.205-70). For example, increased pension costs resulting from changes in actuarial assumptions (e.g., changes in interest rates) would not meet the DFARS definition of restructuring costs. On the other hand, increases in actuarial liabilities of the pension plan resulting from contractor implementation of an early retirement incentive plan would meet the DFARS definition of restructuring costs if done in connection with an external restructuring activity. In either case, the auditor may need to establish a separate review to determine if the changes are in compliance with the requirements of FAR 31.205-6, *Compensation for personal services,* CAS 412, *Cost accounting standard for composition and measurement of pension cost*, and CAS 413, *Adjustment and allocation of pension cost* (see Selected Areas of Cost Guidebook, Chapter 53, *Pensions*).

63-5.3 Evaluation of Facilities Related Costs

- Idle Facilities. FAR 31.205-17, *Idle facilities and idle capacity costs*, provides that costs of idle facilities are allowable for a reasonable period, usually not to exceed one year, depending upon the initiative taken to use, lease, or dispose of the idle facilities. The regulation provides the contracting officer with the flexibility to accept idle facilities costs for a period greater than one year. When the contractor has identified facilities that are expected to be idle for longer than one year, the auditor should recommend that the contracting officer obtain justification from the contractor for the time in excess of one year. The contractor should address, at a minimum, the following areas:
  - Whether the facility will be needed in the future, and if so, why.
  - If not needed for future operations, the actions that are being taken to lease or dispose of the facility.
  - An estimate of the time it should take to lease or dispose of the facility based on an analysis of existing market conditions, such as surveys of real estate prices, public records of real estate sales for similar facilities, etc.

The auditor should assist the contracting officer in determining a reasonable period for accepting idle facilities costs. The contractor and Government should enter into an advance agreement specifying the maximum period for which costs of idle facilities will be reimbursed. If there is no advance agreement between the contractor and the contracting officer to accept idle facilities costs for a period greater than one year, any proposed idle facilities costs beyond one year should be questioned.

- Extraordinary Maintenance and Repairs. The costs of extraordinary maintenance and repairs are allowable provided those costs are reasonable and assigned to the accounting periods in accordance with applicable provisions of CAS and GAAP. However, such costs incurred to prepare a facility for sale are generally factored into the calculation of the gain or loss on the sale. The costs of restoring or rehabilitating the contractor's facilities to approximately the same condition existing immediately before the start of a Government contract, fair wear and tear excepted, are limited in allowability by FAR 31.205-31, *Plant reconversion costs*. Ideally, such costs would be covered by an advance agreement on idle facilities or external restructuring.

- Asset Relocation. Asset relocation costs include the cost of removing the asset from its current location, transportation to the new location, and reinstalling the asset at the new location. Merely moving an asset from one location to another generally does not extend its expected service life or production capacity. Therefore, relocation costs are generally assigned to the cost accounting period in which they are incurred. When incurred in connection with external restructuring, CAS 406-61 *Cost accounting standard – cost accounting period,* provides that asset relocation costs may be included as restructuring costs. When reviewing asset relocation costs, auditors should be alert for the possibility that assets might be improved or bettered in connection with their relocation. If the useful life of a tangible capital asset will be extended or its productivity increased, then the cost of the improvement or betterment should be capitalized and depreciated over the remaining useful life of the asset in accordance with CAS 404-40(d), *Capitalization of tangible assets*. The capitalized costs of betterments or improvements are eligible for facilities capital cost of money under CAS 414, *Cost of Money as an element of the cost of facilities capital*. The reasonableness of proposed relocation costs should be determined under FAR 31.201-3, *Determining reasonableness*.

- Gain/Loss on Sale of Assets. External restructuring is an extraordinary activity that may involve mass or extraordinary dispositions of assets. Dispositions may range from equipment, such as surplus furniture or computer hardware, to an entire plant. The actual gains or losses realized upon disposition of depreciable assets should be reviewed to determine if they are allowable under FAR 31.205-16, *Gains and losses on disposition or impairment of depreciable property or other capital assets* (see Selected Areas of Cost Guidebook, Chapter 19, *Depreciation and CAS 409, Cost accounting standard – depreciation of tangible capital assets*). Proposed gains or losses, which have not been realized and are not based on a firm sales agreement should be treated in accordance with FAR 31.205-7, *Contingencies*. The gain or loss expected from the sale of items for which there is a ready market may be foreseeable within reasonable limits of accuracy. Such projected gains or losses should be included in cost estimates as stated in FAR 31.205-7(c)(1). When a gain or loss cannot be measured or timed within reasonable limits of accuracy, the contractor should exclude it from cost estimates and propose it as a contingency in accordance with FAR 31.205-7(c)(2). When reviewing the contractor's proposed gains or losses, the auditor should be alert for any asset write-ups or write-downs that may have occurred as a result of the business combination (see Selected Areas of Cost Guidebook, Chapter 8, *Business Combination Costs*).

- Environmental Remediation**.** Environmental cleanup efforts may arise in connection with a contractor's external restructuring activities. In general, environmental remediation costs (e.g., cleanup of soil or ground water contamination, removal of asbestos from buildings) do not meet the DFARS definition of restructuring costs. Therefore, these costs should be excluded from the contractor's external restructuring cost and savings proposal and negotiated under a separate advance agreement. The cleaning of a building in preparation for its sale (e.g., cleaning air ducts, removing chemical stains from floors) should normally be treated as extraordinary maintenance and repairs, not environmental remediation (see Selected Areas of Cost Guidebook Chapter 26, *Environmental Costs*).

63-5.4 Evaluation of Other Categories of Costs

- Discontinued Operations. During the external restructuring process, a contractor may have continuing costs associated with discontinued operations (i.e., a segment that is merged, sold, or abandoned). Generally, costs associated with segments that are merged into one or more new or existing segments should be allocated to the new or existing segment where the work effort or contracts are transferred. However, some costs may be addressed by a specific procurement regulation. Pension costs, for example, associated with closed segments should be measured, assigned and allocated in accordance with CAS 413-50(c)(12) *Adjustment and allocation of pension costs*. For other costs, special allocations may be required under CAS 403, *Allocation of home office expenses to segments,* or CAS 418, *Allocation of direct and indirect costs*. To ensure the appropriate regulation is properly applied, the FAO should coordinate with Headquarters (Accounting and Cost Principles Division), through the regional office, when significant costs associated with discontinued operations are encountered.

- Organization and Reorganization Costs. The auditor should be alert for organization or reorganization costs, unallowable under FAR 31.205-27, *Organization costs*, that may have been included in the contractor's external restructuring cost and savings proposal. In addition, when a contractor's external restructuring activities result in the formation or dissolution of separate entities, the auditor should ensure that any organization or reorganization costs are properly excluded from the contractor's external restructuring cost and savings proposals and forward pricing rates. Depending upon the nature and extent of contractor organization or reorganization activities, the auditor may need to establish a separate review to ensure that all associated costs have been properly segregated and excluded from Government contracts (see Selected Areas of Cost Guidebook Chapter 8, *Business Combination Costs*).

- Facilities Capital Cost of Money. Deferred external restructuring costs should not be included in the computation to determine facilities capital cost of money (see CAS 406-61(i) Cost accounting standard – *Cost accounting period*). Deferred charges are not tangible or intangible capital assets as defined in CAS 414-30 Cost accounting standard – *Cost of money as an element of the cost of facilities capital*.

- Credits. Reductions in workforce and facilities should reduce the cost of various employee benefit plans (e.g., health insurance, life insurance) and property and casualty insurance plans. This may lead to credits from insurance companies as reserves are reduced or policies canceled. Auditors should be alert for such credits and the requirement in FAR 31.201-5 *Credits* for the applicable portion to be credited to the Government either as a cost reduction or by cash refund, as appropriate.

63-6 Evaluation of Projected Savings (Return)

General Audit Guidelines

Contractor external restructuring efforts are intended to result in combinations of facilities, operations, or workforce that eliminate redundant capabilities, improve future operations, and reduce overall costs. Benefits which accrue to the Government from a contractor's external restructuring efforts are the overall reduced costs on future contracts and existing flexibly priced contracts. Cost reductions on already negotiated firm-fixed-priced contracts are **not** savings to the Government.

63-7 Determination of Present Value and Overall Reduced Costs (Return)

General Audit Guidelines

DFARS 231.205-70(c)(4)(i) requires a written determination that the audited projected external restructuring savings will exceed external restructuring costs on a present value basis. The auditor should review the contractor's methodology for discounting projected external restructuring costs and savings to determine if it is reasonable under the circumstances. Overall reduced costs should be computed based on external restructuring costs and savings that will be realized over the next five years. Those costs and savings that are not stated in current year dollars should be discounted to current year dollars (present value) using the most recently published Federal Register cost of money rate.

PGI 231.205-70(d)(viii) requires the cognizant ACO to negotiate an advance agreement with the contractor that includes a cumulative cost ceiling for restructuring projects and, when necessary, a cost amortization schedule. Projected external restructuring savings must exceed allowable external restructuring costs, on a present value basis by a factor of at least two to one, or the external restructuring costs allowed, and the business combination will result in the preservation of a critical capability that might otherwise be lost to DoD. Auditors should provide any assistance requested by the ACO in making present value calculations during negotiation of the advance agreement.

63-8 CAS Considerations (Return)

63-8.1 Assignment of Costs to Cost Accounting Periods

The Cost Accounting Standards (CAS) Board issued the interpretation at CAS 406-61 on June 6, 1997. The interpretation clarifies whether external restructuring costs are to be treated as an expense of the current cost accounting period or as a deferred charge that is subsequently amortized over future cost accounting periods. The interpretation is applicable to contractor restructuring costs (both external and internal) that are paid or approved on or after August 15, 1994.

Paragraph (e) of CAS 406-61 requires that the costs of all restructuring activities comprising a specific restructuring event be accounted for as a deferred charge unless the contractor proposes, and the contracting officer agrees, to expense the costs in the current accounting period. A contractor may defer the costs of one restructuring event (e.g., restructuring in connection with acquisition of Company A) and propose to expense the costs of a subsequent restructuring event (e.g., restructuring in connection with Company B years later), subject to the CAS Board rules governing cost accounting practice changes. However, a contractor may not defer the costs of some activities and expense the cost of others that comprise a specific restructuring event. According to CAS 406-61 (e), "*Contractor restructuring costs defined pursuant to this section may be accumulated as deferred cost, and subsequently amortized, over a period during which the benefits of restructuring are expected to accrue. However, a contractor proposal to expense restructuring costs for a specific event in a current period is also acceptable when the Contracting Officer agrees that such treatment will result in a more equitable assignment of costs in the circumstances.*"

The Director, Defense Procurement, Acquisition Policy, and Strategic Sourcing (DPAPSS), issued guidance on May 20, 1997 which stated that it would be appropriate to accept a contractor's proposal to expense restructuring costs in the current period when expensing should result in overall lower costs for DoD. In making this assessment, the business base (Government versus commercial contracts) and the contract mix (fixed price versus cost reimbursement) for current and future years should be considered.

Deferred restructuring costs should be amortized over the same period of time during which the benefits of restructuring are expected to accrue. However, the amortization period is limited by CAS 406-61(h) which states: "*The amortization period for deferred restructuring costs shall not exceed five years. The straight line method of amortization should normally be used, unless another method results in a more appropriate matching of cost to expected benefits*."

63-8.2 Allocation of External Restructuring Costs to Cost Objectives

- Direct External Restructuring Costs. External restructuring costs which benefit a single cost objective should be charged directly to that cost objective. For example, if a contractor's external restructuring activities result in a need to recalibrate special test equipment which is related to a single contract, the recalibration costs should be assigned directly to that contract.

- Indirect Restructuring (Reorganization) Costs. CAS 406-61(j) states: "*Restructuring costs incurred at a home office level shall be treated in accordance with the provisions of 9904.403. Restructuring costs incurred at the segment level that benefit more than one segment should be allocated to the home office and treated as home office expense pursuant to 9904.403. Restructuring costs incurred at the segment level that benefit only that segment shall be treated in accordance with the provisions of 9904.418. If one or more* *indirect cost pools do not comply with the homogeneity requirements of 9904.418 due to the inclusion of the costs of restructuring activities, then the restructuring costs shall be accumulated in indirect cost pools that are distinct from the contractor's ongoing indirect cost pools*."

63-8.3 Disclosure of Cost Accounting Practices and Changes to Cost Accounting Practices

Accurate disclosure statements are required by 48 CFR 9903.202-3. If the deferral of restructuring costs results in a new or changed cost accounting practice, the contractor is required to file a revised disclosure statement describing the cost accounting practices associated with estimating, accumulating, allocating, and reporting of deferred external restructuring costs. The contractor is also required to revise its disclosure statement for any other changes to cost accounting practices that result from the external restructuring. Audits of the revised disclosure statement should be conducted in accordance with CAM 8-303.3.

(f) states: "*If a contractor incurs restructuring costs but does not have an established or disclosed cost accounting practice covering such costs, the deferral of such restructuring costs may be treated as the initial adoption of a cost accounting practice (see 9903.302-2(a)). If a contractor incurs restructuring costs but does have an existing established or disclosed cost accounting practice that does not provide for deferring such costs, any resulting change in cost accounting practice to defer such costs may be presumed to be desirable and not detrimental to the interests of the Government (see 9903.201-6). Changes in cost accounting practices for restructuring costs shall be subject to disclosure statement revision requirements (see 9903.202-3), if applicable*."

Contractor restructuring activities may also result in changes to cost accounting practices other than deferral of restructuring costs. For example, as a direct result of restructuring activities, the contractor may decide to change from a value-added base to a total cost input base for allocation of its G&A pool. It is important for the auditor to gain an understanding of the old cost accounting practice and the new cost accounting practice to determine if the new cost accounting practice complies with CAS and if the change impacts the contractor's estimated restructuring savings.

Cost accounting practice changes associated with restructuring activities that (1) took place prior to June 14, 2000 or (2) do not meet the requirements of 10 U.S.C. 2325 are subject to the administrative procedures outlined in the CAS contract clause at 48 CFR 9903.201-4(a)(4). See further guidance in CAM 8-502.3.

63-9 Reporting Results of Audit (Return)

General Audit Guidelines

Audit reports should follow the format for Audit Reports on Price Proposals, modified as appropriate. To promote consistency, external restructuring cost and savings proposal audit reports should be reviewed prior to issuance by the Regional/CAD Office. Auditors should take appropriate actions to ensure that sufficient time is available to facilitate these reviews within the required due dates.

63-10 Forward Pricing Considerations (Return)

63-10.1 Adjustment of Forward Pricing Rates

A plan for updating forward pricing rates to reflect the impact of projected external restructuring costs and savings should be developed with the contractor and cognizant ACO at an early stage. Upon receipt of the contractor's external restructuring cost and savings proposal, the auditor should be prepared to advise the cognizant ACO on the contractor's adjustments to forward pricing rates to reflect the impact of projected external restructuring costs and savings.

PGI 231.205-70(d)(v) requires that the cognizant Administrative Contracting Officer adjust forward pricing rates to reflect the impact of projected restructuring savings as soon as practicable.

63-10.2 Reopener or Savings Clauses in Forward Pricing Reports

PGI 231.205-70(d)(v) provides that if external restructuring costs are included in forward pricing rates prior to execution of the required advance agreement, the contracting officer shall include a repricing clause in each fixed price action that is priced based on the rates. The repricing clause must provide for a downward price adjustment to remove external restructuring costs if the written determination required by DFARS 231.205-70(c)(4)(i) is not obtained.

In addition to the repricing clause required by PGI 231.205-70(d)(v), the auditor should recommend a contract reopener or savings clause in the audit report on a contract price proposal when a major contractor acquisition, merger, or associated external restructuring is significant and the effect on the price proposal cannot be reasonably determined.

63-10.3 TINA Considerations

Defective pricing occurs when a contractor does not submit or disclose to the Government certified cost or pricing data that is accurate, complete, and current prior to reaching a price agreement. Generally, the auditor establishes the existence of defective pricing in a Truth in Negotiation compliance audit by examining and analyzing the records and data available to the contractor as of the date of prime contract agreement on the price and comparing them with the submitted certified cost or pricing data (CAM 14-102).

63-11 Reimbursement of External Restructuring Cost (Return)

General Audit Guidelines

PGI 231.205-70(d)(ii) requires the cognizant ACO to direct the contractor to segregate external restructuring costs and to suspend these amounts from any billings, final contract price settlements, and overhead settlements until a written determination is obtained from the designated official (DFARS 231.205-70(c)(4)(i)). When contractors incur restructuring costs prior to obtaining the determination, the auditor may need to evaluate the contractor's internal controls to determine if they are adequate to reasonably ensure that external restructuring costs are properly accounted for and excluded from contract billings, final contract price settlements, and overhead settlements. This evaluation should include limited transaction testing to determine if the controls have been implemented and are working effectively. Floor checks, physical observations (see CAM 6-405) or other time sensitive audit procedures may be performed, when appropriate, for the risks identified.

Costs of activities such as external restructuring planning and analysis, contract administration and oversight, and recurring financial and administrative support, when performed by employees whose costs would otherwise have been incurred, are not external restructuring costs as defined by DFARS 231.205-70(b)(2). Therefore, such costs should not be excluded from contract billings, final contract price settlements, and overhead settlements merely because the written determination required by DFARS 231.205-70(c)(4)(i) has not been obtained.

63-12 Internal Reorganization Cost (FAR Part 31.205-27) (Return)

General Audit Guidelines

The term “internal reorganization activities” means all restructuring/reorganization activities that are not subject to DFARS 231.205-70, *External restructuring cost*. While DFARS 231.205-70 does not apply to internal reorganization activities, an advance agreement on internal reorganization costs should be recommended since the costs are unusual and can be substantial. This is particularly true if the cost is to be accounted for as a deferred charge. FAR 31.109(a) advises contracting officers and contractors to seek advance agreement on the treatment of special or unusual costs to avoid possible subsequent disallowance or dispute based on reasonableness, allocability, or allowability.

The criteria in FAR 31.201-3 should be applied in determining the reasonableness of internal reorganization costs. Evidence of reasonableness might include an analysis of costs and benefits (e.g., reduced costs, more efficient use of resources, improved financial capability). The criteria in FAR 31.201-4 should be applied in determining the allocability of internal reorganization costs. Allocations of reorganization costs should comply with applicable Cost Accounting Standards. The interpretation at CAS 406-61 is applicable to reorganization costs associated with restructuring activities taken after a business combination or after a decision is made to execute a significant restructuring event not related to a business combination. CAS 406-61 clarifies, "*Restructuring activities do not include ongoing routine changes an entity makes in its business operations or organizational structure*." CAS 406-61 also states, "*Restructuring costs do not include the cost of such activities when they do not relate either to business combinations or to other significant nonrecurring restructuring decisions*." Costs properly classifiable as internal reorganization costs may be deferred and subsequently amortized over a period during which the benefits of restructuring are expected to accrue (not to exceed 5 years).

The contractor should include the reduction in overall cost levels expected from internal reorganization into its forward pricing rates and contract price proposals. If this does not occur, auditors should follow procedures in CAM 9-1208c and CAM 9-1209b in advising the cognizant ACO to request a revised forward pricing rate proposal from the contractor.

63-13 Auditing Incurred Restructuring Costs (Return)

General Audit Guidelines

The final determination of allowability of incurred restructuring costs can only be made after the contractor provides the annual certified incurred cost proposal. FAR 52.216-7, *Allowable Cost and Payment*, and FAR 42.705-1, *Contracting Officer Determination Procedure*, require the contractor to support its proposal with adequate data. The auditor should obtain from the contractor whatever data is deemed necessary to support the amortized external restructuring or reorganization costs claimed (e.g., amortization schedules for deferred costs and detailed schedules of the incurred costs by fiscal year, project and cost element). The support should be at a level of detail sufficient to allow the auditor to determine the allowability of incurred external restructuring or reorganization costs.

Definitions

Business Combination is defined by DFARS 231.205-70(b)(1) as: "…*a transaction whereby assets or operations of two or more companies not previously under common ownership or control are combined, whether by merger, acquisition, or sale/purchase of assets.*" FASB defines a business combination as: "*a transaction or other event in which an acquirer obtains control of one or more businesses*." (Return)

Common Ownership or Control is, generally, when an individual company or enterprise holds more than 50 percent of the voting ownership interest of each entity. FASB defines control as: "*the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an entity through ownership, by contract, or otherwise.*" (Return)

External restructuring activities is defined by DFARS 231.205-70(b)(2) as: "…*restructuring activities occurring after a business combination that affect the operations of companies not previously under common ownership or control. 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.*" (Return)

Novation agreements are legal instruments executed by Contractor (transferor), the Successor (transferee) and the Government. The transferor guarantees performance of the contract, the transferee assumes all obligations under the contract, and the Government recognizes the transfer of the contract and related assets. (Return)

Present Value (PV) is the current value of a sum of money or an expected future stream of cash flows. It is based on the concept of the time value of money (a dollar today is likely to be worth more than the same dollar is tomorrow). It is determined by discounting the future value by the estimated rate of return that the money could earn if invested. (Return)

Procedures, Guidance and Information is a DFARS companion resource created in the mid-2000s during the DFARS Transformation project. PGI 231.205-70(d) contains internal DoD policies and procedures which are not regulations governing contracting parties. (Return)

Restructuring activities is defined by DFARS 231.205-70(b)(3) 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. Restructuring activities do not include routine or ongoing repositionings 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).*" (Return)

Restructuring costs is defined by DFARS 231.205-70(b)(4) as: "…*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.*" (Return)

Restructuring savings is defined by DFARS 231.205-70(b)(5) as: "*… cost reductions, including both direct and indirect cost reductions, that result from restructuring activities. Reassignments of cost to future periods are not restructuring savings.*" (Return)