

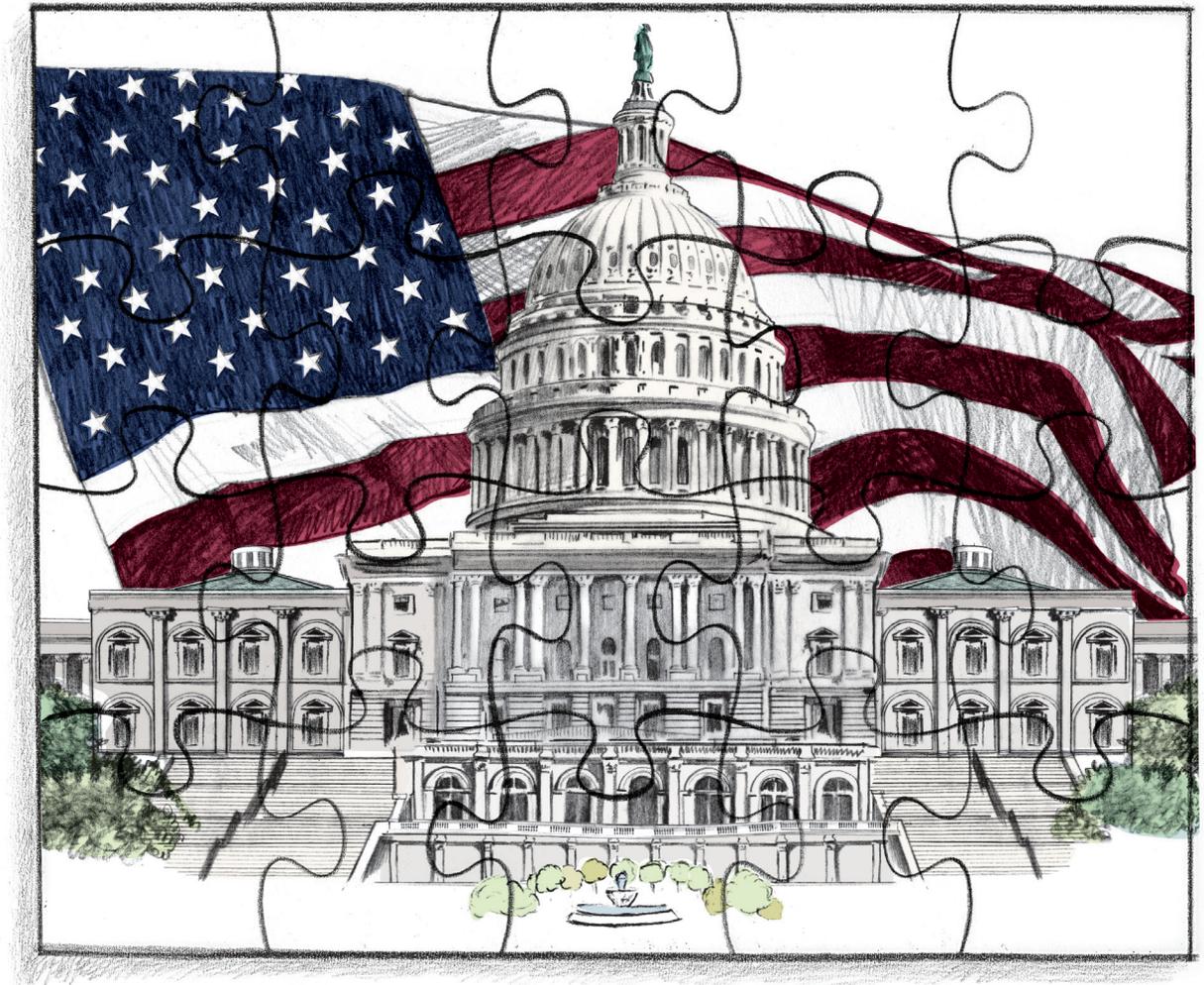


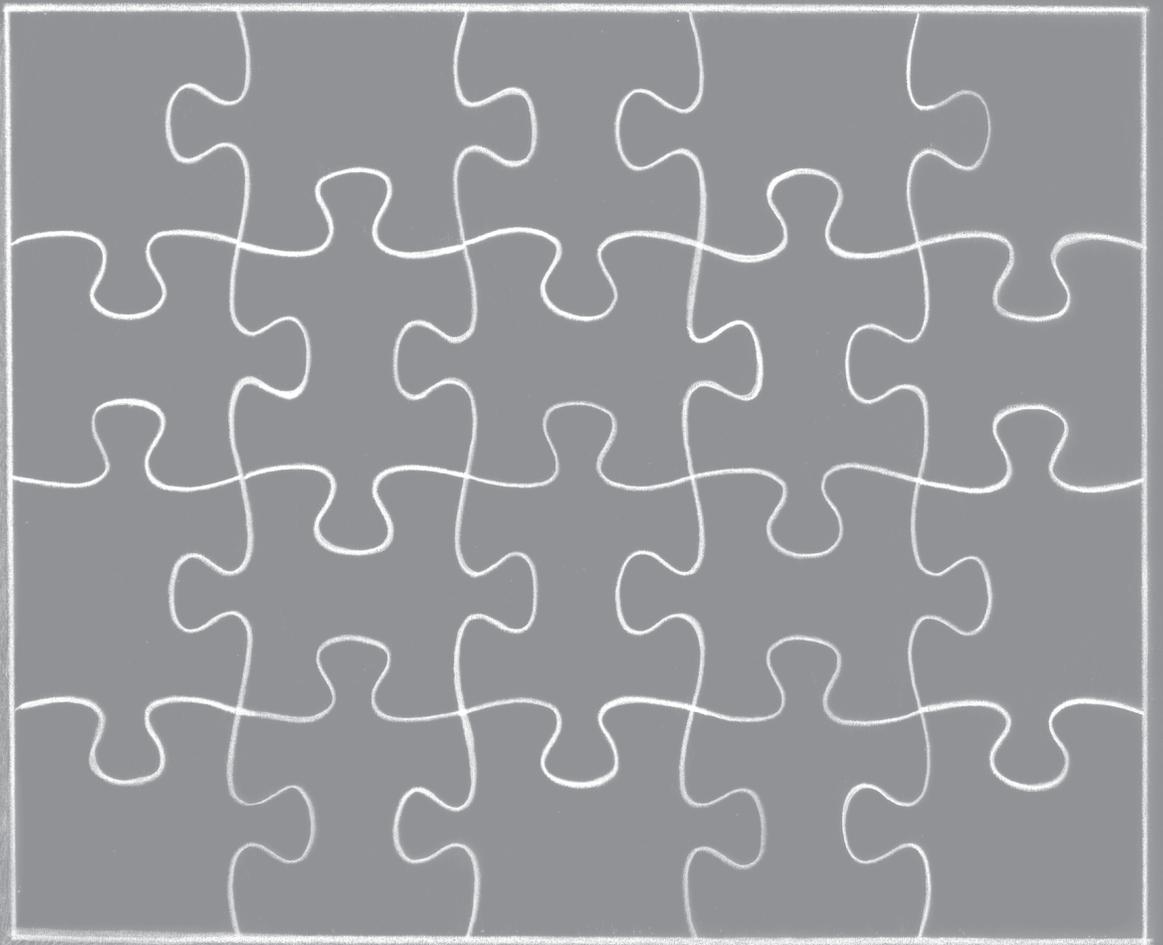
Grant Thornton

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INDUSTRY SURVEY 2012

18th Annual Government Contractor Survey Highlights Book





Introduction

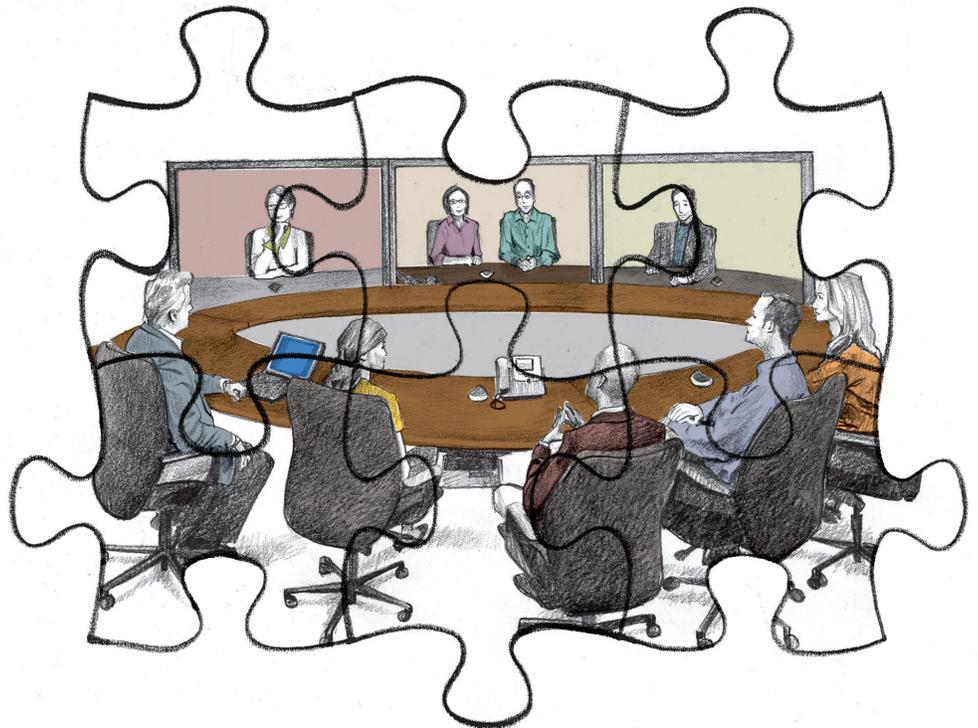
As Grant Thornton releases our 18th Annual Government Contractor Industry Survey, we are presenting the wealth of financial and nonfinancial information provided by government contractors — small, medium and large — from across the country. We sincerely appreciate the participation of the many companies that took part in our survey.

Survey participants are CEOs, CFOs and other key officials of companies whose primary customer is the federal government. Their responses were received in July and August 2012; financial and business statistics typically relate to fiscal years ended in 2011 or early 2012, treated as belonging to 2012.

Through our analysis of participants' responses, we provide a perspective on how the government contracting industry has evolved, discuss trends that may affect the industry in the future, and offer suggestions on effective practices.

This 18th annual survey gained a new element: we incorporated in the questionnaire participants' suggestions that were submitted with last year's survey. You will find this information woven throughout the survey topics.

We hope you enjoy and are inspired by survey results, which appear here in condensed form and are available in full in the complete survey report.



Highlights

Revenue

The survey shows changes in revenue for various contract types such as cost reimbursable, time and material, and firm fixed-price. Revenue from government contracts grew for 36% of responding companies, while 38% reported decreases. Compared with the 2011 survey, this represents a 15% decrease in revenue growth and a 9% increase in revenue decline.

Profit

Our surveys have supported the conclusion that, contrary to conventional wisdom, the profit rate from government contracting is rather modest. As compared with the 17th annual survey, the 2012 survey shows a drop in profit before interest and taxes; 60% of participants reported either no profit or profit in the 1–5% range. This compares with 37% in the 17th annual survey, 50% in the 16th survey, 45% in the 15th survey and 37% in the 14th survey.

Cost accounting

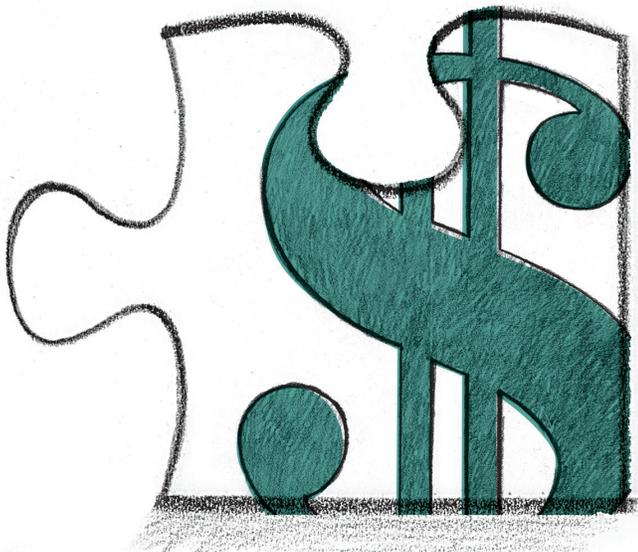
A company's cost accounting practices relative to indirect costs and direct labor can be critical factors in competitiveness and profitability. An important element is the fringe benefit structure. The fringe benefit rates reported in the 18th survey are higher than any of the rates reported in the four previous surveys. It appears that the primary cause was, not unexpectedly, the increasing cost of health benefit plans.

Indirect cost rates, labor multipliers

Along with data on provisional rates and the practices followed to true-up provisional rates to actual rates, the survey presents trend information about indirect cost rates and labor multipliers. Comparing 2012 with 2011, 42% of participants said indirect cost rates were increasing at their company, 17% said the rates were decreasing, and 41% said there was little to no change. The 17% reporting a decrease is a drop from last year's 23%. The labor multipliers are slightly lower than those reported last year.

Uncompensated overtime

The survey found that 78% of participants account for uncompensated overtime through the compression method, which with a cost-reimbursable contract can result in the client receiving free hours and the contractor receiving diminished profits. The rate of exempt employees working uncompensated overtime was 60%, down slightly from last year's 65%. The survey includes information about acceptable systems that comply with Defense Contract Audit Agency (DCAA) guidelines and the best practices to adopt, depending on the extent of cost-reimbursable contracting with the government.



Bid and proposal costs, win rates, bid protests

We asked participants to report bid and proposal costs as a percentage of revenue, as well as their win rates on proposals submitted in a competitive environment for new work. We asked them to additionally report win rates when special business units such as joint ventures were established to seek the new work. This year's survey indicates that since the last survey, there has been almost no change in the win rate of 30%. The rate jumps to 50% when the company was the incumbent on the previous contract for the same work. The survey also includes reports on the frequency of bid protests and whether the protest was successful.

Funding notices

For cost-reimbursable and time and material contracts, companies are required to monitor spending against contract funding and to give the government advance notice when additional funds will be required to complete the contract. For most contractors, the monitoring and notification requirements for funding notices require close coordination between the accounting, program management and contract administration departments. Survey participants rated the effectiveness of their procedures for providing funding notices; 83% rated their procedures as either very effective or somewhat effective, indicating little change from last year.

Out-of-scope work

Participants rated themselves in identification of out-of-scope work. They also explained how they address requests from government officials for out-of-scope work without a contract modification, which is requested of 85% of participants. Only 16% reported that they always refuse these requests. Failure to effectively identify and seek compensation for out-of-scope work contributes to low profit rates from government contracts. This year 63% indicated their procedures were either very effective or somewhat effective, compared with almost 80% in the 17th survey.

Earned value management systems

We asked a series of questions about earned value management systems (EVMS) and their effectiveness as a management tool. Confidence in EVMS seems to be eroding further: only 41% of companies with EVMS reporting requirements indicated they considered it a cost-effective management tool, compared with 37% last year. We also explored the extent of responsiveness from the government after receiving EVMS reports. Only 34% ever receive meaningful feedback.

Business ethics and conduct

Government procurement regulations impose demanding requirements regarding codes of business ethics and conduct. The 18th survey includes a report about codes established by participants, as well as the extent of training and internal or external audits to assure compliance. The survey gauged satisfaction with the regulations; 59% of participants reported that they believe the requirements are excessive and not cost-effective.

Business systems

The government has established stringent new standards for various business systems. Noncompliance can have adverse financial consequences and can be the basis for denying a contract award. Twenty-nine percent of surveyed companies reported they made improvements to their business systems in order to comply with the new standards. Thirty-three percent reported the government had recently audited their business systems.

Cost issues

Another survey topic regards cost issues challenged by the DCAA and the methods companies use to rebut the government's position. We offer suggestions on the most effective rebuttals to DCAA challenges to executive compensation and other frequently challenged costs. Issues related to executive and employee compensation continue to be the leading cause of DCAA challenges.

Relationship with DCAA

The majority of surveyed companies have an adverse opinion of the DCAA and its work product: 53% believe the DCAA's audit conclusions are arbitrary and not appropriately referenced to procurement regulations. Sixty percent believe that the DCAA is inflexible and rarely receptive to contractor rebuttals. The number of companies reporting excellent relationships with their DCAA auditors was the same as in last year's survey: 24%.

Resolution of contract issues

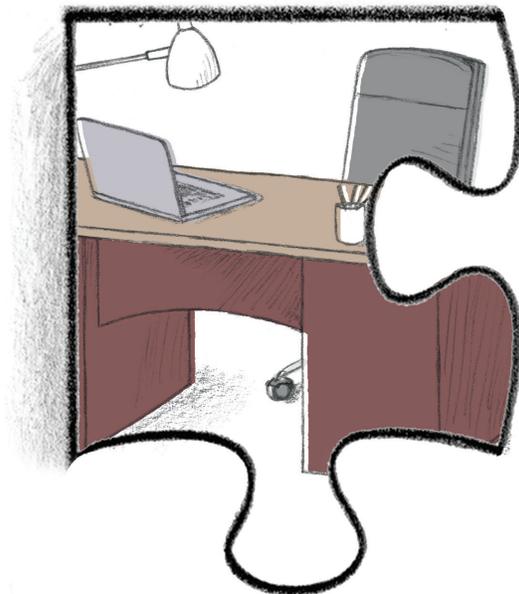
Only 18% of survey participants believe contract issues are resolved efficiently by the government, leaving 82% who believe the government is inefficient in these dealings. The trend of confidence in the government's ability to efficiently resolve disputes has been steadily going downward over the past four years. This year, of the 82% reporting inefficiency, 56% blame the delay on the DCAA, while 26% blame the contracting officer.

Executive compensation

During 2012, the Armed Services Board of Contract Appeals decided two cases on executive compensation in which the board decided in favor of the contractor because of the DCAA's flawed statistical analysis techniques. The arguments in support of the contractor positions are the same as Grant Thornton's guidance on executive compensation presented in annual surveys for many years.

M&A activity

Forty-one percent of surveyed companies expect the environment for M&A to improve during the next 12 months, while 43% expect no change. The remaining 16% expect the environment to worsen. During the past year, 63% of the surveyed companies that considered M&A walked away from the deal because of issues identified during due diligence.



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If you wish to participate in next year's survey or would like information about purchasing the full results of the 2012 survey, contact Lou Crenshaw, National Aerospace and Defense Industry practice leader, at 703.837.4430 or lou.crenshaw@us.gt.com.

Grant Thornton professionals can assist you with planning and strategy. We draw upon years of experience in the government contracting industry, forming the supporting infrastructure to work with you on maximizing opportunities, and improving your business strategies and processes.

For further information about how Grant Thornton professionals can help, contact us:

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