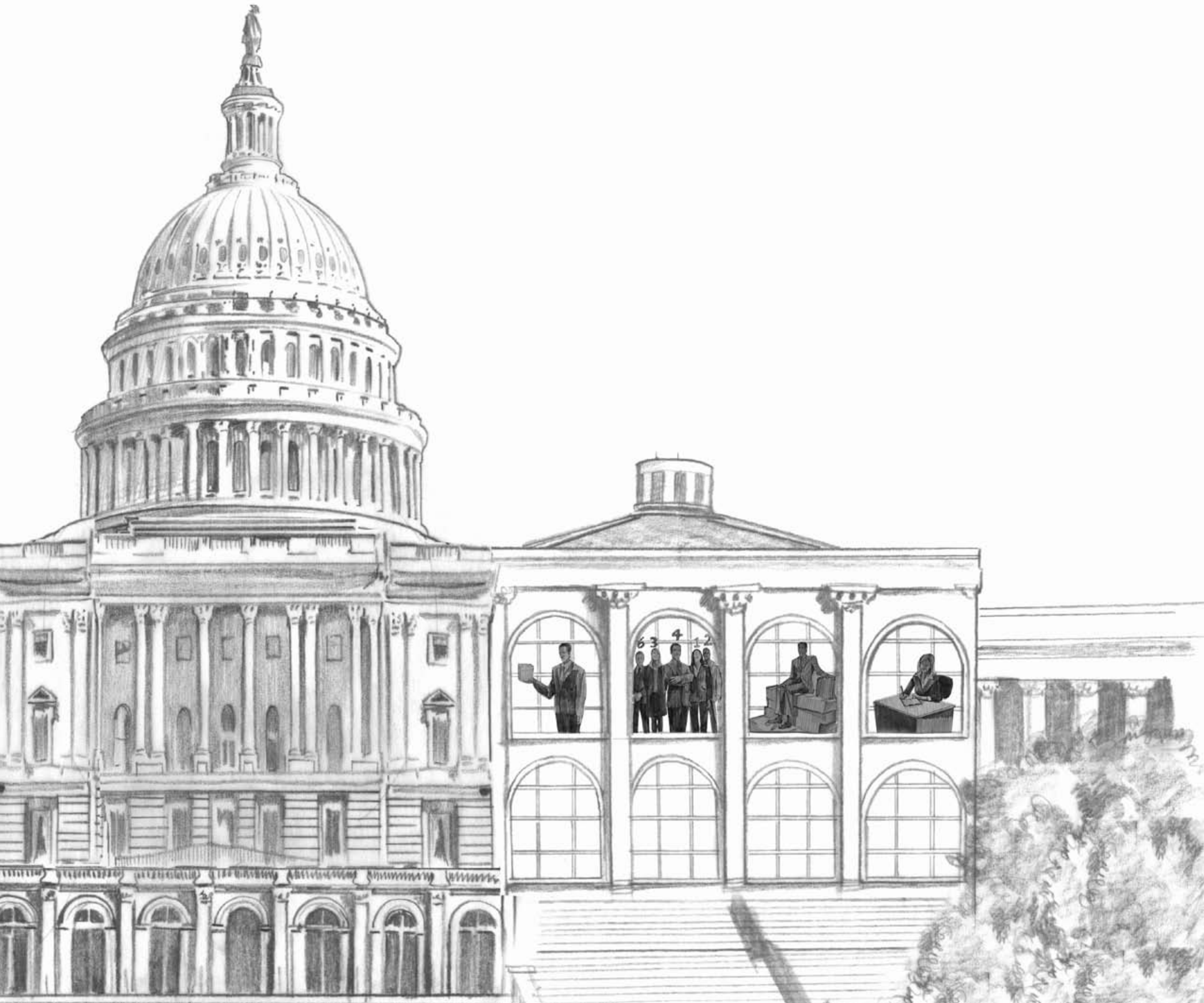
14th Annual Government Contractor Industry Highlights Book

Industry survey highlights 2008



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"For over 20 years Grant Thornton's Government Contractor Industry Practice has provided thought leadership to the industry...an industry we serve with passion and pride."

Kerry B. Hall
Government Contractor Industry Practice Leader

Introduction

Grant Thornton provides this annual survey as part of our continued thought leadership within the government contractor community — a community we serve with pride.

The Annual Government Contractor Industry Survey was developed by Grant Thornton for companies considering entering the government contracting arena. We hope that existing industry participants will also find the results of interest. Survey findings provide a comprehensive look at the industry as a whole, as well as detailed information on the day-to-day business of being a government contractor.

Through collection and analysis of responses from a cross-section of companies that consider the federal government to be a significant customer, the survey provides a perspective on how the government contracting industry has evolved over the past year. This feedback identifies key trends leading to future challenges and opportunities.

Whether you are an established government contractor or a business considering entering this market, we hope you will find the information contained in Grant Thornton's 14th Annual Government Contractor Industry Survey helpful in planning the future of your business.

Grant Thornton prides itself on being a firm of thought leaders who provide personalized attention and the highest quality of service. Our goal is to ensure that this survey continues to evolve and provides those interested in government contracting the most specific and useful information possible. To offer suggestions for next year's survey, please contact me directly at Kerry.Hall@gt.com or 703.847.7515.

We are fortunate to be supported by our generous sponsors, who share our passion for this industry: BB&T Capital Markets | Windsor Group, Holland & Knight LLP, Microsoft Corporation, Professional Services Council (PSC) and Washington Technology.

Executive summary

The Grant Thornton Annual Government Contractor Survey presents business information from small, medium and large companies that represent a cross-section of the government contractor industry. We sincerely appreciate the participation of the many companies that participated in our survey. We welcome comments and suggestions from survey participants and endeavor to incorporate those comments and suggestions when updating our questionnaire for future surveys.

Revenue by market

On average, survey participants report that approximately 90% of total revenue comes from government contracts, which is identical to last year's survey. However, the percentage of revenue from the Department of Defense is increasing while the percentage of revenue from other federal agencies is declining.

Revenue trends

55% of survey participants experienced revenue increases from federal businesses during the past year while 18% suffered decreases. These findings continue the trend from prior years.

Management and support headcount

At 16%, management and support headcount is significantly higher as a percentage of total headcount than in prior years. One factor that may be contributing to the increase is the somewhat elaborate compliance system requirements recently prescribed by the government.

Profit rate

Profits before interest and taxes continue to be moderate in the government contracting industry. 37% of surveyed companies had either no profit or profit rates between 1-5% of revenue.

Current ratio

65% of surveyed companies report a current ratio of 2 to 1 or less, which is an increase from the 54% reported last year.

Labor multipliers

Labor multipliers inclusive of fee have increased over last year's survey. The multiplier for company site direct labor grew from 2.3 to 2.4 and for customer site labor from 1.9 to 2.0.

Uncompensated overtime

35% of surveyed companies do not account for all hours worked and as a result are at risk for under-billing time and material contracts.

Proposal win rates

Survey participants report a 30% win rate from proposals for non-sole source business. The win rate jumps to 65% when the company establishes a special business unit such as a joint venture or a limited liability corporation to bid the work.

Identifying out-of-scope work

65% of surveyed companies consider their procedures for identifying out-of-scope work to be either ineffective or only somewhat effective. This finding is practically identical to last year's survey.

Earned value management systems

28% of surveyed companies have contracts which require Earned value management systems (EVMS). Of these, only 40% report they ever receive meaningful feedback from the government regarding information in the EVMS reports. 85% of these companies would not use an EVMS system if it were not required by the government.

Executive compensation

Executive compensation remains the cost most frequently challenged by DCAA.

New compliance regulations

The government has recently created requirements for elaborate new compliance systems which are applicable to most government contractors. Compliance with these regulations is mandatory and failure to comply can result in prosecution, suspension and debarment.

Company profile

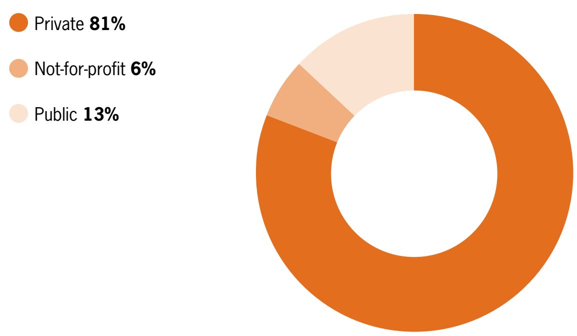
Grant Thornton's 14th Annual Government Contractor Survey represents findings from approximately 120 companies who do business with the federal government. Survey questionnaires were distributed in early 2008 and responses were received by July 2008. Financial and business statistics in the survey typically relate to fiscal years ended in 2007.

We analyze all data provided by respondents to assure that the data in the survey is statistically valid and representative of most respondents. Throughout the survey, data is presented as a whole or by company revenue size when appropriate. We also include a narrative in each section of the survey interpreting the data and, in many cases, compare the data to the results from prior Grant Thornton Government Contractor Surveys to identify trends.

Ownership structure

Continuing the trend from prior surveys, the majority of the survey participants are privately held companies. Company management or individual investors account for 81% of the surveyed companies while 13% are publicly traded. The remaining 6% are not-for-profit organizations. See Figure 1. In last year's survey, 82% of participants were privately held, 9% were publicly traded, and 9% were not-for-profit organizations.

Figure 1: Ownership structure



Location of the company

Survey responses were received from companies in 23 states and the District of Columbia. 70% of the respondents were located in Maryland, Virginia, and Washington, DC, and others are located in California, Colorado, Delaware, Florida, Hawaii, Kentucky, Maine, Massachusetts, New Jersey, New Mexico, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Tennessee, Texas, Vermont, Washington, West Virginia and Wisconsin.

Primary products or services

More than 90% of surveyed companies sell professional services to their clients while a very small percentage sell products. This is not surprising given the government trend to outsource more and more services as time goes by. The services companies in this year's survey provide a wide range of skills including consulting, information technology, research, engineering, general business services, science and technology and other services.

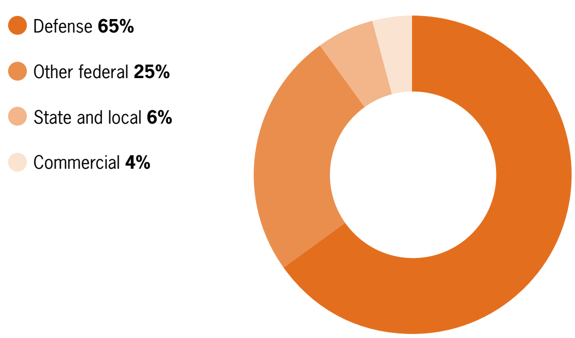
Revenue by market

Participants in the survey report that, on average, 90% of their revenue was from contracts with the federal government. See Figure 2. This percentage is identical to last year's survey except that revenue from Department of Defense work grew from 60% to 65% while revenue from other federal agencies fell from 30% to 25%. The percentage of revenue from contracts with the federal government was 79% in the 10th Annual Survey, 84% in the 11th, 88% in the 12th, and 90% in the 13th and 14th. It appears that revenue from the federal government may have peaked at the 90% level; however, this could change in the future depending on policy changes that may be implemented by the recently elected Administration.

The increase in revenue from contracts with DOD continues the trend from recent years. The revenue from DOD contracts has grown steadily in recent years growing from 56% in the 12th Annual Survey, to 60% in the 13th, and to 65% in the 14th.

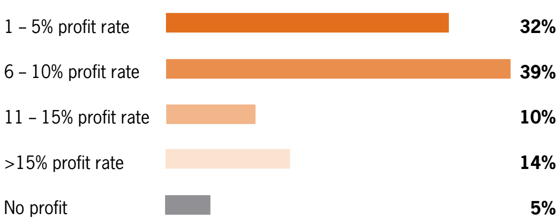
At 4%, revenue from commercial clients continues to be very low as a percentage of total revenue. Revenue from commercial clients was 15% of total revenue in the 10th Annual Survey, 10% in the 11th, 6% in the 12th, and 4% in the 13th and 14th surveys. It is evident from this trend that as the federal budget increases, government contractors are devoting their time and energy to maximizing business from that market rather than applying resources to expand commercial business.

Figure 2: Revenue by market



Financial statistics

Figure 3: Profit rate before interest and taxes



We asked surveyed companies to provide a wide variety of information that illustrates the financial health of their organization. The responses are presented in this section of the survey.

Profit rate (before interest and taxes)

Contrary to public and politicians' perception, government contracting is not a high-profit business where companies make abnormally high profits. Indeed, the information provided by surveyed respondents demonstrates the reality is far different from the perception and that profits are unusually low, particularly when considering the performance and financial risks inherent in government contracting.

Surveyed companies provided financial information on profit before interest and taxes as a percentage of gross revenue and the results are shown in Figure 3. 37% of surveyed companies had either no profit or profit rates between 1-5% while 76% had either no profit or profit rates between 1-10%. Only 14% of the government contractors participating in this survey had profit rates over 15%.

These findings are consistent with the results from last year's survey which demonstrates that low profits are a steady trend in government contracting. The profit rates in Figure 8 are further diminished significantly after deducting interest and taxes.

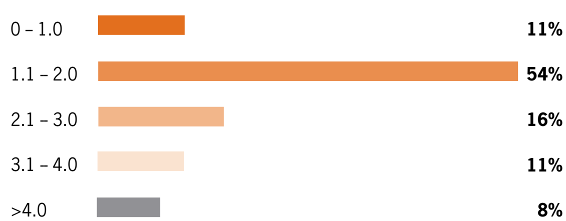
Current ratio

The current ratio is derived by dividing current assets by current liabilities from the balance sheet. A current ratio of 2 to 1 or higher generally indicates a financially healthy company.

Survey participants provided their current ratios and the results are shown in Figure 4. 65% of the respondents report a current ratio of 2 to 1 or less compared to 54% in last year's survey. 16% report current ratios between 2.1 to 3 compared to 24% last year, and the remaining 19% report 3.1 or higher compared to 22% last year.

The current ratios reported in this year's survey reflect a deterioration in the financial health of government contractors which is contrary to the perception held by many outside the industry. While costs to contractors and the government will surely increase in the near-term, profits and improved current ratios are unlikely to grow commensurate with the increased expenses.

Figure 4: Current ratio



Government contracts

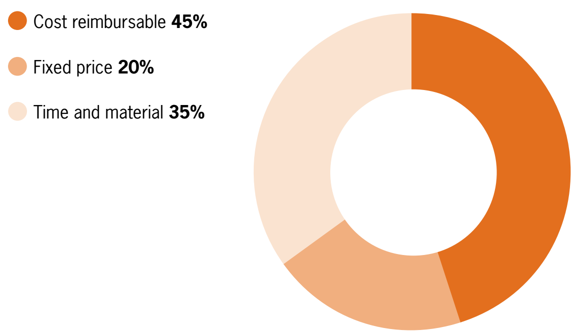
In the mid-1990s, the federal government streamlined its systems to procure goods and services. Prior to that time, government procurement was a lengthy, inefficient process that put a premium on massive proposal submissions, time consuming pre-award audits, and a bureaucratic source selection process that emphasized the content and format of the proposal rather than the past performance of the proposer. By the mid-1990s, the procurement process was no longer able to keep up with the new products and technologies being offered by businesses leaving the government with little choice other than streamlining.

Revenue by contract type

The government's change in direction from efficient commercial practices to an audit and investigation intensive environment is evidenced by survey responses on revenue by contract type. See Figure 5.

In this year's survey, respondents reported that 45% of the revenue from the government was from cost reimbursable work which continues the upward trend noted in recent years. Cost reimbursable contracts accounted for 28% of the revenue in the 11th Annual Survey, 39% in the 12th Annual Survey, and 40% in the 13th Annual Survey. It is difficult to equate the high use of cost reimbursable contracts with the notion that the government is attempting to use more commercial processes to streamline federal procurement. The commercial environment normally uses fixed price or time and material contracts while the government continues to maximize the use of cost reimbursable contracts.

Figure 5: Revenue by contract type



Dealing with the government

Relationship with the government auditor

The Defense Contract Audit Agency (DCAA) is the largest contract audit resource within the federal government employing more than 3,000 auditors in approximately 300 field audit offices throughout the United States and overseas. Although DCAA is part of the Department of Defense, it frequently performs contract audits for other government agencies.

We asked surveyed companies to describe the quality of their business relationship with DCAA. 88% reported that their relationship is excellent, or good, while 12% reported it is only fair or poor. See Figure 6.

We also asked how the relationship with DCAA has changed in the past year. The results are shown in Figure 7. 86% reported the relationship has stayed the same compared to 81% in last year's survey. 6% of respondents reported the relationship had deteriorated, which is less than the 10% reported last year. 8% reported the relationship with DCAA had improved compared to 9% in last year's survey.

Figure 6: Relationship with government auditor

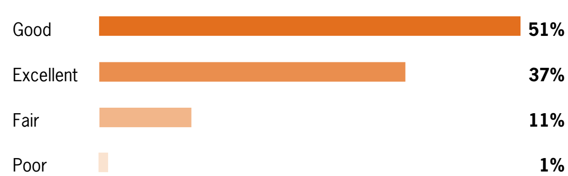
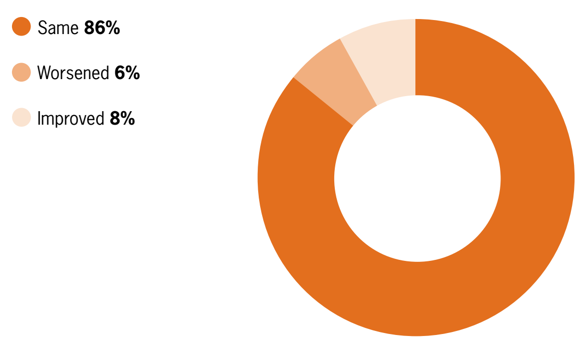


Figure 7: Change in relationship with government auditor



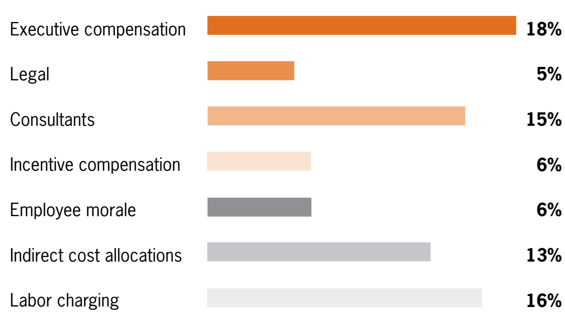
Most frequent cost issues

Surveyed companies were asked to identify the categories of costs that were most frequently challenged by DCAA. The results are presented in Figure 8.

Executive compensation continues the trend from the last several surveys as the most frequently challenged cost and is discussed in more detail later in this survey.

Consultant costs are also receiving more attention from DCAA than in prior years, being cited as a frequent audit issue by 15% of survey respondents compared to 9% in the 13th Annual Survey. From our experience assisting clients, DCAA often questions consultant costs if the consultant agreement is either missing, out of date, or incomplete with regard to services provided or the rate of pay for the services. We believe such an approach is unreasonable and ignores the fact that services were provided and benefit was conveyed to the company and the government. When documentation supporting consultant costs is lacking, we recommend providing other corroborating evidence to DCAA in support of the charges.

Figure 8: Most frequent cost issues



Workforce compensation

Medical benefits

We asked surveyed companies to provide the medical benefits costs as a percentage of labor costs. The results are shown in Figure 9. In general, the costs of health benefits appear to be higher than last year although the changes vary from range to range and the variation could be the result of changes to the plan offerings and not just the cost.

In most companies, the cost of medical benefits is shared by the company and the employee. We asked surveyed companies to provide the percentage of medical benefits paid by the employee. The results are summarized in Figure 10. The findings are consistent with last year's survey.

Figure 9: Health insurance as a percentage of labor costs

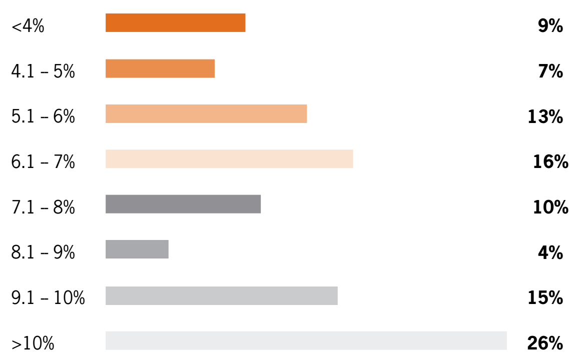
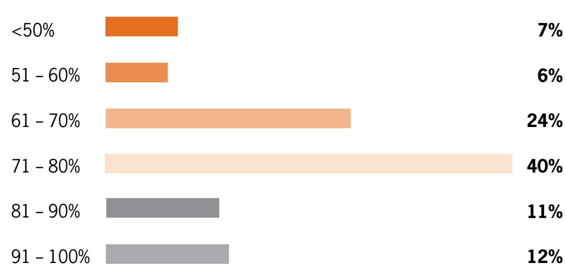


Figure 10: Percentage of health insurance paid by the company



Wage increases

We asked surveyed companies to provide information on the average wage increase paid to full-time employees during the past year. On average, wage increases were 3.5-4.0% of labor costs which is identical to the percentage reported in last year's survey. It's possible that companies are increasing their emphasis on other forms of incentive compensation in place of annual wage increases since the amount of incentive compensation paid is discretionary and it can be targeted to those employees who are considered most valuable to the company.

Business strategies

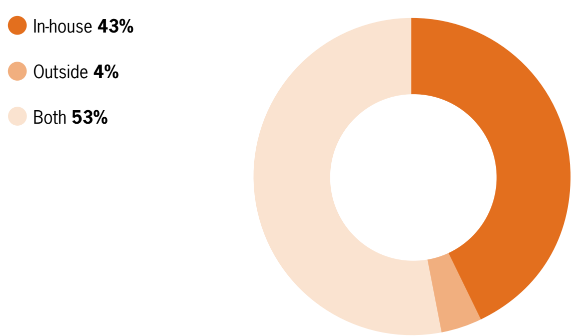
Due diligence

In our experience, we find far greater business risks in government contracting than are found in commercial contracts. Outstanding performance is never enough to secure the future for government contractors. Government procurement regulations require a rigorous competitive process before contracts are awarded and the source selection often puts a premium on price above experience. Government contract terms and conditions impose unique compliance burdens in practically all aspects of the company's business and those burdens are increasing continually as the politicization of government contracting increases. Ongoing programs are often curtailed with short notice because of changing budget priorities. And then of course there are the audit risks. Costs which have been routinely accepted for years can suddenly be challenged by government auditors with potentially severe consequences for the financial health of the business. It is extremely important that these unique risks be well examined while performing due diligence on a government contractor.

We asked surveyed companies to identify who performed due diligence on their mergers and acquisitions. In 43% of the cases, due diligence was performed in-house while 53% used a combination of in-house personnel and outside firms. See Figure 11. In last year's survey, the findings were practically reversed with 54% performing due diligence in-house and 42% used a combination of in-house personnel and outside firms.

Price reductions resulted from due diligence in 20% of the cases compared to 32% in last year's survey. The risk areas that caused price reductions included overvalued net worth, collectability of unbilled receivables, quality of funded and unfunded backlog projections, contract renewals, eligibility for small business awards, value of fixed assets, and specific terms and conditions in government contracts.

Figure 11: Performance of due diligence



Executive compensation

DCAA challenges to executive compensation

As stated previously, executive compensation is challenged by DCAA far more frequently than any other element of cost. DCAA's analytical technique is simplistic and formula driven and applies little or no auditor judgment in the initial analysis. First, DCAA selects three or four commercially available compensation surveys. They then extract compensation data at the median level for the highest paid executive positions for companies of similar revenue size in similar industries as the company being audited. On occasion, DCAA will fragment the total revenue of the company being audited to the division level revenue thereby drawing compensation data from surveys for companies much smaller than the company being audited. Oftentimes, DCAA will be forced to extrapolate median level compensation by company size using regression analysis techniques since the surveys often don't present data by company size comparable to the size of the company being audited. The auditor will then average the median compensation by position using the data drawn or extrapolated from the three or four surveys used in their analysis. DCAA typically then adds 10% to the average and disallows the difference between the contractor's actual costs and the amount computed by DCAA.

We asked surveyed companies to express their opinion on the validity of DCAA's methodology for auditing executive compensation. 57% of respondents believe that DCAA's methodology is invalid while the remaining 43% consider it valid.

Surveyed companies that faced DCAA challenges to executive compensation provided information on the ultimate resolution of the issue. The company position was sustained in 25% of the cases compared to 28% in last year's survey. A reasonable compromise was reported by 39% of respondents compared to 44% last year. The DCAA position or an unreasonable compromise resulted in 36% of the cases reported compared to 28% last year.

Intellectual property

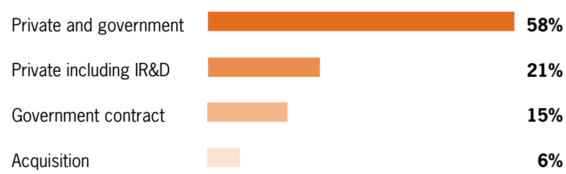
Ownership of intellectual property

46% of surveyed companies own intellectual property, which is comparable to the 49% reported in the 13th Annual Survey and to the 46% reported in the 12th Annual Survey.

We asked surveyed companies how the intellectual property was acquired and the results are shown in Figure 12. 79% report that intellectual property was developed entirely at private expense, or with a mix of private and government funding compared to 92% in last year's survey. 15% of respondents report that the intellectual property was developed exclusively with government funding compared to 4% last year.

Government regulations classify development paid for with IR&D funds as private expense even in situations where the IR&D costs are allocated to government contracts as an indirect cost. We are skeptical of the finding that 15% of the intellectual property was developed exclusively with government funding. While the government frequently funds customization of commercial products for government use, it is rare that the government funds all of the development of the core technology with contract funds.

Figure 12: Source of intellectual property



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14th Annual Government Contractor Industry Survey complete table of contents

The table of contents below summarizes the information included in the full survey results. To learn how to obtain a full copy of the survey, or to participate in next year's survey, please contact Melissa.Epstein@gt.com.

Contacts

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Our professionals help government contractors form the strategies and supporting infrastructure that will maximize opportunities, build a successful business base, minimize taxes and improve profitability.

Grant Thornton's Government Contracting practice is a thought leader in this industry. The practice holds quarterly roundtables on such topics as mergers and acquisitions and the annual government contractors survey.

Please visit the Grant Thornton Government Contractor Industry website to learn more about the services we provide and to download a copy of the Government Contractor Industry Survey Highlights booklet. **www.GrantThornton.com/govcon**.

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