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Working for the federal government: What technology companies need to know about government contracts

Insights for technology companies July 2009

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A growing number of companies across several industries are recognizing the many advantages to providing products and services to the federal government. With a staggering budget, the federal government has substantial needs for products and services, and outsources an expanding number each year. Moreover, its budgets tend to increase annually, and the government is a reliable and credit-worthy customer — a rare and valuable commodity in an uncertain economy.

Of course, there are always downsides: in this case, the many rules, regulations and nuances of working with the federal government and the challenges of dealing with a sluggish bureaucracy. However, if companies know what to expect, they can anticipate and manage these potential drawbacks to ensure they don't detract from the benefits of being a government contractor.

What follows are some important considerations and need-to-know information for technology companies that are thinking about pursuing government contracts.

Understanding the landscape

While there are a number of benefits to government contracting, it's important to understand the inherent risks before entering into a contract. First, government procurement regulations often require a rigorous competitive process before contracts are awarded, and selection criteria typically favor price over experience. Contrary to the commercial sector, outstanding prior performance may not be enough to secure future government contracts.

Second, government contract terms and conditions impose unique compliance burdens on practically all aspects of the company's business, so it's critical that the company fully understand these terms and conditions before accepting a contract. Third, ongoing programs may be curtailed with short notice because of changing budget priorities or a new administration. However, the regulations provide for generous settlements to any company whose contract is terminated for convenience.

Finally, there are the inevitable audit risks. Costs that have been accepted routinely for years can be challenged by government auditors with potentially severe consequences for the financial health of the business. In such cases, the company must be well-versed in procurement regulations to protect itself from arbitrary or incorrect interpretations of these regulations by the government.

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Procurement rules under FAR

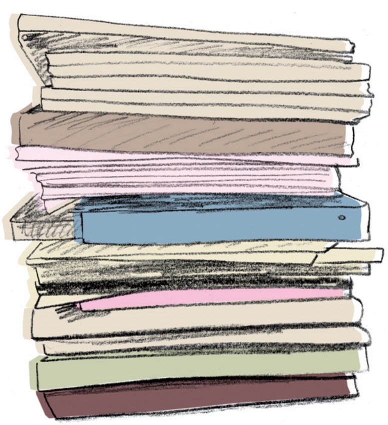
Government contracts usually require a company to implement business processes and to comply with contract terms, conditions and procurement regulations that differ greatly from those of commercial contracts. These unique obligations are embodied in a federal statute, the Federal Acquisition Regulation (FAR), and agency-specific FAR supplements. FAR regulations include specific requirements for each phase of contracting, including communications with the government, ethics, pricing, negotiations, accounting, and contract administration and performance.

For example, depending on the type of award, companies need to submit different documentation in their proposals. For contracts that are competitively bid, the documentation is less rigorous than sole-source bids. For a sole-source bid, companies often must provide very detailed cost breakdowns of the proposed price and must certify that the data provided is current, complete and accurate as of the date of the agreement.

The degree to which companies are subject to various portions of FAR depends on the size and length of the contract and other factors, but understanding their obligations under FAR is essential. Failure to comply can result in a variety of consequences, ranging from financial loss, termination of the contract, investigations and allegations of overcharging, to ultimate suspension or debarment from future government contracts.

Types of contracts

There are three main types of contracts awarded by the government: cost-reimbursable, labor hour and firm-fixed-price contracts. With cost-reimbursable contracts, the government reimburses actual allowable costs plus a negotiated profit. Labor hour or time-and-material contracts include a negotiated billing rate, which covers labor costs as well as indirect costs and profit, so a profit is virtually guaranteed. Firm-fixed-price contracts carry more risk for the contractor and put a premium on managing the contract and budget. With the risk, however, comes the opportunity for a higher profit if the contract and budget are managed properly. Keep in mind that while a profit is likely with government contracts, it is generally modest, typically ranging from 1 to 10 percent of contract costs.



Audit risk looms

Government contractors' records are subject to audit at any time, and audits are likely to increase in frequency as American Recovery and Reinvestment Act (ARRA) funds are awarded. ARRA sets aside substantial funds for hiring more auditors to increase oversight of companies receiving stimulus funds. Audits can pose an administrative burden in dealing with auditors and responding to requests, however, maintaining staff to administer the contract and handle audits is a recoverable cost under certain government contracts.

Currently, the Defense Contract Audit Agency (DCAA) is the largest contract audit resource within the federal government, employing more than 3,000 auditors across nearly 300 offices throughout the U.S. and overseas. Although the DCAA is part of the Department of Defense, it frequently performs contract audits for other government agencies.

Most government contractors are required to be compliant with a code of conduct and business ethics. New compliance regulations require written policies and procedures, as well as formal training for all personnel involved in the performance of the government contract. In addition, the contractor must perform periodic internal or external reviews to make sure these policies and procedures are being followed.

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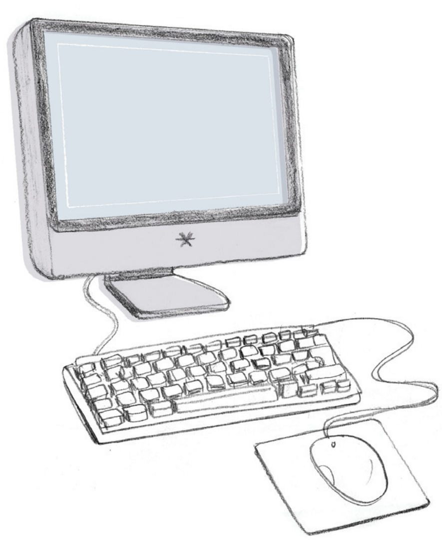
Allowable costs

There are certain costs that are allowable under FAR and others that are prohibited. Costs such as penalties, interest on debt, lobbying, entertainment and bad debt expenses are among the items that are not allowable charges against government contracts. There also are limitations on certain costs, such as executive compensation. For instance, if a company is paying its CEO $1 million per year, only a set amount would be recoverable from the federal government. During DCAA audits, executive compensation is challenged by auditors more often than any other cost.



Accounting system considerations

Companies need to maintain cost accounting records that have the capability to track and allocate costs to the projects they are working on. The cost accounting system also must define direct and indirect costs, provide for the exclusion of unallowable costs, and have a rational basis for allocating indirect costs to projects. Because the cost accounting requirements for government and commercial projects are so different, government regulations permit the use of memorandum records for government contract cost accounting. Commercial companies often want to pursue government contracts without any disruption to the business systems and corporate culture already in place, which may be possible with the appropriate guidance and consultation.

Getting started

Before companies are ready to bid on contracts, they must first familiarize themselves with the regulations and learn how to satisfy the requirements of government contracts. Then, they need to take the time to understand the government's spending priorities and begin to direct their marketing efforts appropriately. Companies can subscribe to information database services that track trends in government spending and monitor which contracts are scheduled to be out for bid in the coming months. This can be helpful to companies that are new to the government contracting space, as well as those that already are well-established and providing services to the federal government.

Working for the federal government as a contractor offers numerous benefits, particularly in a challenging economy. Yet being successful is predicated on satisfying not just the end customer, but also regulators and auditors. To do so requires the ability to effectively navigate and comply with the government's many contractual terms and requirements. •

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