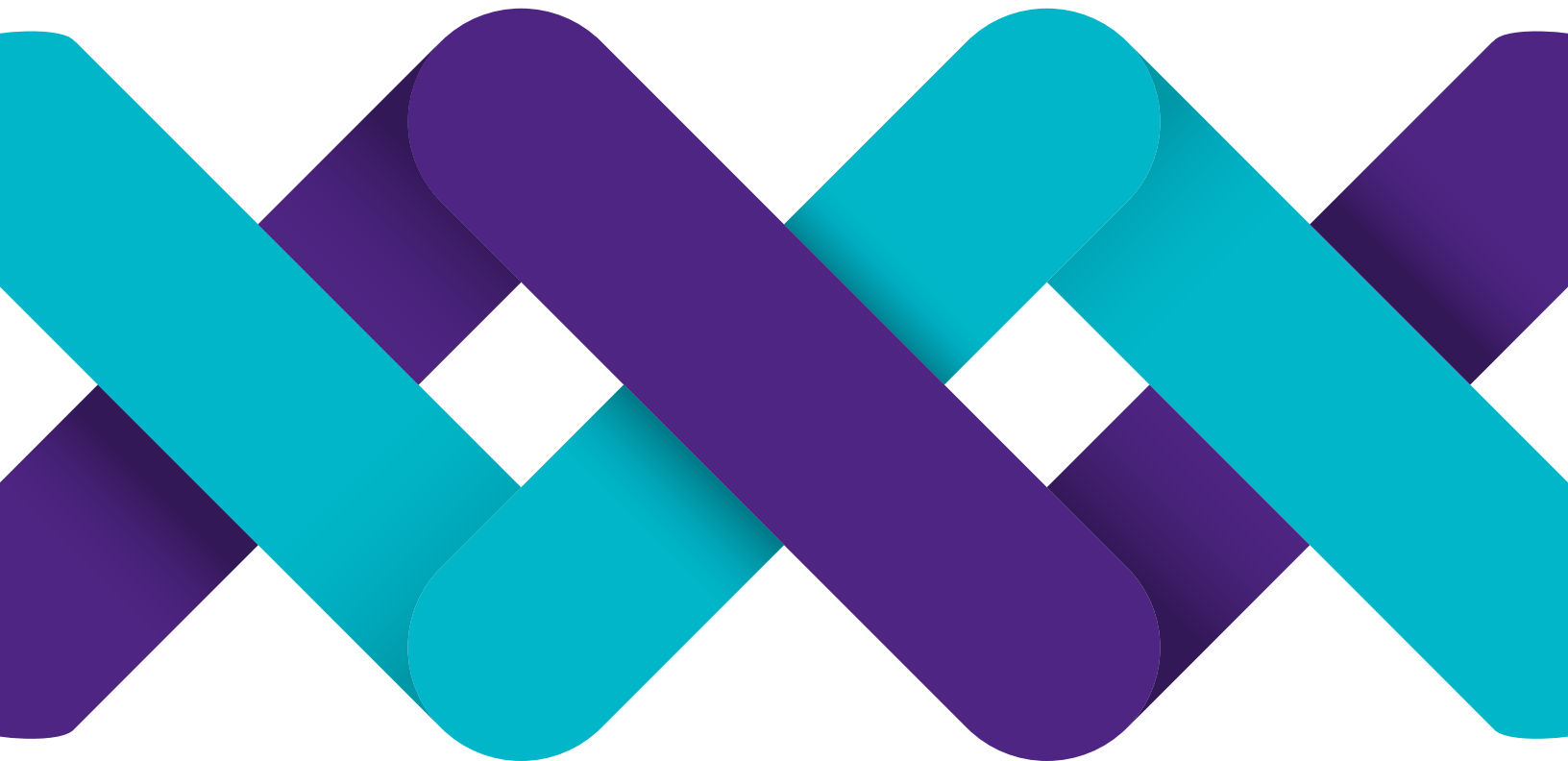


2017 Government Contractor Survey

SPRING 2018



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Methodology

Grant Thornton's 2017 Government Contractor Survey is based on information provided by companies that conduct business with the United States federal government as a primary customer. We distributed questionnaires and received responses from participating companies between October and December of 2017. Respondents to the 2017 survey are from small, medium, and large companies, including both publicly and privately owned institutions, that provide a variety of products and services to governmental entities. Financial statistics in the survey relate to respondents most recently completed fiscal year as of the date each survey was completed.

Grant Thornton reviewed the data provided by respondents to be certain it was statistically valid and representative of the companies that responded to the survey. However, as is inherent in any survey process, the completeness and accuracy of submissions ultimately rests with the submitting respondents. Data is presented in the survey as a whole or by company size when appropriate. In many instances, we also provide data from prior years' surveys in order to identify trends from survey to survey. As a note, survey respondents also vary from year to year, so the data presented herein should be considered in that context when drawing conclusions or inferences from the results reported.

In our 2017 Government Contractor Survey, Grant Thornton provides a comprehensive look at the industry through the analysis and presentation of a wide range of metrics. Our survey is designed to cover areas that can directly affect the cost recovery and profitability of a government contractor and

which help companies remain and become more competitive in the marketplace. Whether your company is an established government contractor or a business considering entering the government market, Grant Thornton hopes you will find the information in this survey to be useful in managing your business now and planning for the future.

The 2017 survey is part of Grant Thornton's continued thought leadership within the government contracting community and includes practical advice in several areas to assist companies in their effort to maintain competitiveness, profitability and compliance. Our goal is to ensure that our survey continues to evolve and provide those interested in government contracting with the most useful and insightful information possible.

This survey would not have been possible without our generous sponsors as well as the participation of the dozens of companies that filled out the survey. We sincerely appreciate the participation of the many companies that contributed to this effort. In particular, we want to thank the Professional Services Council for its support and partnership with the 2017 survey and its help in promoting this survey report. In addition, Kevin Savage, Ramie Jester and Charlotte Bennett from Grant Thornton's professional government contracts practice team were instrumental in supporting this year's survey.

We welcome feedback on this year's survey and solicit input for specific topics to cover in our next survey. Please contact Bill Johnston, National Governmental Contracting Industry practice leader, at bill.johnston@us.gt.com with your suggestions.

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Executive summary

Grant Thornton is pleased to provide our *2017 Government Contractor Survey*. The report presents a wealth of financial and nonfinancial information provided by government contractors located across the country and representing a broad cross-section of the government contractor industry.

This survey incorporates a wide range of metrics and includes data on the day-to-day business of government contractors, information on changes in government regulations in addition to revisions in policies and priorities of the government.

This year's survey reveals some interesting and noteworthy trends in the industry. These are highlighted below in "Notable Trends in the 2017 Survey."

For the United States and its government contracting community, we would be remiss if we did not first mention the election of a new president and members of Congress and the impact they have for 2018 and beyond. In responding to the survey, many companies remarked that they are uncertain about the future; citing that from their perspective, it is hard to anticipate or prepare for the future when many of the communications from the administration are at times confusing, unclear or contradictory.

As we look to 2018, one of the new and most pressing issues contractors face will be the budget process, where the increased funding commitment will be to the U.S. Department of Defense (DoD) while other agencies are likely to have no increases or even

budget cuts. The actual funding of the government, especially the continuing resolutions, are an issue for all contractors due to delays in congressional approval and the disruptions to planning and staffing shutdowns which result. We noted that, during this uncertainty, contractors are looking to increase hiring, acquire or sell companies, bid on numerous and diverse procurements, modernize IT systems and improve critical enablers such as cybersecurity, cloud computing and big data. Another major issue for government contractors were the government shutdowns in April 2017 and January 2018; although short in duration, the shutdowns impacted rates, both direct and indirect, as well as contract performance. Finally, contractors recommended that operations and maintenance budgets be increased to simply maintain the status quo.

Another significant focus for 2018 will be the reduction in number and types of regulations. We have seen several noteworthy trends in 2017 and prior years including: (1) allowing outside auditors to perform cost accounting audits previously performed by the Defense Contract Audit Agency (DCAA), and (2) requiring agencies to eliminate two regulations for each new one proposed. Additionally, audits performed by the DCAA may have a substantial impact on a company's performance and compliance, especially in the approval of accounting systems, forward pricing and incurred cost submissions. Compliance continues to be a concern with billing, procurement and new guidance that deviates from past norms, such as fixed price development contracts, ceilings on rates and elimination of previous allowable costs.

Notable trends in the 2017 survey

In the past year, the key factors for government contractors include competition, profitability and compliance with laws and regulations while the government's focus has been on reducing program costs through Low Price Technically Acceptable (LPTA) bids, use of Indefinite Delivery/Indefinite Quantity (IDIQ) terms on large contracts, and the management of difficult negotiations with both the DCAA and contracting officers.

For contractors, doing business with the federal government poses a different business relationship than that between companies conducting business (or "B2B") in a commercial environment. Government procurement regulations dictate the business relationship – a structure that is not found, for the most part, in the private sector.

For 2017, we saw a transitional year with a new administration, many regulations repealed or changed, and continued government focus on reducing costs while facilitating the efficient purchase of equipment, supplies and services for our nation.



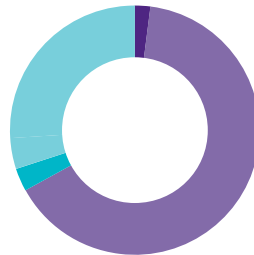
Key takeaways

- 1 Because of uncertainty with federal funding and ongoing risks of government shutdowns, contractors found it necessary to seek contracting opportunities outside the federal government.
- 2 The practices used for the allocation of indirect costs are often a major factor when addressing issues of competitiveness and profitability.
- 3 Companies found it necessary to review current pricing techniques to determine if any adjustments are necessary to win a greater percentage of pricing proposals.
- 4 Whenever possible, in instances where the actual rates are higher than provisional billing rates, contractors are reviewing their estimating practices to determine if practices followed in developing provisional billing rates should be adjusted to be more aligned with actual rates.
- 5 Hot-ticket items receiving the highest scrutiny by government auditors are bonuses/incentive compensation, executive compensation, consultant fees, expenditures for employee morale and welfare, and penalties on unallowable costs.
- 6 The failure to disclose updated information at negotiations is frequently the basis for government “false claims” allegations against government contractors.
- 7 The DCAA has not performed defective pricing audits on the overwhelming majority of contracts that are subject to Truthful Cost or Pricing Data (TCPD) over the past five years; however, when performed, TCPD compliance audits usually resulted in a refund to the government.
- 8 80 percent of companies responded that they had no allegations of ethics or compliance violations in the past two years.
- 9 The DCAA is currently updating its standard audit program for accounting system reviews. Contractors should become familiar with the updated audit program as soon as it is released.
- 10 To enhance the likelihood of system approval, contractors should adopt written policies and procedures addressing compliance with each of the Defense Contract Management Agency’s (DCMA’s) 35 Contractor Procurement System Review topics.
- 11 95 percent of surveyed companies report that they rely on in-house personnel to perform cost and price analysis of subcontractors while only 5 percent are requesting government-assisted audits.
- 12 As for cost, not much has changed as cost multipliers or “wrap rates” remain largely stable and comparable to our last several surveys for both company-site and customer-site rates.

Revenue and profits

Products or services offered by respondents

- Administrative support **2%**
- IT/Engineering and Professional Services/R&D Consulting **65%**
- Products **3%**
- Training/Education **4%**
- Other **26%**



The results of the survey showed that the majority of companies responding provide IT/engineering and professional services to government entities; this is not unexpected as most respondents are headquartered in the Washington, D.C. region. This is consistent with previous survey results showing the majority of respondents provide professional services in support of federal government contracts. “Other” responses included: technical assistance, consulting and research services.

Changes in revenue growth

- 0-3% **49%**
- 4-7% **14%**
- 8-10% **12%**
- Over 10% **25%**



Another notable trend was the increase in companies’ revenue over the prior year. Approximately 51 percent of respondents showed increases in revenue growth of 4 percent or more and half of those (25 percent) showed increases of 10 percent or more in revenue. This may be attributable to changes in the White House administration resulting in greater expenditures in areas such as the DoD as well some respondents benefitting from M&A activity. We anticipate this trend to continue in the DoD and other specified agencies in the foreseeable future whereas other targeted agencies could see significant reductions in funding.

Customer base of respondents

- Federal Government **56%**
- State and Local Government **11%**
- International **12%**
- Commercial/Private-Business Accounts **21%**



Overall, 2017 saw respondents’ federal government sales remain relatively steady, with approximately 56 percent of sales being derived from the federal government as compared to 54 percent in 2016. In recent years, minimal change in federal sales are due to greater diversification of customer bases to include more state and local, commercial and international clients. Because of uncertainty with federal funding and ongoing risks of government shutdowns, contractors are diversifying by seeking contracting opportunities outside of the federal government. With the Trump administration, we anticipate an increase in certain federal contracts, particularly within the DoD and other specified agencies, while other targeted agencies could see significant reductions to their budgets.

Each year we also ask respondents about their contract mix by type of contract. Three years ago, the split between contracts was nearly even between Cost Type, Time and Materials (T&M), and Firm Fixed Price. The split skewed toward T&M last year at 39 vs. 30 percent for both Cost type and Firm Fixed Price. This year’s respondents averaged the following in term of contract mix:

Type of contract

- Cost Type **42%**
- Time and Materials **26%**
- Firm Fixed Price **32%**



Cost accounting

A company's cost accounting practices are often a critical factor in the competitiveness and profitability of the company. Government regulations on cost accounting practices are conceptual and provide a great deal of discretion for selecting specific cost accounting practices that are the most effective in the various markets where a company operates.

Once a company has implemented its cost accounting practices, they generally must be consistently applied. In some situations, changes to cost accounting practices must be reviewed and approved by a contracting officer (CO) or government auditor before the changes can be implemented. In other situations, particularly in regards to new business, different cost accounting practices may be implemented.

Historically, the Defense Contract Audit Agency (DCAA) has been the resource used by most government agencies to conduct audits to determine the adequacy of a contractor's cost accounting system. It should be noted that an approved cost accounting system is a prerequisite for awarding cost reimbursable contracts. Some government agencies are now authorizing government contractors to obtain system reviews by CPA firms in lieu of DCAA audits and are also now recognizing CPA reports as adequate evidence of the acceptability of a cost accounting system pursuant to the standards for an adequate system in the Defense Federal Acquisition Regulations (DFAR). We are also seeing the DCAA request access to audit firm's workpapers as part of their procedures on cost allowability.

We asked companies whether they had considered changing their organizational structure or cost accounting practices to improve competitiveness and profitability, and 82 percent reported having considered such changes. This compares to the 2016 survey that showed 74 percent of respondents having considered such changes.

Organization or cost structure changes

- Yes **82%**
- No **18%**



The practices used for the allocation of indirect costs is often a major factor when addressing issues of competitiveness and profitability. We continue to observe that many professional services companies have a simple cost structure with a single fringe benefit rate, an on-site overhead rate, an off-site overhead rate and a General and Administrative (G&A) rate. Such a system may be simple to maintain but it offers little or no flexibility when pursuing new business, particularly when it is very price sensitive. However, a "one size fits all" cost structure is rarely effective for contractors pursuing price-sensitive business.

Government regulations on the allocation of indirect costs are flexible and generally encourage separate burden pools for different types of business. The creation of additional burden pools does not require the creation of new legal entities to perform the work. New business units can be created within the existing legal entity as necessary to achieve competitiveness and profitability for new work. We also found many companies are new to contracting with the federal government. These new entrants are encountering significant compliance mandates in government accounting such as approval of their accounting system and the need for approved rates including forward pricing agreements. Additionally, for companies entering federal government contracting, becoming either modified or full Cost Accounting Standards (CAS) compliant and creating a disclosure statement as well as an accounting system that segregates costs is a concern.

81 percent of respondents have already made changes to their organization or cost structure. This can partially be attributable to recent trends in increased competition that drives down pricing and profit percentages on federal contracts. Companies have found it necessary to review current pricing techniques to determine if adjustments are necessary to win a greater percentage of proposals. Additionally, oversight by agencies such as the DCAA have required changes to be compliant with government regulations.

Labor multipliers or “wrap rates”

	2017	2016	2015
Company Site	2.1	2.1	2.2
Customer Site	1.9	1.8	1.8

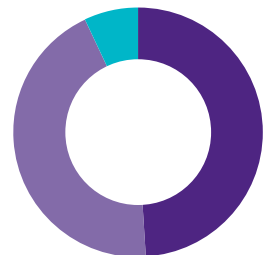
Over time, we have seen a great deal of consistency amongst average wrap rates for both on-site and off-site multipliers. Because contractors often classify and account for the same indirect costs in different cost pools or vary in the way they account for items such as uncompensated overtime, the total multiplier of indirect costs on direct labor is an important benchmark to preface the comparisons of indirect rates for fringe benefits, overhead, G&A and material handling that appear on the pages of the survey that follow. It is equally important to recognize that the data below are averages, with the range of multipliers for on-site rates from a low of 1.47 to as high as 3, while the range for customer site multipliers is from 1.4 to 2.3. These ranges reflect the types of work being performed by survey respondents. Based on complexity and skills offered, ranges can result in higher or lower cost structures being used and the degree to which the customer is basing their pricing decision on “best value” versus “lowest price technically acceptable” (LPTA) criteria.

Fringe benefits

Many government contractors offering professional services account for fringe benefits in a separate burden pool that is allocated to projects and other indirect cost pools as a rate applied to total labor costs. The fringe benefits pool generally includes costs for payroll taxes, paid time off, health insurance, retirement plans and other employee benefits. Some contractors include employee bonuses in the fringe benefits pool while others charge benefits to other indirect cost pools or as a direct charge to projects. It is important to note that large bonuses can have a significant impact on indirect cost rates. We asked respondents if they include bonuses in their fringe benefits pool. 49 percent responded that they do include bonuses in their fringe benefit pool. This represents a slight increase compared to the 2016 survey where 44 percent included bonuses in the fringe benefit pool.

Extent to which respondents include bonuses in fringe pools

- Yes **49%**
- No **44%**
- Not applicable **7%**



Excluding the effect of bonuses on fringe rates, the median overall fringe benefit rate was 36 percent in this survey, which is comparable to the 37 percent rate in the 2016 survey.

On-site overhead rates

The overall median on-site overhead rate reported by this year's survey respondents was 50 percent, lower than the 60 percent reported in the 2016 survey. As is the case with surveys of this type where respondents vary from year to year, we caution readers to this fact and recommend data of this type to be used only as directional in nature.

Base for overhead rates allocations*

- Direct labor **29%**
- Direct labor and associate fringes **31%**
- Direct labor + IR&D labor/B&P labor **14%**
- Direct labor + IR&D/B&P and associated fringes **9%**
- Other **7%**
- Pool not applicable **10%**



* IR&D/B&P = "independent research and development/bid and proposal"

Firms that offer professional services to federal agencies usually maintain indirect cost pools to accumulate the costs of indirect charges for management and support time as well as other indirect expenses associated with the direct charging personnel who perform the contract statement of work. These indirect cost pools are usually referred to as labor overhead and are generally allocated to contracts by a rate applied to direct labor costs. Some government contractors include the fringe benefits associated with the direct labor costs in the allocation base rather than in the labor overhead pool. While moving fringe benefits associated with direct labor from the numerator to the denominator yields a lower calculated overhead rate, the sum total of the costs for direct labor, fringe benefits and labor overhead remain the same under either method. Our 2017 survey determined that 74 percent of overhead rates were calculated on the basis of direct labor or direct labor with fringes and/or independent research and development/bid and proposal (IR&D/B&P) costs.

Off-site overhead rates

Off-site or customer location overhead rates varied quite widely across this year's respondents, but on average were identical to the 2016 survey as the median off-site rate was 33 percent. We also note that many contractors maintain multiple off-site rates to match the cost characteristics of a particular geographic location or customer set to the related contracts.

Base for off-site overhead rates

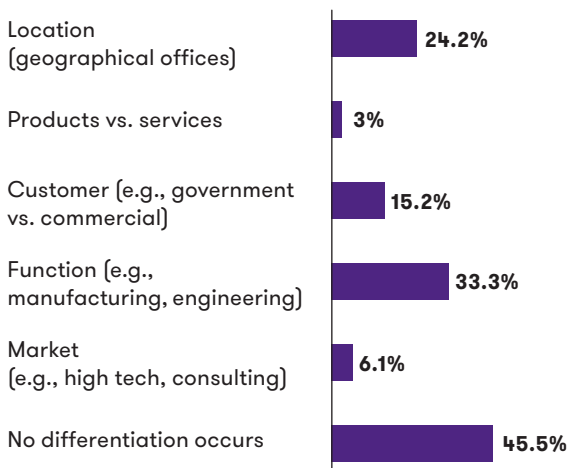
- Direct labor **22%**
- Direct labor and associate fringes **39%**
- Direct labor + IR&D labor/B&P labor **6%**
- Direct labor + IR&D/B&P and associated fringes **8%**
- Other **6%**
- Pool not applicable **19%**



Often a company will establish an off-site overhead rate when the pool costs and allocation base costs associated with the off-site location are significantly different than the normal overhead rate for the entity. Typically, off-site overhead rates exclude facilities and other infrastructure costs being provided to contractors by clients for contract performance. In those instances, the normal on-site overhead rate (usually higher) would not represent an appropriate causal/beneficial relationship to personnel working at client locations.

We asked the surveyed companies to share their primary basis for establishing off-site overhead rates, and approximately 75 percent used direct labor and derivatives of direct labor for fringe benefits and IR&D/B&P labor.

The key driver for creation of multiple overhead rates



We asked surveyed companies if they have multiple overhead rates and how their rates are differentiated. 46 percent of respondents report no differentiation, implying they use a single overhead and/or G&A rate across all departments of their organization. Of those that do differentiate overhead rates, 33 percent of respondents differentiate their rates by function, which implies they developed separate overhead rates for major functions of their organization. Finally, 24 percent of respondents reported that they developed separate indirect rates by geographical location to better represent economic differences.

G&A rates

The survey requested general and administrative (G&A) rates from respondents; using the information they shared, we determined that G&A rates varied significantly, ranging from 5 to 30 percent. This is primarily attributable to the allocation base utilized in calculating the G&A rate. The use of a total cost input (TCI) base would typically result in a lower G&A rate since all costs other than G&A costs are included in the allocation base. A value-added cost input (VACI) base would typically result in a slightly higher G&A rate since the allocation base excludes G&A costs, direct materials and direct subcontracts. An allocation base other than TCI and VACI based on a single direct cost element or hours may result in higher G&A rates since the allocation base would typically have lower overall costs.

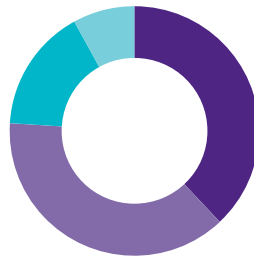
The table below shows the relative consistency of G&A rates across the broad group of respondents in recent surveys.

G&A rates by year of survey

G&A Rates by Allocation Base	Total Cost Input	Value-Added Cost Input
Median G&A Rate	13%	15%
2017	13%	16%
2016	14%	13%
2015	13%	17%
2013	12%	15%
2012	14%	15%
2011	13%	16%
2010	13%	15%

Allocation base or method

- Total cost input (total cost less G&A) **38%**
- Value-added cost input (total cost input less subcontracts and materials) **38%**
- Direct labor **16%**
- Not applicable **8%**



The cost structures of most government contractors include a G&A expense pool. G&A typically includes the cost of headquarters functions such as executive management, accounting, legal, contract administration, human resources, and sales and marketing. G&A frequently includes the company-funded portion of IR&D and B&P costs. The G&A pool is usually allocated to projects at a rate applied to TCI or VACI, although other methods are authorized in CAS 410 where neither TCI nor VACI would yield equitable results. TCI is the sum of total costs excluding G&A expenses while VACI is total costs excluding G&A, direct materials, and direct subcontracts.

Based on the survey results, 38 percent of companies use a TCI base and 38 percent use a VACI base, while a smaller percentage, 16 percent, use a direct labor allocation base.

Material handling and subcontract administrative rates

Many government contractors that allocate G&A on a VACI base also establish a material handling rate/subcontract administration rate. Other government contractors apply an indirect cost rate to the costs for direct materials and direct subcontracts that is lower than the full G&A rate applied to other costs in the VACI base. The material/subcontract rate typically includes the costs of the company's procurement function, the costs of warehousing the items when the company is procuring inventory, and charges for contract administration, legal and program management as appropriate.

For the 2017 survey, the respondents' material/subcontract rates varied from slightly below 2 percent to 9 percent.

The median material handling rate in this year's survey from all respondents, where applicable, was 3.2 percent. The median subcontract administration rate in this year's survey was 3.8 percent.

Actual rates vs. provisional rates

- Actual rates higher **42%**
- Approximately the same **42%**
- Actual rates lower **8%**
- Not applicable **8%**



We surveyed companies to compare differences between actual rates and provisional billing rates used for invoicing in 2017. Approximately 42 percent that actual rates were higher, 42 percent stated noted no differences, and 8 percent stated that actual rates were lower than provisional billing rates. In instances where the actual rates are higher than provisional billing rates, contractors should review their estimating practices to determine if practices followed in developing provisional billing rates should be adjusted to be more aligned with actual rates incurred. Additionally, contractors are usually allowed to make in-year adjustments to provisional billing rates if it can be demonstrated that large variances are consistently occurring on a monthly basis that will result in larger invoice adjustments at year-end or at contract close-out.

Causes of actual rates vs. provisional rates

- Actual indirect costs greater than projected **14%**
- Actual indirect costs less than projected **5%**
- No difference in actual rates vs. provisional rates **32%**
- Actual base less than projected **41%**
- Actual base more than projected **8%**



Primary causes for difference in actual versus provisional rates

We surveyed companies to determine the primary reasons for differences in actual versus provisional billing rates as shown above. For the instances where actuals were higher than provisional rates, the reasons cited were that the actual indirect costs were greater than projected and/or the actual base was less than that projected. For those where actual rates were less than projected rates, the reasons cited were indirect costs were less than projected and/or the actual base greater than projected.

Passing on additional actual costs to customers

- All of the additional costs **31%**
- Some, but not all of the additional costs **25%**
- None of the additional costs **22%**
- Not applicable — No cost reimbursable contracts **22%**



We surveyed companies to determine if actual rates exceed provisional rates on cost-reimbursable contracts and how much of the additional costs are recoverable. The survey responses showed that 31 percent of companies are able to recover all additional costs and another 25 percent were able to recover some of those additional costs. The survey responses showed that 22 percent of companies were unable to recover any of those costs resulting from higher actual rates than provisional rates.

For instances where companies failed to collect all or any additional costs on contracts where actual rates exceeded provisional rates, numerous reasons were cited, including:

- Ceilings placed on indirect rates in the contract;
- Fixed G&A rates;
- Customer relationship;
- Immateriality;
- Remaining funding limited or none remaining;
- Administratively burdensome;
- De-obligation of funds before establishment of final rates; and
- Rate caps.

Revised provisional billing rates at year-end reflecting actual rates incurred

- Request approval for the DCAA or other cognizant office to bill for the rate variance **27%**
- Bill the rate variance immediately without approval **12%**
- Wait for government to complete its incurred cost audit prior to billing **19%**
- Wait for contract closeout to bill the rate variance **7%**
- Other method for revising **7%**
- No revisions are made **28%**



Trends in indirect rates

- Indirect rates are increasing **28%**
- Indirect rates are decreasing **40%**
- No significant change in indirect rates **29%**
- Not applicable **3%**



Surveyed companies were asked to provide information on the trend of indirect rates at their company; the results are summarized above. Indirect rates are decreasing for 40 percent of the companies and increasing for 28 percent of them. The downward trend in indirect rates can be partially attributed to cost-cutting efforts related to indirect costs in an effort to be more competitive in the federal marketplace.

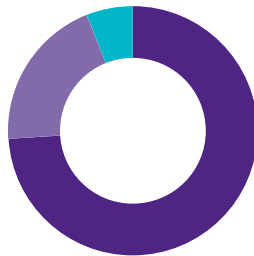
Proposal costs

Bid and proposal costs as a percentage of revenue

In each survey we ask respondents to share with us the amount of bid and proposal costs they incur as a percentage of revenue. This year's percentages were significant and ranged from less than 1 percent to as much as 15 percent of revenue. Nearly one-third of the respondents are spending between 1 and 2 percent of revenue, which is relatively consistent with prior years. The overall median percentage from all respondents in this year's survey was 3.6 percent, slightly higher than the prior year's survey median of 2.9 percent. This increase is consistent with our overall view of the current market where organic growth has been very difficult to achieve and retaining current contracts is a significant focus of management teams, resulting in increased resources being focused in this area.

Effectiveness of controls over funding notifications

- Very effective **74%**
- Somewhat effective **20%**
- Not applicable **6%**



Our survey determined that 74 percent of respondents state that their compliance controls for notifying the government prior to exceeding 75-85 percent of available funding on flexibly priced contracts is very effective and 20 percent stated that their controls are somewhat effective.

Respondents with a CAS disclosure statement

- Yes **62%**
- No **3%**
- Not applicable **35%**

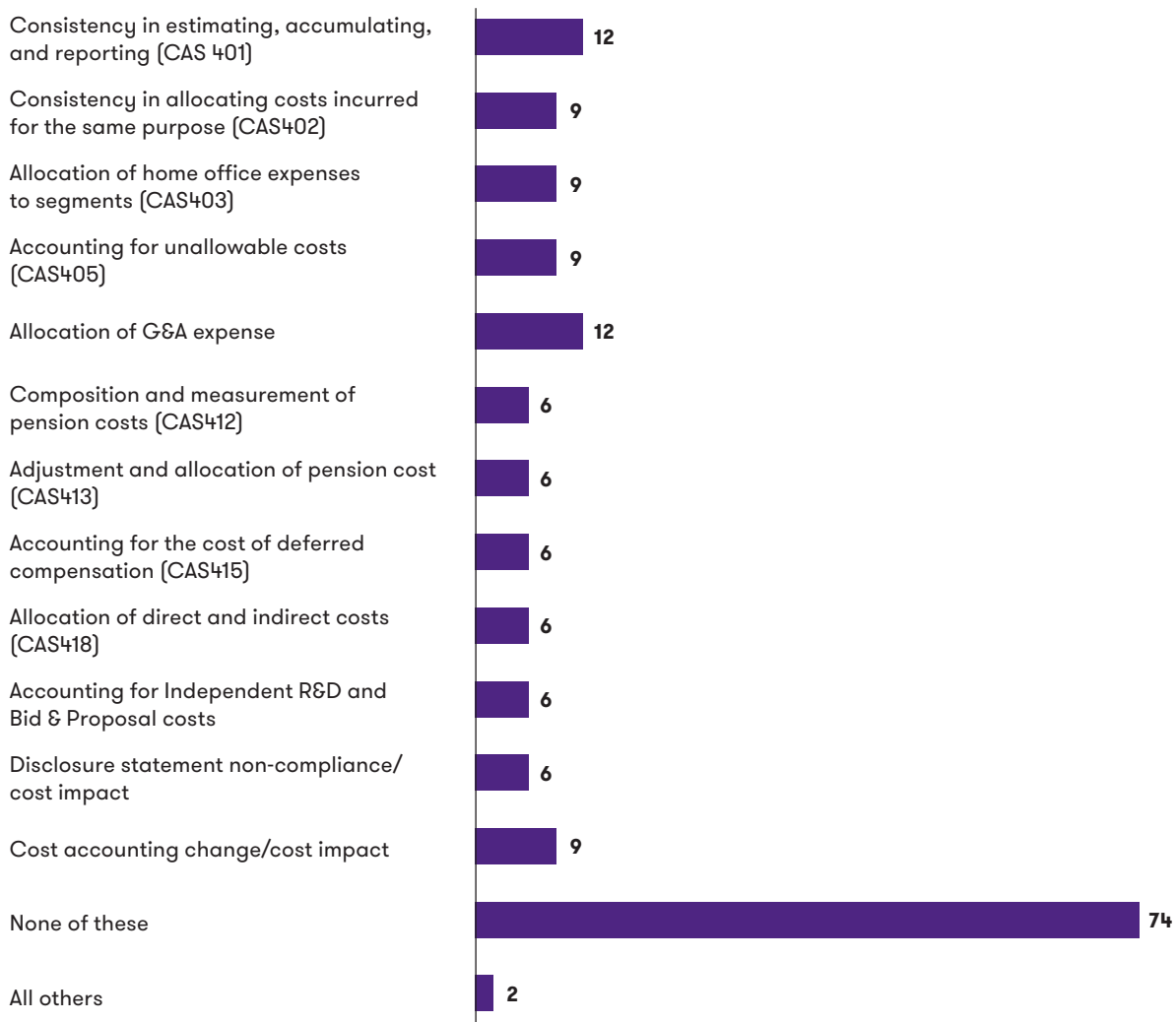


A CAS disclosure statement is required for any single CAS-covered contract that exceed \$50 million, or when a combination of all CAS-covered contracts exceeds \$50 million in the most recent accounting period.

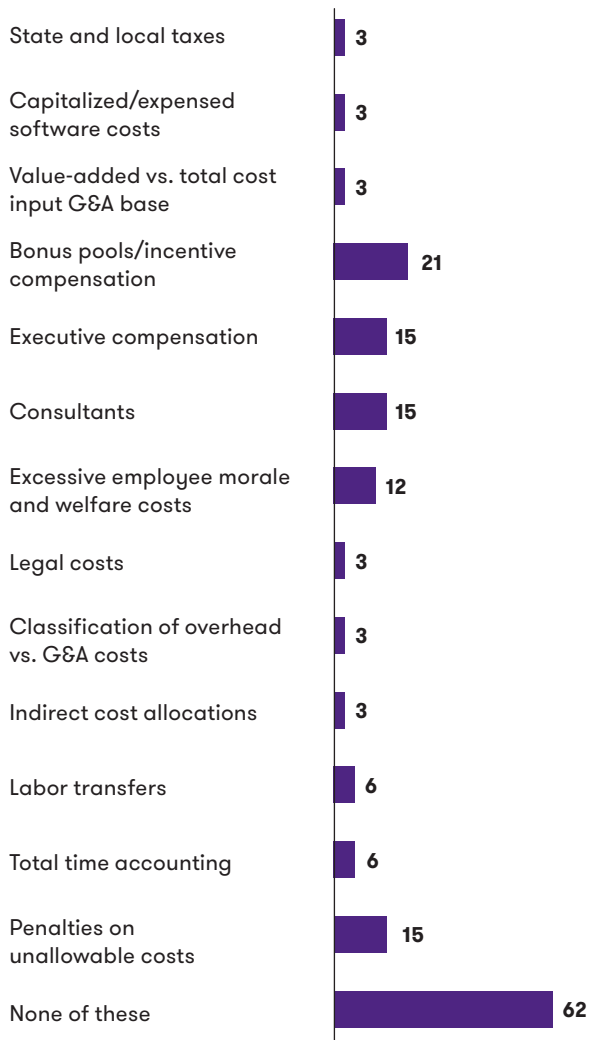
The CAS disclosure is a formalized "living" document that sets forth a contractor's disclosed cost accounting practices and procedures in accordance with Federal Acquisition Regulations (FAR) and CAS. Any proposed changes to the disclosed practices must be submitted to the appropriate government representatives for review and approval.

We asked surveyed companies whether they had an approved CAS disclosure statement and discovered that 62 percent had one. However, 35 percent of respondents are not subject to the CAS disclosure statement requirements.

Types of CAS non-compliance issues raised by auditors



Types of CAS non-compliance issues raised by auditors



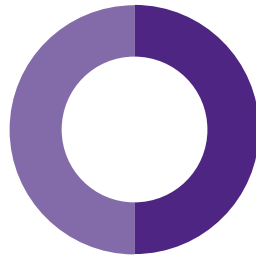
Based on the results of the survey asking what “hot-ticket” items are being questioned by government auditors, the items receiving the highest scrutiny are bonuses/incentive compensation, executive compensation, consultants, excessive employee morale and welfare costs, and penalties on unallowable costs. These are similar to the costs that the Grant Thornton Government Industry Practice team assess during system reviews as well as those evaluated by government contractors during incurred cost audits.

Costs disallowed in government audits

Of this year’s respondents, 52 percent indicated that they had no costs disallowed in government audits performed in the past year, while 28 percent had less than 1 percent of costs claimed disallowed and the remaining 21 percent had over 1 percent of claimed costs disallowed. We have noted in our client base an increase in situations where an entire year of claimed costs were not subject to a detailed audit when past results have been positive and the company is deemed to be “low risk.” When entire years are being waived, these incidents could be driving the low rate of disallowances. Improved internal control environments and systems may also be contributors.

Truthful Cost or Pricing Data (TCPD)

- Yes **50%**
- No **50%**



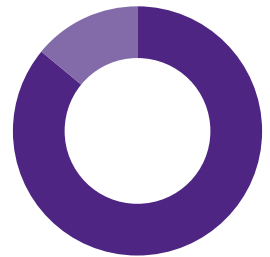
The Truthful Cost or Pricing Data (TCPD), formerly known as the Truth in Negotiations Act (TINA), requires a contractor to certify, as of the date of agreement on price, that they have disclosed to the government all factual information reasonably available which could significantly affect the negotiated price. TCPD applies to all contracts where cost is submitted in support of the proposed price. However, TCPD does not apply to procurements or contracts with a value below \$750,000 nor does it apply to contracts awarded based on adequate price competition or contracts for the procurement of commercial items or services.

Where TCPD applies, the most practical burden it imposes on a contractor is a review of the initial cost proposal just before beginning negotiations with the government and disclosure of updated information to the government. This review process should be a fundamental part of any cost estimating system since several months typically pass from the date the initial proposal is submitted to the date when the government is ready to begin negotiations. The failure to disclose updated information at negotiations is frequently the basis for government false claims allegations against government contractors.

The 2017 survey determined that 50 percent of companies had contracts subject to the TCPD requirements negotiated in the past year. This is a higher number of contracts subject to TCPD than in the 2016 survey and is in part due to larger dollar value contracts being negotiated in 2017.

Respondents subjected to DCAA defective pricing audits in 2017

- Yes **86%**
- No **14%**

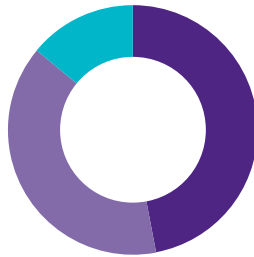


Our survey determined that the DCAA has not performed defective pricing audits on the overwhelming majority of contracts that are subject to TCPD over the past five years. Defective pricing audits are performed to determine if the contractor disclosed the most current, accurate and complete pricing data as of the final agreement on price. The DCAA has drastically reduced the number of these audits in recent years in part due to their mandate to reduce their backlog of incurred cost audits. All respondents that answered “yes” to the question also reported that the TCPD compliance audits resulted in a refund to the government.

Project management and contract administration

Compliance and ethics programs

- Yes **47%**
- No **39%**
- Not applicable **14%**



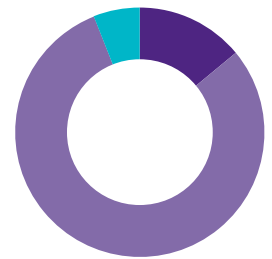
In 2010, the federal government mandated new compliance and ethics requirements for all contracts in excess of \$5.5 million with a performance period of 120 days or more. Contractors are required to establish a written code of business ethics and make it available to each employee involved in the performance of the contract. Unless the contract is awarded to a small business or involves the procurement of a commercial item, the regulations also require the contractor to establish business ethics/awareness and compliance programs within 90 days of contract award. Under such programs, contractors are required to conduct periodic training for their employees, agents and subcontractors involved in the performance of the contract. In addition, contractors are required to exercise due diligence to prevent and detect criminal conduct and to promote an organizational culture that encourages ethical conduct and a commitment to comply with the law.

The regulations require a contractor to disclose in writing to the agency's Office of Inspector General (OIG) and contracting officer whenever the contractor has credible evidence that a principal, an employee, an agent or a subcontractor may have committed a violation of federal criminal law involving fraud, conflict of interest, bribery, gratuity violations or Civil False Claim Act violations.

We asked the surveyed companies subject to the internal controls requirements whether they are conducting the required periodic monitoring and auditing and only 47 percent report that such audits are being performed.

Allegations of ethics or compliance violations in the past two years

- Yes **14%**
- No **80%**
- Not applicable **6%**



The compliance and ethics regulations also require contractors to maintain internal controls with standards and procedures to facilitate timely discovery of improper conduct in connection with government contracts, which assures corrective measures are taken promptly. The internal control program must include:

- Monitoring and auditing to detect criminal conduct;
- Periodic evaluation of the business ethics/awareness and compliance programs and internal control systems;
- Periodic assessment of the risk of criminal conduct, with appropriate steps to design, implement or modify the business ethics/awareness and compliance programs and the internal control systems as necessary to reduce the risk of criminal conduct;
- An internal reporting system, such as a hotline, that allows for anonymity or confidentiality through which employees may report suspected instances of improper conduct, and instructions that encourage the employees to make such reports;
- Disciplinary action for improper conduct or for failing to take reasonable steps to prevent or detect improper conduct; and
- Timely disclosure of suspected violations to the agency's OIG and CO.

We asked surveyed companies subject to the internal controls requirements whether there have been allegations of ethics or compliance violations in the past two years and 80 percent report that no allegations have occurred.

DCAA/DCMA audits in the past two years

- Yes **47%**
- No **53%**



For DoD contracts, DFARS clause 252.242-7005 “Contractor Business Systems,” requires contractors to maintain adequate business systems when the following specific clauses are included in contracts:

- 1 DFARS 252.215-7002 Cost Estimating System Requirements;
- 2 DFARS 252.234-7002 Earned Value Management System;
- 3 DFARS 252.242-7004 Material Management and Accounting System;
- 4 DFARS 252.242-7006 Accounting System Administration;
- 5 DFARS 252.244-7001 Contractor Purchasing System Administration; and
- 6 DFARS 252.245-7003 Contractor Property Management System Administration.

The DCMA has primary responsibility within the DoD for contractor-earned value management, and purchasing and property systems; whereas the DCAA has prime responsibility within the DoD for estimating, material management and accounting, and accounting systems. The DCMA has tended to be timelier in their reviews of business systems where they have primary responsibility compared to the DCAA. However, we do not believe this trend will continue as the DCAA becomes better staffed and reduces its backlog of audit assignments in other areas.

We asked surveyed companies whether any of their business systems have been reviewed by DCAA/DCMA in the past two years and 47 percent report they have been audited.

Accounting systems reviewed and approved by DCAA

- Reviewed by the government and approved **70%**
- Reviewed by the government and deficiencies exist **3%**
- Not reviewed **27%**



Government regulations set requirements for contractor accounting systems, and government requests for proposals for new work frequently consider the approved status of a contractor’s accounting system, especially on flexibly priced contracts, to be a major factor in source selection. The lack of an approved accounting system often will cause a government agency or prime contractor to withhold further consideration of a contractor/subcontractor during source selection.

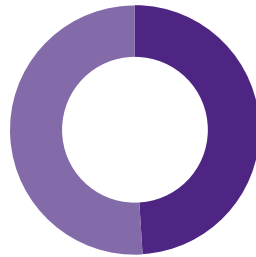
For DoD contracts containing the DFARS clause 252.242-7006, “Accounting System Administration”, an approved accounting system is defined as one that complies with all 18 system criteria in performing accounting system reviews. The 18 criteria set forth in the DFARS clause provide reasonable assurance that: (1) applicable laws and regulations are complied with; (2) the accounting system and data are reliable; (3) the risk of misallocations and mischarges is minimized; and (4) contract allocations and charges are consistent with billing procedures.

The DCAA is the government agency within the DoD primarily involved in contractor accounting system reviews and the agency is updating its standard audit program for accounting system reviews. Contractors should become familiar with the updated audit program as soon as possible after it is released.

We asked surveyed companies whether they have an approved purchasing system, and 70 percent report their system has been reviewed and approved by the DCAA.

Purchasing systems reviewed and approved by DCMA

- Reviewed by the government and approved **49%**
- Not reviewed by the government **51%**



Government regulations set requirements for contractor purchasing systems, and government requests for proposals for new work frequently consider the approved status of a contractor's purchasing system as a factor in source selection.

The DCMA is the primary government agency within the DoD involved in Contractor Purchasing System Reviews (CPSR), and it has published an internal CPSR review guidebook which describes in detail its approach to conducting CPSRs. A major area of DCMA concentration is to review the [1] contractor's written policies and procedures, and [2] actual documentation in subcontractor files to assure policies and procedures are being followed.

The CPSR guidebook also includes a list of 35 specific topics which are reviewed as part of the CPSR. Although the list is lengthy and comprehensive, none of the items on the list are particularly complex or difficult for a contractor to perform. As a strategy to enhance the likelihood of system approval, we recommend to contractors that their written policies and procedures address each of the 35 topics and how the contractor complies with each of the topics.

We asked surveyed companies whether they have an approved purchasing system, and 49 percent report their system has been reviewed and approved by the DCMA.

DCAA audits of cost estimating systems

- Approved **30%**
- Not approved **35%**
- Other — Write in **35%**



An estimating system is defined as the contractor's policies, procedures and practices for budgeting and planning controls as well as generating estimates of costs and other data included in proposals submitted to customers in the expectation of receiving contract awards.

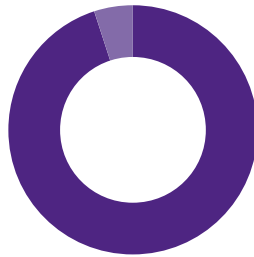
DFARS clause 252.215-7002 states that an adequate cost estimating system is one that:

- 1 Is maintained, reliable and consistently applied;
- 2 Produces verifiable, supportable, documented and timely cost estimates that are an acceptable basis for negotiation of fair and reasonable prices;
- 3 Is consistent with and integrated with the contractor's related management systems; and
- 4 Is subject to applicable financial control systems.

The DCAA is the government agency within the DoD primarily responsible for reviews of cost estimating systems. The DCAA has not given priority to cost estimating system reviews since the DFARS requirements were released. We asked surveyed companies whether they have an approved cost estimating system and a majority reported that the DCAA has not performed an audit of their cost estimating system under the DFARS requirements.

DCAA assist audits of subcontractors

- Performed by the company **95%**
- Requested government assist audit **5%**



One of the most significant risks for TCPD non-compliance is in proposed materials and subcontract costs. It is not unusual for a contractor to obtain proposals from one or more suppliers or subcontractors and incorporate those into their initial proposal to the government. Often, a contractor's subcontract administrator or purchasing official will begin discussions and negotiations with the supplier or subcontractor in anticipation of a future award from the government. When the results of these discussions are to be incorporated into the proposal, it is important that they be disclosed to the government during negotiations. Additionally, cost and price analysis is highly scrutinized as to propriety by the DCMA when performing CPSRs. For DoD contractors, non-approval of a contractor's purchasing systems could result in denial of a contract award or loss of an awarded contract.

The exposure to TCPD compliance risks from material and subcontractor costs is greater because of recent changes to the DCAA's role in the proposal process for DoD awards. Previously, many contractors could depend on the DCAA to perform assist audits of proposals from suppliers or subcontractors. We asked surveyed companies whether cost or price analysis is performed by in-house personnel or by assist audit, and 95 percent of surveyed company's report that they rely on in-house personnel to perform cost and price analysis of subcontractors while only 5 percent request government assist audits.



Survey feedback

We appreciate the feedback received from respondent in the *Grant Thornton 2017 Government Contractors Survey*. We recognize aspects of the survey were not as specific as some of the companies would like to see and the following comments and recommendations were received regarding the survey after it was completed:

- “Too focused on cost reimbursable contracts. It should include more questions on industry trends, revenue drivers and profitability.”
- “Should include more details on staffing back office by FTE, categorized by revenue brackets.”
- “Should ask about lead time for proposal awards, improvement of procurement environment, LPTA, etc.”
- “Difficult to disclose one overhead rate when many companies have multiple overhead rates.”
- “Hard to understand for those with limited accounting and government compliance knowledge. Should include information annotation.”

We will incorporate these suggestions in future iterations of our *Government Contractors Survey*.



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