

Contracts, Cash Flow, Controls

Critical Management Challenges for High-Growth Government Contractors

This is the first in a series of articles presented by the Government Contractor Practice of Tatum, LLC designed to offer real-world strategies for mastering these three competencies. Too often, they represent roadblocks to growth and long term success. Helping companies overcome critical challenges begins by identifying key issues, describing why they are important, and offering solutions based on experience. These are key steps towards successful growth.

CONTRACT MANAGEMENT

Many Government Contractors are completely dependent on winning federal, state and local contracts for survival and growth. Since the ultimate objective is new business, companies must allocate their bid & proposal, marketing and internal R&D budgeted funds wisely to successfully pursue multiple procurements. However, in our experience, many companies bid on everything that shows up on their radar screens, taking a shotgun approach that drains B&P funds and human resources. In other situations, companies bid without a full understanding of the client and/or the contract requirements.

Both approaches are a product of inadequate business planning, and are destined to disappoint. Since there is no reward for coming in second place, except maybe in some multiple award situations, government contractors should bid only on procurements for which a high probability of success exists.

Knowing your potential customer's hopes, fears, fiscal constraints and socio-economic requirements will add a great deal to the effectiveness of your cost and technical proposal. In-depth knowledge of your own strengths and weaknesses will also help. These should focus on key competencies including technical capabilities, contractual experience, management strengths and weaknesses, financial stability, liquidity, and systems.

Based on recent studies, as many as three-quarters of all proposals received by the Government are deemed non-responsive or inadequate. In addition to the dilution of scarce corporate resources, non-acceptance of a proposal can be demoralizing. Especially in small organizations, almost every staff member is fully aware of ongoing procurement efforts. It is not uncommon for many individuals from operations, marketing and finance to actively participate in such a process, thereby building expectations and hopes. Submitting quality proposals that either win or miss due to circumstances beyond your control will pay team building dividends.

Disciplined management of contract targeting, bidding, and the proposal process is essential to the long term success that comes from obeying the First Commandment of Prosperity: "Thou Shalt Book Quality New Business." In our many years of working for and with government contractors, we have found that a well-established contract management function overseen by a top executive is a primary differentiator of highly successful companies.

BACKLOG

Why is backlog so important for every organization, regardless of size? Of course, backlog represents an identified future revenue stream. A healthy backlog also reduces risk for lenders (more on this topic in our following articles on cash flow). Finally, it demonstrates to government auditing agencies that planned business growth over a period of time justifies an expansion in business base, thereby reducing the organizations indirect costs in the long term. Building a backlog is probably the most difficult challenge facing government contractors, due to the constantly increasing number of new entrants in the market place and the limited resources available to small organizations.

If we assume that your company is currently generating \$24M in annual revenues, it will burn approximately \$2M monthly of your contract backlog. This means that you will need to win \$2M a month in new or re-compete business just to keep the status quo. If your company has a win ratio of 50%, you will need to bid \$4M in new business each month to maintain the current level of revenues.

Of course, \$4M in proposals requires a robust pipeline. This example, which is simplified but realistic, illustrates the rigorous attention to backlog growth which is necessary for long term success. We see CEOs of our most successful clients taking an active role in this strategy, stressing aggressive but realistic goals. A simplifying equation of new business generation can make use of the inherent conflict between the business development and finance departments, which can be healthy if properly managed: (Business Development Projections) - (Finance Dept. Reality Check) = Reasonable Estimate of New Business.

TEAMING ARRANGEMENTS FOR SMALL GOVERNMENT CONTRACTORS

Opportunities for small contractors have never been better because the government uses its buying power to promote and achieve certain social and economic goals. Some of these socio-economic goals are incorporated in the body of the RFP, namely Sections I and L, Part II and III respectively.

There are myriad opportunities available to small organizations:

- 5% of all Federal contracts awarded (up to 10% for DOT, NASA) must be directed to Small Disadvantaged Businesses
- Small Business Innovation Research Programs (SBIR), a three-phase R&D program with funding of \$100,000 in Phase 1, funding of \$750,000 in phase 2 and commercialization of the product in Phase 3
- Mentor-Protégé Programs, another socio-economic initiative that encourages DoD Prime Contractors to develop the technical and business capabilities of small disadvantaged business, qualified organizations that employ people with severe disabilities and women-owned small businesses

And there is of course the expressly mandated directive in each major Federal Procurement to allocate between 20% and 28% of their contract award to small business.

Subcontracting arrangements can be excellent sources of recurring revenues and can also result in building long-term relationships with strong partners. Perhaps the most important consideration in a sub-contractor to prime relationship is that the terms and conditions in the Prime's Agreement with the Government generally flow down to the subcontractor. In other words, the subcontractor is equally bound to comply with the applicable acquisition rules and regulations.

While the prime is contractually obligated to administer its subcontracts, the government reserves the right to interject itself into the process on the premise of "protecting the public interest". Therefore, subcontractors may find both the Prime and the government reviewers looking over their shoulders. Since the FAR expressly requires prime contractors to certify cost and pricing data from subcontractors, it is not uncommon that the Prime may want to include an indemnification clause for defective pricing in its subcontracts. Therefore, more than ever before, small organizations are compelled to ramp up their operations, contract administration processes and infrastructure to sustain this increasing level of scrutiny.

COST STRATEGY

The Government generally determines the contract type to be used. However, contract type is theoretically a matter for negotiation. This is a more cogent reason for every subcontractor, regardless of size, financial strengths, past performance, to know its client, understand its needs, hopes, constraints, and its biases. Based on this acquired knowledge of the customer goals and objectives, a wise contractor may even be able to determine the type of contract to be awarded.

Concurrently, the contractor must know its economic limitations and most importantly its cost structure. The government's overall objective is to establish a contract type and price that will result in a reasonable contractor risk, while providing the contractor with the greatest incentive for effective and economic performance. Generally a Firm Fixed Price contract, which makes best use of the inherent profit motive, is used when the contractor's risk is minimal or can be predicted with an acceptable degree of certainty.

Since the current trend in contracting awards is Firm Fixed Price contracts, with limited recourse to Fixed Price Incentive contracts, it is critical to understand the threat posed by an inadequate cost estimation process. Cost understatement will cause a loss on the contract; cost overstatements can trigger a downward price adjustment as a result of Defective Pricing.

In addition to understanding its cost structure, a contractor must pool and allocate indirect costs to contracts on some equitable basis. The FAR states that indirect costs must be accumulated in logical groupings and the base of such groupings (Pools) should be selected so as to permit allocation of the costs on the basis of the benefits accruing to the final cost objectives. More specifically, the design of a cost structure should take into consideration the following:

- **Number of Overhead pools.** Using a single, companywide rate for applying indirect costs could result in over costing some services and under costing others. Activity-based Costing (ABC), unlike the traditional product costing method, attempts to identify why an overhead item exists; the reason is referred to as cost driver, because it drives the cost. ABC is an accounting system that identifies the various activities performed in an organization and collects costs on the basis of the underlying nature and extent of such activities.

- **G&A Allocation method.** G&A costs are frequently accumulated in a single pool and are allocated to the entire business based on three DCAA accepted methods: 1. Total Cost Input, 2. Value-Added, and 3. Single element method. There have been numerous debates and a few court decisions regarding which G&A allocation method is the most acceptable. The CAS allows any of these methods; however, a non-CAS covered organization is not restricted to the use of only these three G&A allocation bases. It is up to the contractor to select the method that best fits the requirements of its operations as long as it is consistently applied.
- **Fringe Benefits Pool and Service Centers.** It is preferable, but not mandated, to segregate fringe benefits costs, statutory and non-statutory, into a homogeneous pool and then allocate out these costs to all contracts based on the prevailing cost driver, which in this case will be total labor dollars. The alternative is to “lump” such costs into the numerator of an O/H Pool. This practice, although acceptable, does not lend itself to easy monitoring and control of costs. Service Centers come into play when there is a need to allocate to each corporate segment shared services, like computer mainframe, facility costs, or a testing facility.

The underlying theme of an effective cost structure is consistency: when a method is selected, it must be consistently applied. DCAA and other auditing agencies will not expressly require one specific accounting system. However, it is recommended that government contractors invest in a system that will allow proper accumulation and segregation of costs between allowable and non allowable, that is project centric, allowing accumulation of costs by project, and that automatically allocates out its indirect costs on the basis of parameters consistently applied.

Many of our client engagements include significant accounting system and/or cost structure modifications and conversions. Properly structuring overhead pools, G&A allocations, and fringe benefit/service center pools can make the difference between anemic and acceptable profitability on lower margin contracts. Lack of consistency in methods used can, over time, create a significant barrier to new contract acquisition. And most important, an accounting system is only as good as the logic and methodology used to set up its architecture and reporting structure.

ABOUT THE AUTHORS

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