RETHINK *Everything*

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The New Imperative for Federal Government Contractors

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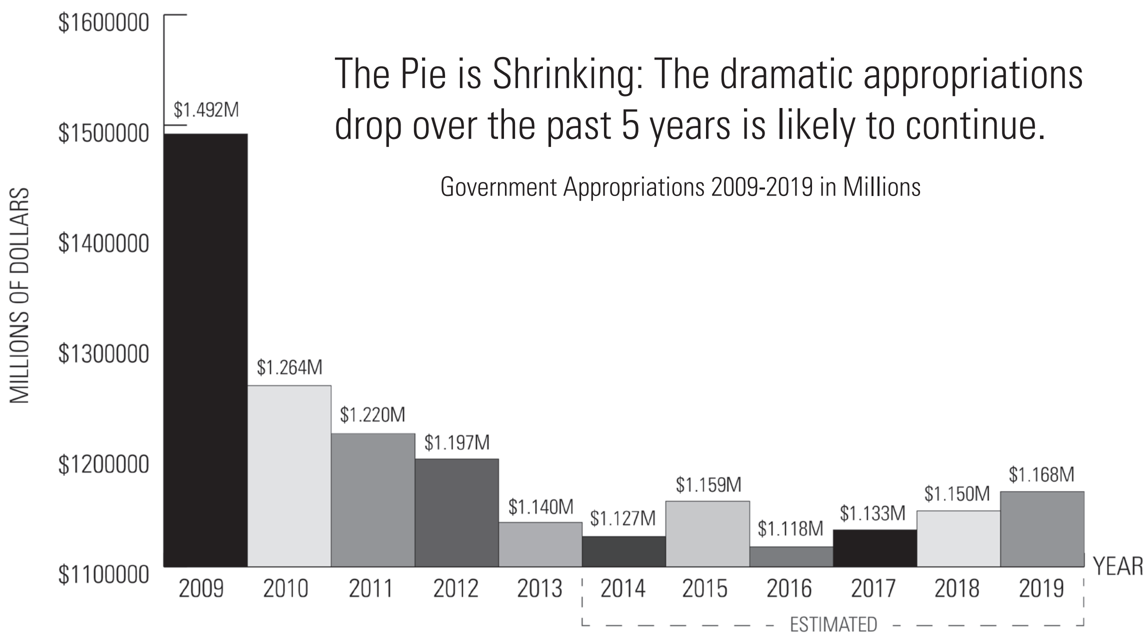
WHY GOVERNMENT CONTRACTORS NEED TO <RETHINK> EVERYTHING

Federal government spending on contracts, which experienced a steady decline from FY2009 to fiscal 2012, fell further by nearly $58 billion in fiscal 2013. All indicators point to flat spending at best being the new normal in the coming years.

Office of Management and Budget spokesman Frank Benenati recently delivered a sobering statement on the immediate future of federal contracting. He said OMB is expecting agencies "…to continue these smarter buying practices to deliver even more value to the taxpayers." The implication for contractors is clear: be prepared to be more competitive, that is, for fewer contracts and smaller margins.

According to Lexy Kessler, lead partner of the Government Contract Services Group at Aronson LLC, this means that the prospects for federal government contractors have changed substantially. "The latest budget projections clearly demonstrate that government contractors have a customer that isn't spending money like it used to," she said. "With increased oversight and a higher cost of doing business with the government, savvy government contractors will have to rethink everything they do to operate more competitively in this environment. Thinking outside the box will be critical in securing contracts and staying profitable."



Source: Office of Management and Budget, Budget of the United States Government 2015, HIstorical Tables, Table 5.6

In an industry that not long ago saw continuous and unprecedented growth, contractors must now look at ways to reengineer processes and operational tactics to combat dwindling profit margins and gain market share. Contractors need to think commercially and be more aggressive in establishing competitive differentiators. In addition, the shift to the Lowest Price Technically Acceptable (LPTA) contract award mechanism will continue to squeeze margins.

This whitepaper offers government contractors an inside look at the key issues they face in 2014 and beyond and Aronson's recommended strategies for turning these challenges into opportunities.

1. EARNING LESS, COMPETING MORE

While federal spending will remain flat, the areas where those dollars are allocated will be subject to great fluctuation. Military spending has already experienced a significant decline and, barring a new crisis, that drop is expected to continue. However, federal spending on cybersecurity, green initiatives and health IT is growing. As those priorities become better known, the number of contractors bidding for work in those areas will also grow. This, in combination with the emphasis on LPTA, will lead to heightened competition in these hot markets.

> "Because of budget cuts, average lease terms for contractors in Northern Virginia last year fell 22.5%."
>
> *Source: Washington Post Article 'Government contractors cut back on leases in 2013'*

GSA's mandate to increase its market share is leading to procedural changes that are also driving prices down. According to Hope Lane, lead consulting partner in Aronson's Government Contract Services Group, commercial pricing practices of others on the GSA Schedule should be of particular concern if your contract is coming up for renewal. "D.C.-area contractors are being squeezed out by competitors in regions where salaries, real estate and other overhead is significantly lower," she said. "Rethinking pricing strategy is going to be an important part of doing business with the government moving forward."

More effective management of both direct and indirect costs will also help contractors beat their competition. "Looking at pricing from both a bottoms-up and top-down approach is paramount," Lane said. "If a top-down analysis indicates that a win on a particular vehicle will lead to losses, move on. Bid & Proposal (B&P) dollars are precious and should be treated that way."

Aronson government contracting partner Mike Muscatello says that being increasingly strategic about bid/no-bid decisions will also be critically important. "More than ever, you must know the customer and the likelihood that the proposal will make it all the way through award." B&P dollars will need to be more tightly managed than ever before on a risk-adjusted basis to avoid spending on efforts that will not be successful or never awarded.

For current work, contractors will be best served by managing their direct and indirect costs. In the new environment, CFOs will need to go line-by-line and person-by-person on direct costs to ensure that loaded labor rates yield a profit. Assuming they are qualified, employees may need to be reassigned to different contracts or labor categories to ensure profitability.

Contractors will also need to look at diversification.

Diversification can occur both organically or through mergers and acquisitions (M&A). M&A will be an increasingly popular tactic and many small business contractors that are unprepared for today's new climate consider merging together or being acquired by larger companies. In addition, certain companies may have underused contract vehicles that can be a real opportunity for a buyer that needs a particular vehicle to grow.

According to Muscatello, this strategy can be a win/win in the current environment because it will provide cash flow from an underutilized vehicle while providing growth opportunities for a company that knows how to capitalize on the contract. Smaller companies that tend to have higher concentrations of customers should consider diversification into new customers within current agencies or into new agencies altogether to mitigate the risks associated with inevitable shifts in spending.

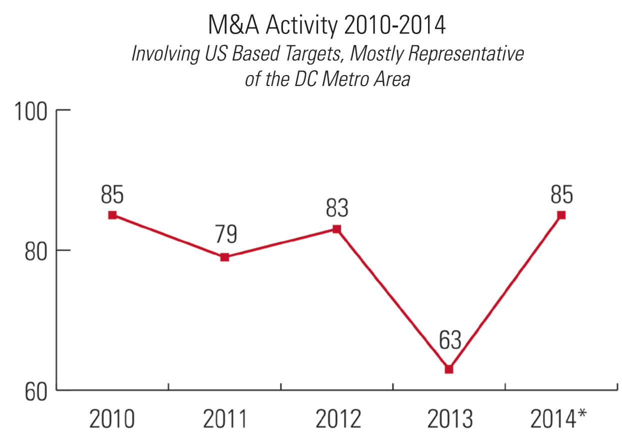
Contractors should also consider joint ventures and teaming agreements to win new contracts. "Bidding with other businesses that have complementary strengths can make a more complete and compelling proposal, Muscatello said. "Contractors must identify the contract vehicles that will be the most advantageous for them over the next few years and determine the best way to get on those vehicles, whether through B&P efforts, M&A activity, or joint ventures and teaming partners."

2. M&A ACTIVITY BACK ON THE UPSWING

Many contractors looking to diversify will need to become merger and acquisition players in coming years.

Aronson Capital Partners' Principal Larry Davis expects a significant increase in deals in 2014. "We will see an increase in mergers among small and mid-size companies that are highly focused in priority markets," he said. "The market will see an uptick in larger transactions resulting from the Bipartisan Budget Act of 2013. We also will continue to see divestitures from primes as they focus on building critical mass in areas where they have competitive differentiation. Businesses outside those areas will be sold, split off, or ended."

After a dramatic drop in 2013, 2014 M&A Activity is projected to rebound.



*While 2013 was certainly a down year, there was a significant uptick in quarter one of 2014, supporting the conclusion that 2014 will see around 85 deals closed by the end of quarter four.

Source: Aronson Capital Partners research

Davis believes that companies with significant exposure to set-aside contracts or non-mission critical programs may need to consider a broader array of liquidity options to maximize shareholder value. In the current M&A environment, the adoption of an employee stock ownership plan (ESOP) or a minority recapitalization may provide a superior outcome for these companies compared to a sale to a strategic buyer.

“When considering liquidity event strategies, organizational tax structuring should be a key component in the decision-making process,” said Aronson’s lead tax partner Mario DeLuca. “The increased sale to ESOPs will present both challenges and opportunities for contractors. On the one hand, they will need to contemplate the costs associated with setting up and maintaining an ESOP. On the other hand, those costs may be balanced by deferring some of the tax gain pursuant to the Internal Revenue Code.”

According to DeLuca, contractors should continue to expect to see Section 338(h)(10) elections where a stock sale is treated as an asset in acquisitions of corporate subsidiaries or S corporations. Under the right circumstances, this tax structure results in a win-win for both buyer and seller because it allows the buyer to generate current tax deductions and the seller to pay the tax at the lower capital gains rates.

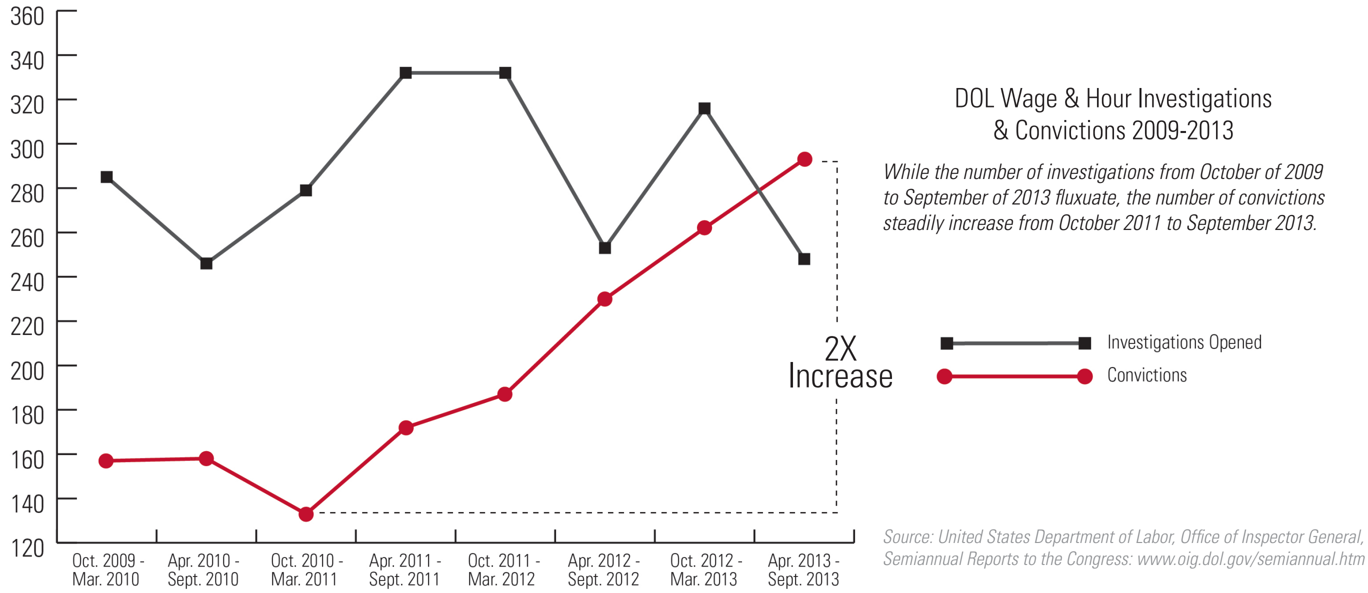
3. RULE BREAKERS BEWARE

There has been an increased focus on contractor compliance since the GAO’s report on the Defense Contract Audit Agency (DCAA) was issued in September 2009. Today, the focus continues to be on transparency. As DCAA works through its backlog of incurred cost submissions, contractors will be subject to increased scrutiny on what were commonly treated as standard practices several years ago. These practices may be viewed differently – and more negatively -- through today’s lens, however.

Although DCAA recently focused on auditing incurred cost submissions, it will soon get back to normal audit activity such as Cost Accounting Standard (CAS) compliance. “CAS audits significantly decreased as DCAA focused on ICS, but we can expect to see these audits in the next 18 months if you submitted amendments to your CAS disclosure statement,” said Aronson government compliance partner Nicole Mitchell. “CAS noncompliance could result in a contractor owing money back to the government, so ensuring CAS compliance is critical to reducing financial risk.”

Federal Acquisition Regulation (FAR) and CAS compliance is not the only area about which contractors need to be aware. Since the Department of Labor increased the number of investigators looking at Service Contract Act (SCA) compliance, more and more contractors are finding themselves under that microscope as well.
Many contractors tend to gloss over SCA compliance because their fringe rate is rising and they assume that indicates they will be inherently fine. “This is big a mistake,” Lane says. “Companies are not naturally compliant with SCA: it has to be intentional. Usually, SCA compliance is based on an individual calculation. It doesn’t matter how healthy your fringe package is if your employees are opting out of healthcare coverage.” This is particularly true of retired federal government employees and new graduates who tend to opt out of company-sponsored insurance.

There's a New Sheriff in Town: Convictions double after DOL adds 250 investigators.



4. GOVERNMENT CONTRACTING IN THE CYBER AGE

Government agencies are increasingly concerned with the protection of sensitive information and contractors should expect to see greater focus on the development of acquisition regulations surrounding cybersecurity.

Contractors can make security improvements that will prepare them for inevitable compliance requirements by scrutinizing security controls on the organization's various systems. Server configuration settings, ports, protocols, services, firewalls, and intrusion detection systems aren't the only areas that should be considered. Policies, processes, and procedures governing human behavior are equally as important in addressing overall IT risk.

Defense contractors have already seen the impact of cybersecurity concerns on their business. The Department of Defense's latest acquisition clause on safeguarding Unclassified Controlled Technical Information (UCTI) on all new contracts affects DoD contractors of all sizes. Failure to comply with the requirements or to report a cyber incident now constitutes a breach and could result in fines or loss of contract.

While DoD is the first agency to use acquisition regulations to deal with contractor cybersecurity, Aronson IT security expert Jeff Cook says other agencies will follow suit in the near future. The General Services Administration (GSA) is already translating recommendations from a joint DoD and GSA working group's report on improving cybersecurity through acquisition. "It is only a question of when government contractors will be required to implement or improve cybersecurity." Cook recommends all contractors review the new DFARS clause and proactively implement the associated controls. "No one wants to be the target of federal compliance investigators. Even if you don't do business with DoD today, implementing the security controls the clause references will put you ahead of your competitors and reduce your company's cybersecurity risk." At a minimum, Cook adds, contractors should develop a strong incident response policy to address the handling of inevitable cyber incidents.

5. PUT YOUR BACK OFFICE ON THE FRONT BURNER

A contractor's back office will be one of its most effective weapons in weathering government contracting challenges over the next few years. Accounting systems will likely play a key role in doing more with less, and changes in accounting standards and tax legislation will present important new opportunities.

Aronson partner Steve Swales says that contractors looking to trim costs must leverage their infrastructure to increase their bottom line while improving compliance. "The answer to virtually every accounting or compliance challenge is based on deploying more hands or a better tool, and the better tool pays greater dividends in the long run. Profitability in the government contracting space will go to those who effectively manage their indirect costs." That means, Swales says, that an accounting system must not only be capable of the tasks at hand, but also optimized and operated properly to boost compliance without adding personnel. Larger companies may want to consider more comprehensive ERP technology that tracks customers, opportunities, proposal efforts, and workforce planning, in addition to core accounting functions.

On the accounting side, as U.S. GAAP continues to converge with international standards, there will be changes in revenue recognition and lease accounting standards. The adoption of new standards of revenue recognition seems likely, but lease changes, on the other hand, are less certain. Regardless of what changes are made and when they occur, contractors will be required to track more and, in some cases, entirely new data.

Understanding the new rules early will allow contractors to configure systems to track the necessary data before it is required and that will make implementation of the new rules easier when the time comes. In addition, lenders will need to be educated on the new standards because financial covenants in loan agreements may require proactive modification. This is where a contractor's outside audit and accounting advisors will be of help.

The Private Company Council (PCC) has already issued three optional standards (with others on the way) that greatly simplify current accounting rules for privately-held federal contractors. The PCC created alternatives to impairment considerations for goodwill and hedging agreements and for private companies who lease facilities from related parties. If adopted by government contractors, these changes will simplify accounting processes and, ultimately, the audit process as well.

Private contractors will have to monitor these changes closely and consult with experts to determine when they can take advantage of new rules. "All of these standards were created to simplify reporting activities for smaller private businesses that previously faced onerous reporting requirements," said Aronson's lead audit partner Muscatello. "The good news is that similar changes are forthcoming."

6. TAX OPPORTUNITIES AND CHALLENGES

According to Mark Gossart, tax partner in Aronson's Government Contract Services Group, tax planning should be a key component of every contractor's 'Rethink Everything' strategy. Every dollar saved will help companies be more profitable and compete on price.

"There will be opportunities to save on your tax bill in the coming years," Gossart said. "For example, many companies historically have overlooked federal and state research and development (R&D) tax credits due to misconceptions regarding the definition of R&D." Assuming the federal R&D tax credit is extended, there are many activities within their contracts that federal contractors should consider in claiming these credits and lowering their tax bill.

For example, contractors with a research component embedded in their contracts typically assume that the R&D efforts belong to the government. However, in certain situations, the contract may contain language that indicates the company may be eligible for the tax credits.

Other tax benefits that may apply to government contractors include worker opportunity tax credits, Sensitive Compartmented Information Facility (SCIF) and security clearance cost credits, high technology incentives, manufacturing incentives, telework credits and enterprise zone incentives.

Government contractors should expect a continued focus on state tax filing requirements. State taxing authorities are increasingly aggressive in pursuit of revenue earned in their state. Further, government contractors that have a broad interstate footprint (telecommuters, people working on various military bases, etc.) may face significant challenges related to income tax sourcing. An increasing number of states have shifted to a revenue sourcing rule that is based on where the services are received, as opposed to where they are performed. Thus, taxpayers will no longer be able to rely on their prior methodology for determining where to source their revenue.

Because IRS has been growing its international tax review team and pursuing companies that are not in compliance, there are also foreign income reporting issues that contractors should be aware of as they expand their footprint outside the United States.

A government contractor has several formation options when planning for cross-border activities in a foreign country. Whether conducting business through a foreign division or forming an in-country foreign corporation, it is important to evaluate each option's pros, cons, and potential tax benefits or risks based on the contracts and the company's strategic goals. A wrong choice could have a significant impact on the business' success.

7. FALLING THROUGH THE GENERATION GAP

Retaining Millennials will be a major challenge to government contractors.

As profit margins on contracts dwindle, government contractors will have less ability to offer competitive compensation and benefits for good talent, and individuals will shift their focus to the commercial world in search of more lucrative salaries. It will be critical for contractors to have a plan that attracts, retains, innovates, and motivates the next generation of employees and executives while remaining price competitive. Millenials want to make a difference in their work, so contractors will have to create an environment that motivates younger employees and fosters engagement regardless of their client agency's existing culture.

Companies will also have to look for creative solutions to recruit, retain, and reward top talent and key employees in the most competitive niches. Incentives may need to include both real and synthetic equity as well as intrinsic autonomy motivators. For example, companies may consider stock appreciation rights (SAR) plans that are structured with very flexible terms as an excellent retention tool. These plans provide key employees with synthetic equity that allows them to share in the upside should there be a change in control.

How to Retain a Millennial: Top 10 Most Important Retention Attributes

Topics of Importance	% of Importance
Sense of achievement in work	88
Good work-life balance	89
Feel valued/treated with respect	90
Pleaseant physical environment	86
Job security	84
Good manager/leaders	88
Career advancement	81
Opportunity to be creative/innovative	76
Job status	77
Location	84

Source: The Millennial Compass: Truths about the 30-and-Under Millennial Generation in the Workplace; MSLGroup

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It won't be enough to address one or two topics covered here. Today's environment of increased competition, expanding compliance requirements and financial pressures demand government contractors think and operate differently. To stay in the game, contractors will have to rethink their entire operational strategy. With some strategic planning and streamlining, challenges can be turned into opportunities.

Consult with industry experts, like Aronson, who provide critical services to government contractors for every phase of the business life cycle, including tax, assurance, compliance, contract consulting, business accounting systems and M&A. Aronson's government contracting experts go beyond basic compliance to identify opportunities and mitigate risk, while allowing clients to focus on their business. For information on how Aronson can deliver the fresh perspective your business needs, please visit www.aronsonllc.com/industries/government-contracting-accounting.