

Government Contractor Industry Roundtable: An industry under pressure

White paper 2011

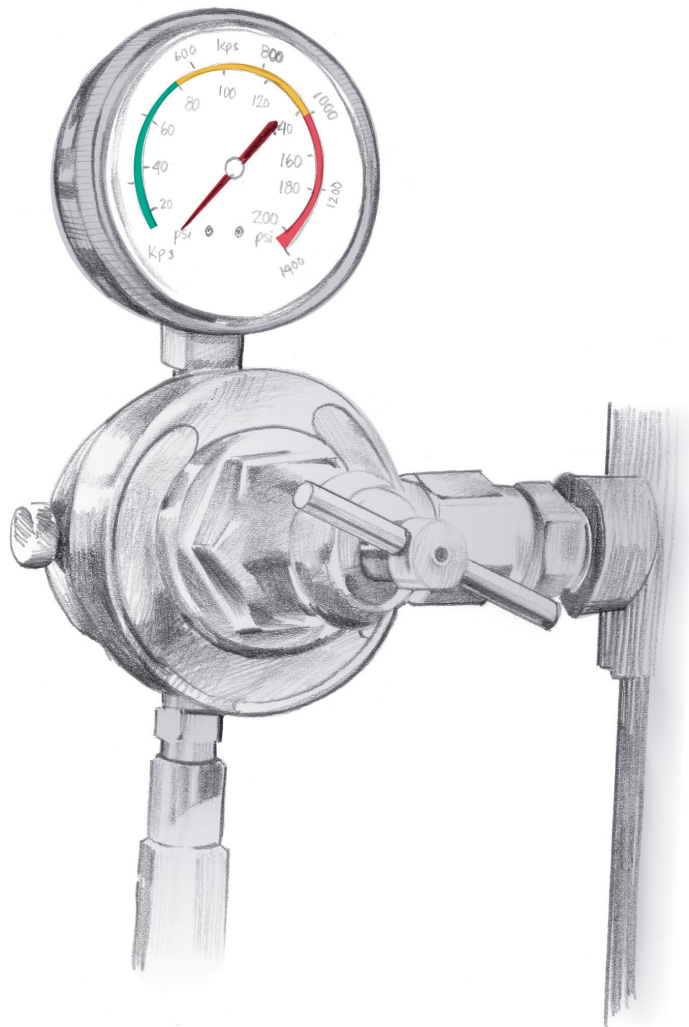


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Executive summary

Grant Thornton LLP's most recent Government Contractor Industry Roundtable, held March 3, 2011 in McLean, Virginia, featured a discussion about the policy, regulatory and enforcement environment in the government contracting industry. Two prominent government contracting experts shared their perspectives during the Roundtable: Stan Soloway, president of the Professional Services Council, and Richard Duvall, practice leader of Holland & Knight's National Government Contracts practice.

While government contracting is typically a growth business, over the past few years business risks have grown more quickly than revenue. The 16th annual *Government Contractor Survey* shows a decrease in profit margins from the last year. This year's survey — as well as those from prior years — makes it very clear that government contracting is not a high-profit business. In fact, half (50%) of government contractors did not make a profit, experienced a loss, or posted a profit of 1–5% of revenue, according to this year's survey.

Government contracting can be a high-risk business, considering the complex noncommercial regulations that govern the industry and the bureaucratic procurement process. These risks are compounded by a number of regulatory, contract selection, administration and negotiation, and enforcement challenges.

A number of issues were on the minds of Roundtable participants:

Government shutdown worries. On March 18, 2011, President Obama signed into law a temporary spending measure to keep the government funded for another three weeks, while Congress continued to wage war over a longer-term budget. Subsequent to the Roundtable, Congress approved a budget for the remainder of the government's fiscal year. The looming battle over the fiscal year 2012 budget may be even more contentious.

Growing competition around pricing. Government contractors are under pressure to be more efficient and reduce costs while providing the same service. We've heard from several contractors who are concerned that the government is awarding projects based on the best price rather than the best value.

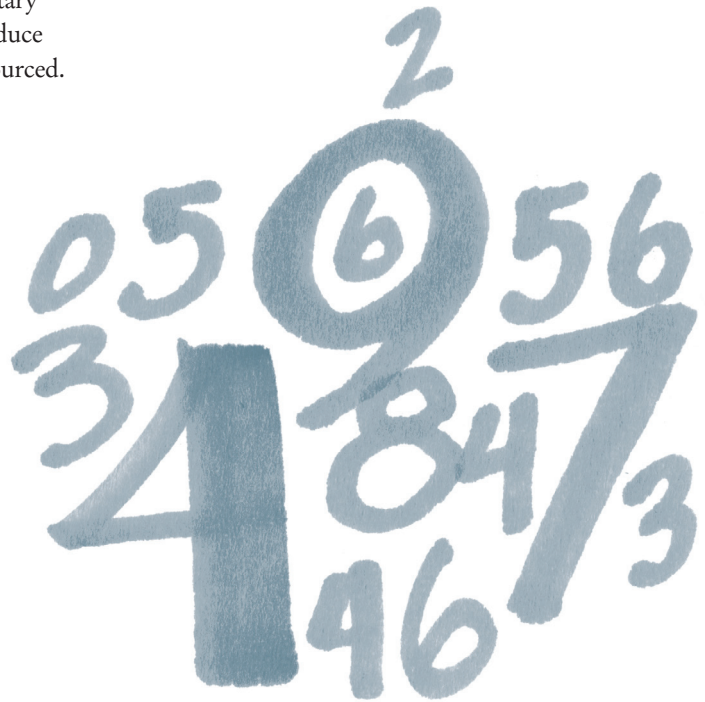
Types of contracts. The current administration has expressed a desire to have new contracts awarded as fixed-price contracts in an effort to reduce its risk. In fact, the stimulus bill encouraged the use of fixed-price contracts to the maximum extent possible. But our survey findings tell a different story: fixed-price contracts have remained steady at 20% of respondents' contracts over the last several years, while time and materials (T&M) contracts — the least favored by the federal government — have actually increased from 28% in 2007 to 40% this year.

Relationships with DCAA and contracting officers. Relationships between government contractors and their Defense Contract Audit Agency (DCAA) auditors have worsened over the past year. This largely reflects the continued pressure on DCAA by the Government Accountability Office (GAO). This year, 11% of contractors report a poor relationship with their DCAA auditors and 5% report a poor relationship with their contracting officers. The relationship with government auditors has worsened at 14% of companies, while only 2% reported a decline in the quality of the business relationship with their contracting officer.

Insourcing. Shrinking revenues as a result of government insourcing continues to be a concern. Nearly half (47%) of respondents report that they have lost positions as a result of government insourcing. Secretary of Defense Robert Gates announced in May 2010 that the Pentagon planned to reduce contractors by 10% in each of the next three years, though in August 2010 he reversed course from his earlier directive and admitted that the expected cost savings from insourcing have not materialized.

The budget issue

Since the government shutdown has been averted for fiscal year 2011, Congress has now turned their attention to fiscal year 2012. Republican leaders are focused on reducing government spending and health care and entitlement programs to reduce the federal deficit. The Democrats and the President's proposals include a combination of spending cuts and tax increases. Given that the Republicans control the House while the Democrats control the Senate, the 2012 budget battle is shaping up to be more contentious than 2011. Both parties acknowledge that the country's debt levels are unsustainable, but as of now, neither side can agree on an approach to get the debt under control. Additionally, as a result of these factors, we may see fiscal year 2012 begin without an approved federal budget. The budgetary strains are being felt by contractors through pressures to reduce prices charged to the government and employers being insourced.



Threats from insourcing

Government contractors are rightfully concerned about insourcing and its effect on their revenues. Nearly half (47%) of respondents reported employee job losses due to insourcing.

Historically, government regulations gave preference to outsourcing work to commercial companies rather than having government employees perform the work in-house. In the last few years, however, the government has begun transferring jobs from contractors and bringing them in-house to be performed by government employees.

The government's current policy of insourcing is based on the belief that a government employee is less expensive than a contractor employee and that insourcing will create cost savings. There is some disagreement regarding this issue: some argue that the proponents of insourcing may not be taking into full effect two factors: the cost of pensions and the duration of employee costs.

The Department of Defense (DoD) acknowledged in August 2010 that the expected cost savings from insourcing have not materialized. Similarly, in a memo released February 1, 2010, Army Secretary John McHugh stated that no additional positions should be insourced unless a review has shown it to be cost-effective.

One thing is clear as it relates to insourcing: When government contractors are directly affected by insourcing, they should exercise all rights provided under the contract. One such right is to insist that the customer formalize the insourcing as a partial termination for convenience, so that the contractor can be compensated for the higher costs of the continuing work on the smaller contract.

The contractor is entitled to an equitable adjustment in the event of a contract termination, but that adjustment is far more generous in the case of terminations for convenience than in terminations for default. The procurement regulations allow the renegotiation of the price of continuing work when a portion of the contract work has been terminated. In practically every case, the partial termination results in an increase in the price of the continuing work.

Among companies that experienced partial terminations for the government's convenience, only 25% of respondents report that they negotiated an equitable adjustment for the continuing work.

Contract selection, negotiation and administration

Government regulations state a clear preference for fixed-price contracts and impose specific requirements that must be met before a cost-reimbursable or time-and-materials (T&M) contract can be issued. In fact, government regulations specify that contracting officers must make a determination that no other contract type is suitable before awarding a time-and-materials contract.

“If you look at the government’s acquisition policies, we are looking at a potential risk shift that could impact profitability for many contractors. The DoD is on a warpath on T&M contracts, which may affect net corporate profitability,” says Soloway.

Our survey results, however, might suggest that this stated preference for fixed price contracts has not yet trickled down to procurement officers. In spite of the government’s stated preference, fixed-price contracts only account for 20% of revenue for survey respondents, a percentage that has held steady for three years. The remaining 80% of revenue is equally distributed between cost-reimbursable and time-and-materials contracts. Revenue from T&M contracts has actually grown over the past few years, from 28% in 2007 to 40% in this year’s survey.

“A fixed-price contract makes sense when the scope of work is very clear,” says Soloway. “When it comes to work that involves research and testing — for example, building a new fighter jet — there are many more unpredictable variables, and the timeline and statement of work can vary tremendously.”

Competition and pressure on pricing

Contractors also report much more pressure and competition around pricing than ever.

“While the government is supposed to accept a bid based on best value, which includes consideration of technical qualifications as well as pricing, we are hearing from contractors that companies are losing proposals strictly because of price. These projects are being won by low-bidding companies that often don’t have the technical qualifications that historically have been required for the work,” says Soloway.

There is also growing concern that both the government and the government contracting industry are in the midst of a talent drain. Simply put, government compensation cannot compete with private sector compensation.

“Government contracting companies are having a hard time attracting cutting-edge talent. The government will not pay wage rates that will match up with what these people can earn in the private sector. When talent is continually being pulled away from government work into the private sector, it dampens innovation,” says Soloway.

Strained relationships with DCAA

Relationships between government contractors and DCAA are not what they used to be, and many contractors are feeling the strain of the growing gap between the operational contracting community and the oversight community.

The relationship has suffered since the U.S. Government Accountability Office (GAO) issued extremely critical reports on DCAA in 2007 and 2008, raising concerns about its independence and quality assurance processes. As a result of these reports, there are a number of new protocols in DCAA’s audits. DCAA’s audit guidance now also emphasizes the implementation of compliance and ethics programs.

These new protocols have slowed the audit process considerably. Many contractors report increasing delays with resolving issues, which can limit their ability to bid on new contracts. More than half (56%) of respondents say their auditor delayed issues, up from 45% in 2009.

The end result is that relationships with contractors and their DCAA auditors, and to a lesser extent, their contracting officers, have worsened. This year, 11% of contractors report a poor relationship with their DCAA auditors, up from 2% in 2009. Five percent report a poor relationship with their contracting officers, up from zero in 2009. The relationship with DCAA auditors has worsened for 14% of respondents.

DCAA is now performing more system audits, including accounting system audits. Since DCAA has moved to a pass/fail grading system, a fail rating can have a significant adverse impact on a contractor's operations. Many contractors have reported receiving fail ratings on their accounting system, but have received no guidance from DCAA regarding the reasons for the failure. When these contractors then correct the deficiency, they cannot get the DCAA to perform a follow-up audit. This may cause contractors to be unable to bid on certain contracts or submit their invoices electronically, which can delay payment.

The reasonableness of executive compensation remains the most frequent cost issue raised by DCAA, continuing a three-year trend of increasing each year (27% in this year's survey, 23% in 2009, and 18% in 2008). In our experience, DCAA most often challenges these costs at small to medium-sized companies, where the pay of the top executives may be below the statutory ceilings described in the procurement regulations. Grant Thornton frequently assists clients facing this issue, and it is our view that the DCAA's standard analytical techniques for assessing executive compensation are flawed and easily refuted.



Climate of enforcement

There has been a distinct shift in the government over the past few years toward tighter regulations and increasing enforcement. Government contractors must comply with an ever-growing slate of rules and regulations geared toward detecting fraud, organizational conflicts of interest (OCIs), false claims and ethics violations, among others.

“There are some significant bureaucracies that seem to grow more invested in finding wrongdoing with each passing year,” says Dick Duvall, practice leader of Holland & Knight’s National Government Contracts practice. “This trend toward increasing enforcement is a reality that will play out over a number of years.”

Code of ethics and conduct

Effective Dec. 24, 2007, a contractor code of ethics and conduct clause was inserted into all contracts with a value in excess of \$5 million and a performance period in excess of 120 days. The clause has been modified twice; the most recent modification became effective April 22, 2010.

The latest version of the clause requires contractors to establish a written code of business ethics and conduct within 30 days of contract award and to make a copy available to each employee engaged in performance of the contract. The clause also requires the contractor to exercise due diligence to prevent and detect criminal conduct and otherwise promote an organizational culture that encourages ethical conduct and a commitment to comply with the law.

In addition, the code of ethics and conduct clause also requires mandatory disclosure. The contractor must disclose in writing to the agency’s Office of Inspector General and the contracting officer if the contractor has credible evidence that a principal, employee, agent or subcontractor has committed a violation of federal criminal law involving fraud, conflict of interest, or bribery or gratuity violations or, alternatively, has violated the Civil False Claims Act. We understand that the contractor code of ethics and conduct will be receiving attention from DCAA in future audits.

More than eight in 10 respondents (81%) have established formal policies and procedures to satisfy these requirements. Nearly one in 10 government contractors (9%) has faced allegations of ethics or conduct violations.

“Contractors not only need to put these codes of ethics and conduct in place; they need to periodically test the code of ethics and conduct and document this process. If there is a finding during the testing, contractors should appropriately document any findings so it does not raise questions or additional audits when the DCAA auditor comes in,” explains Ricky White, Grant Thornton audit senior manager.

Organizational conflicts of interest

OCIs continue to be the subject of regulatory attention. On December 29, 2010, DoD issued a final rule regarding OCIs for major defense acquisition programs (MDAPs) and systems engineering and technical assistance contracts. The proposed rule would have applied to all DoD contracts except those for commercially available off-the-shelf (COTS) items.

These new OCI rules offer some clarification about what to do in the event of an OCI or what might appear to be an OCI. The guidance is that real or potential OCIs, or circumstances that may give rise to the appearance of an OCI, should be disclosed and addressed in mitigation plans.

False claims

The Federal False Claims Act is another area that can be a compliance nightmare for government contractors and subcontractors. While all are aware that falsifying time or billing fraudulently amounts to false claims, some are not aware that failing to comply with any of the myriad rules in their contracts can be an “implied certification” that can lead to a false claim accusation on the part of the government. If the government can make the case that the issue is material to the contract, it can be determined to be a false claim.

Moreover, there is no coherent enforcement under the False Claims Act, although there are “relators,” who monitor litigation and can file claims on behalf of the government. These relators typically trigger some type of investigation, which in itself is an expensive prospect for contractors.

Mandatory disclosure

FAR contracts also require mandatory disclosure as a contract term. Mandatory disclosure applies in situations where a contractor has knowledge, in connection with the award, performance or closeout of a federal contract or a subcontract, of a violation of federal criminal law involving fraud, conflict of interest, bribery or gratuity in violation of Title 18, a violation of the Civil False Claims Act, or significant overpayments.

A contractor’s failure to disclose wrongdoing in any of the aforementioned areas has been added to the growing list of grounds for suspension or debarment, punitive mechanisms used by the federal government. Moreover, the federal government has greatly increased its use of suspension and debarment in the last few years.

What should you expect from new OCI regulations?

Proposed regulation issued by the DoD on April 22, 2010 (75 F.R. 20954, et. seq.) provide insights as to what to expect from FAR changes to OCI regulations:

- Expect a broadened definition to include the GAO tests for an OCI (biased ground rules, unequal access to information, and impaired objectivity). Also expect that “appearance of a conflict” will be treated as a conflict.
- Expect that OCI regulation will apply to all contracts, including task orders; that there will be no exception for nonprofits; and the regulations will apply to the acquisition of commercial items, but not to commercial off-the-shelf (COTS) items.
- There will likely be a premium on disclosure and decision-making authority of contracting officers.
- Uncertainty concerning OCI definitions and application, and the threat of liability and limitations, create huge incentives for companies to opt for structural approaches to avoid liability and wasted investment.

Looking ahead

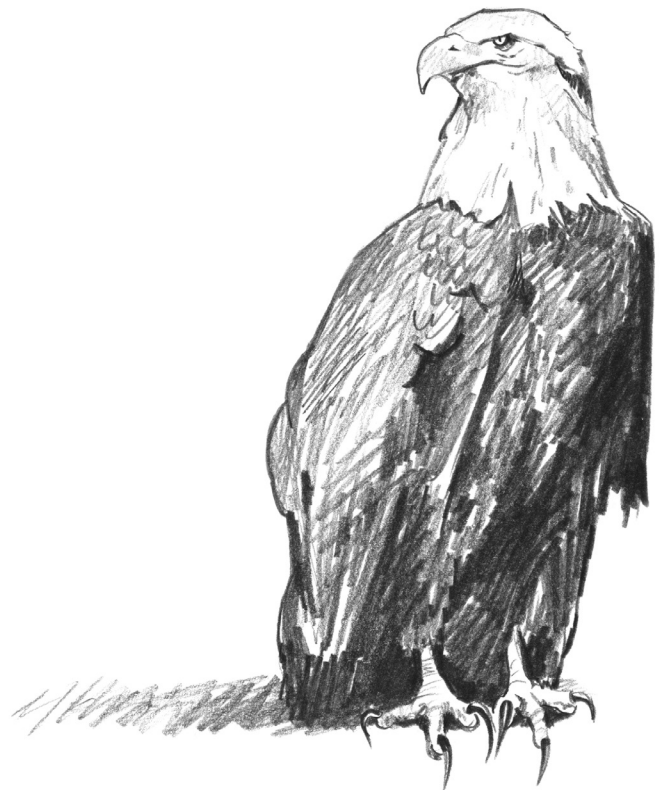
The government contracting industry has faced numerous challenges over the past year. Profit margins have shrunk while regulations have grown, and the climate of enforcement has intensified. Government contractors must be increasingly vigilant about compliance or risk running afoul of numerous and oft-changing rules including false claims, codes of ethics and conduct, the DCAA procurement process, mandatory disclosure and OCIs.

At the same time, government contractors must deal with pricing and bidding pressures; threats from insourcing, which have forced many contractors to lay off employees; and strained relationships with DCAA auditors. Adding insult to injury, concerns over a possible government shutdown, although ultimately averted, added a new and unwelcome layer of uncertainty.

“In light of these issues, effective risk management is increasingly becoming a key discriminator between successful and unsuccessful companies in this sector,” says Kerry Hall, partner-in-charge of Grant Thornton’s Government Contractor Industry Practice.

For companies that are able to manage and mitigate these risks, the government contracting industry remains robust and, certainly, at least somewhat profitable.

“Given the dynamics of government, even in an austere environment, you will see some growth,” concludes Soloway.



Additional information

About the Government Contractors Industry Roundtable

This white paper summarizes discussions held at the Grant Thornton LLP Government Contractor Roundtable on March 3, 2011, at the Ritz-Carlton in McLean, Virginia. Each year, Grant Thornton's Government Contractor practice holds a number of roundtables for industry professionals on pressing topics in the government contracting industry, including mergers and acquisitions, the state of the industry, as well as highlights from Grant Thornton's *Annual Government Contractor Industry Survey*.

The most recent survey, the *16th Annual Government Contractor Industry Survey*, is based on information provided by companies that do business with the federal government as a primary customer. Survey questionnaires were distributed in early 2010, and responses were received over the following several months. Financial and business statistics in the survey typically relate to fiscal years ending in 2009 or early 2010 and are treated as belonging to the current year for convenience. For more information about the roundtables or the *Annual Government Contractor Industry Survey*, please contact Kerry B. Hall.

About Grant Thornton's Government Contractor Practice

The Grant Thornton government contractor industry team is dedicated to helping companies meet the challenges and complexities of the government contracting industry. It is imperative that companies and organizations seeking to do business with the federal government are as efficient and competent as possible. The government contracts marketplace is more competitive than ever. Grant Thornton professionals help clients form the strategies and supporting infrastructure that will maximize opportunities, build a successful business base, minimize taxes and improve profitability.

For more information, please contact:

Kerry B. Hall
Grant Thornton LLP
Partner-in-charge
Government Contractor Industry Practice
T 703.847.7515
E kerry.hall@us.gt.com



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