



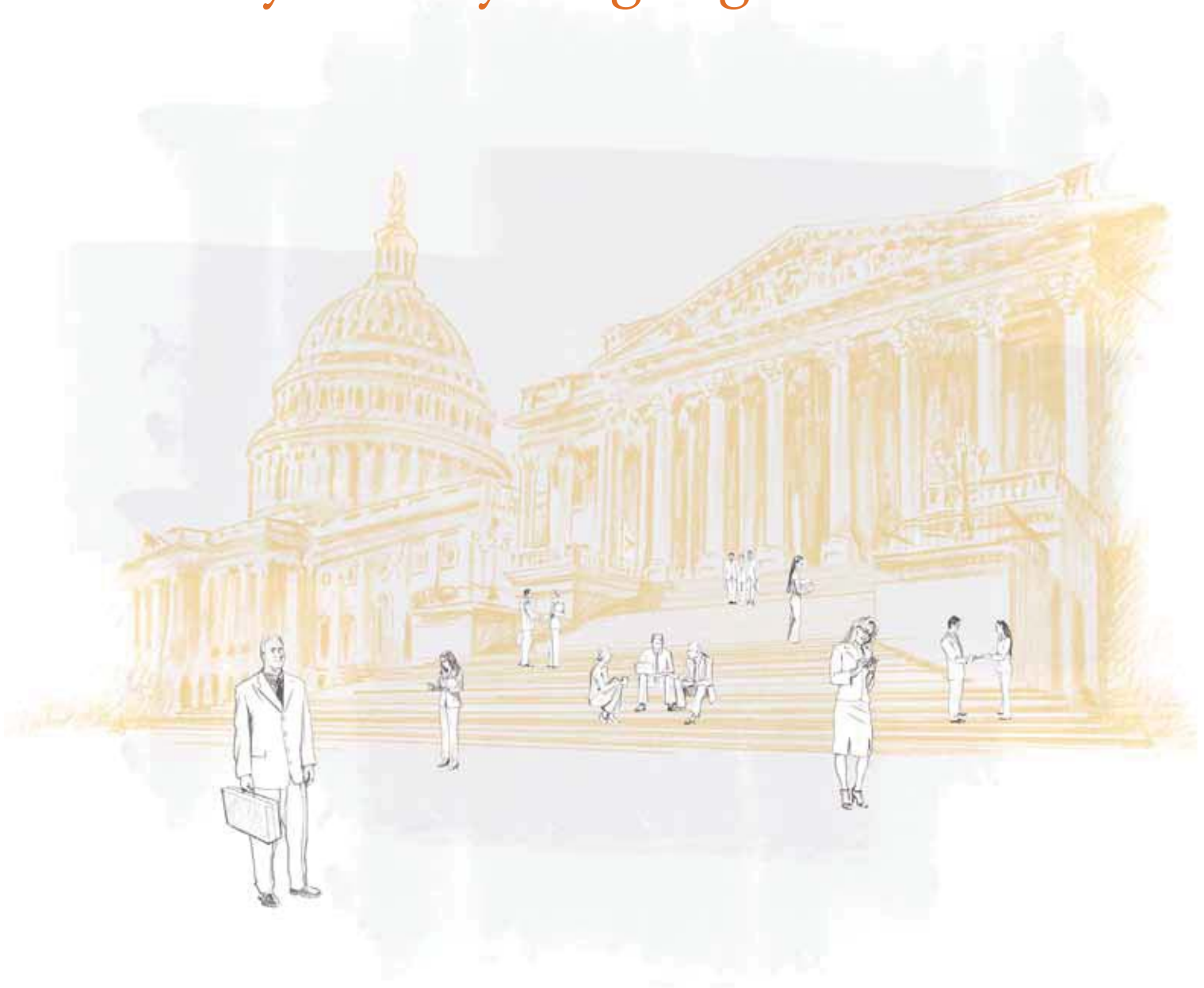
Grant Thornton

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INDUSTRY SURVEY HIGHLIGHTS 2011

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# 17th Annual Government Contractor Industry Survey Highlights Book



# 17th 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 [caitlin.rankin@us.gt.com](mailto:caitlin.rankin@us.gt.com).

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# Introduction



Grant Thornton LLP is pleased to provide the *17<sup>th</sup> Annual Government Contractor Industry Survey* as part of our continued support of the government contractor community – a community we have proudly served for three decades.

Our annual survey provides a comprehensive look at the industry as a whole. It measures the impact of new requirements in government contracting regulations, as well as the effects of changing priorities in the enforcement of procurement regulations by government personnel involved in the procurement process.

The survey is designed to cover sensitive areas that can directly affect the revenue and profitability of a government contractor and to help companies remain competitive in the marketplace. We also offer suggestions on how to safely navigate contractual and financial issues that may arise during the performance of government contracts. Whether you are an established government contractor or a business considering entering this market, we hope you will find the information in this survey to be helpful in managing your business and planning for its future.

We pride ourselves on being a firm of thought leaders who provide personalized attention and the highest quality of service. Our goal is to ensure this survey continues to evolve and to provide those interested in government contracting with the most specific and useful information possible. We welcome any suggestions for specific topics to cover in next year's survey. Please contact me directly at [kerry.hall@us.gt.com](mailto:kerry.hall@us.gt.com) or 703.847.7515 with your suggestions.

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Sincerely,

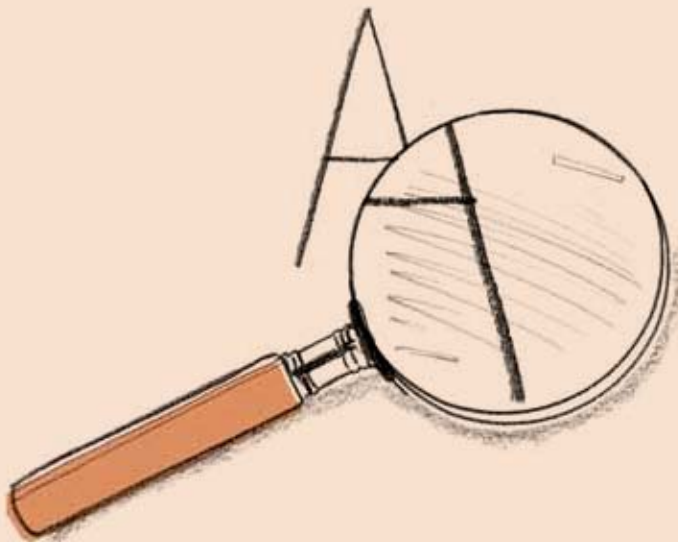
A handwritten signature in black ink that reads "Kerry Hall". The signature is written in a cursive, flowing style.

Kerry B. Hall  
Grant Thornton LLP  
Government Contractor Industry Practice Leader

# Executive summary

Grant Thornton's survey presents a wealth of financial and nonfinancial information provided by government contractors in 24 states and the District of Columbia. The government contractors that participated in this survey are small, medium and large companies that represent a cross section of the industry. We sincerely appreciate the participation of the many companies that took part in our survey.

A summary of survey information is presented here.



## Revenue from government contracts

During the past year, revenue from government contracts has grown for 50% of survey participants, while 21% experienced no significant change and 29% experienced reductions in revenue. The fact that the highest percentage of companies experienced revenue growth continues a long-term trend reported in previous surveys, indicating that government contractors are far less vulnerable than commercial companies to recessions or slow growth in the overall economy. However, the 29% of companies experiencing revenue reductions is the highest percentage reported in several surveys, indicating that government efforts to reduce deficits are adversely impacting government contractor revenue.

## Ratio of indirect-charging headcount to total headcount

The ratio of indirect-charging headcount to total headcount was 12.3% in the 17<sup>th</sup> annual survey, which is consistent with the results from the 16<sup>th</sup> annual survey. However, the ratio is significantly lower than the percentages reported in the 15<sup>th</sup> and 14<sup>th</sup> surveys.

## Profit before interest and taxes

Profit rates reported by survey participants followed a predictable pattern consistent with the profit guidelines in the government procurement regulations. Thirty-one percent of participants reported profit rates of 1-5% as a percentage of revenue; 37% experienced profit rates of 6-10%; 18% saw profit rates between 11% and 15%; and, 8% reported profit rates above 15%. The remaining 6% of participants either broke even or experienced a loss. On an overall basis, profits appear to have improved slightly compared with the results in the 16<sup>th</sup> annual survey.

## Collecting accounts receivable

The average time to collect accounts receivable from government contracts was less than 30 days for 21% of survey participants, while 60% reported receivables were collected between 30 to 60 days. The remaining 19% of respondents reported that it generally takes more than 60 days to collect accounts receivable.

### Accounting for uncompensated overtime

Seventy-two percent of survey participants account for uncompensated overtime by computing a diluted hourly rate (compression method) to allocate labor costs to cost objectives. The remaining 28% of participants apply a standard hourly rate (standard/variance method) to the hours reported and record the variance to overhead. The use of the compression method can result in free hours to the client in a cost-reimbursable contract environment.

### Trend in indirect cost rates

Indirect cost rates are increasing at 39% of the surveyed companies and decreasing at 23% of the companies. The remaining 38% of surveyed companies reported no significant change in their indirect cost rates. Only 32% of surveyed companies reported increasing indirect rates in the 16<sup>th</sup> annual survey, so it appears that indirect cost rates may be increasing on an overall basis.

### Proposal win rates

On average, survey participants reported a 30% win rate on proposals submitted in a competitive environment for new work. This rate is consistent with the win rates reported in prior surveys.

### Revenue by contract type for government contracts

On average, 45% of surveyed companies' revenue was from cost-reimbursable contracts and 35% was from time and materials (T&M) contracts. The remaining 20% was from firm-fixed-price (FFP) contracts. These findings are consistent with the findings from the four previous surveys.

### Identifying claims for out-of-scope work

We asked respondents to rate the effectiveness of their procedures for identifying out-of-scope work. Only 35% of respondents consider their procedures to be very effective, while 65% see the procedures as either somewhat effective or not effective. These results are consistent with the 16<sup>th</sup> annual survey. The failure to seek compensation for out-of-scope work contributes to low profit rates.

### Government requests for out-of-scope work without contract modification

Eighty-one percent of surveyed companies reported that the government either frequently or occasionally requests they perform out-of-scope work without a contract modification. Only 16% of respondents reported that they always refuse such requests. Such requests by government personnel are not consistent with the government's own procurement regulations, and the frequency of such requests should be a matter of serious concern among government officials.

### Earned value management systems

On major programs, the government spends large amounts for reporting using earned value management systems (EVMS). Only 37% of the surveyed companies with EVMS reporting requirements believe that EVMS is a cost-efficient management tool. Further, only 27% of the companies with EVMS requirements reported ever receiving meaningful feedback from government personnel regarding information in the EVMS reports.

### Relationship with contracting officers

The relationship between contractors and government auditors and contracting officers has deteriorated during the past year. The relationship with auditors was rated as fair or poor by 19% of the surveyed companies, compared with 11% in the 16<sup>th</sup> annual survey. The relationship with contracting officers was rated fair or poor by 10% of the participants in the 17<sup>th</sup> annual survey, compared with 5% in the prior survey.

### Government efficiency in resolving contract issues

Only 22% of survey participants believe that contract issues are resolved efficiently. This represents a decline from the 26% reported in the 16<sup>th</sup> annual survey. A far greater proportion of the respondents in the 17<sup>th</sup> annual survey blame the contracting officer rather than the auditor for the inefficiencies in resolving contract issues.

# Company profile

Grant Thornton's 17<sup>th</sup> Annual Government Contractor Survey is based on information provided by companies that do business with the federal government as a primary customer. We distributed questionnaires during the first half of 2011 and received responses from participating companies over the next several months. Financial and business statistics in the survey typically relate to fiscal years ended in 2010 or early 2011 and are treated as belonging to the current year in this survey.

We analyzed all data provided by respondents to be certain that it was statistically valid and representative of most companies. Data is presented in the survey as a whole or by company size when appropriate. In many instances, we also provide data from the current survey along with data from prior surveys in order to identify trends from survey to survey. We also include a narrative for each topic covered in the survey and in several instances offer suggestions on best practices for cost accounting and contract administration for government contracts.

## Ownership structure

As shown in Figure 1, 83% of the government contractors participating in the survey are privately owned, with the remaining 17% almost equally divided between publicly traded companies and not-for-profit organizations. The ownership structures of the companies participating in this year's survey are very similar to last year's survey.

## Age of the business

We asked respondents how many years their organization had been in business and the responses by age range are shown in Figure 2. The distribution of companies among the four age ranges suggests that the survey data represents an excellent cross section of companies in the government contractor industry.

## Location of the company

Survey responses were received from government contractors located in 24 states and the District of Columbia. The dispersion of these companies across the country is another indication that the survey data represents an excellent cross section of companies in the government contractor industry.

Figure 1: Ownership structure

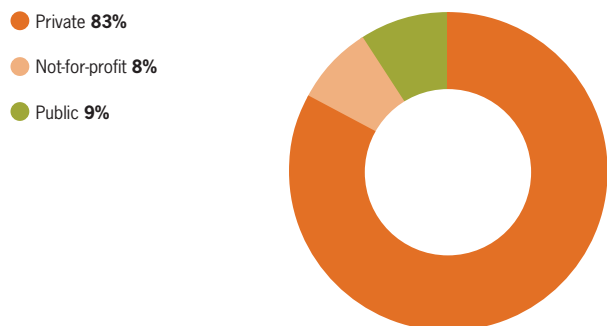


Figure 2: Age of business



### Size of the business

Survey companies provided their annual revenue and the results by revenue range are summarized in Figure 3. Each of the five revenue ranges shown is well-populated.

We also asked whether the companies were classified as small businesses using the size standards published by the Small Business Administration. Forty-six percent of surveyed companies are small businesses, which is very similar to the results from the 16<sup>th</sup> and 15<sup>th</sup> annual surveys.

### Revenue by market

Revenue by market is shown in Figure 4 and continues a trend from prior years showing that survey respondents focus most of their marketing efforts on the federal government in order to generate revenue.

This year, surveyed companies reported that 93% of their revenue comes from the federal government, with approximately 63% of that revenue from the Department of Defense (DoD) and 30% from other federal agencies. Respondents reported that on average, only 7% of revenue was from other sources and that revenue was approximately equally distributed between revenue from state and local government and commercial customers.

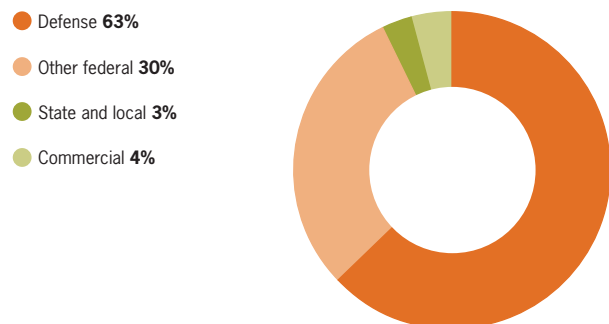
The very high percentage of revenue from the federal government continues a trend from the last seven surveys, which showed 79% in the 10<sup>th</sup> annual survey, 84% in the 11<sup>th</sup>, 88% in the 12<sup>th</sup>, 90% in the 13<sup>th</sup> and 14<sup>th</sup>, 91% in the 15<sup>th</sup>, and 94% in the 16<sup>th</sup>.

Revenue from state and local government and commercial clients was 7% this year compared with 6% in the 16<sup>th</sup> annual survey. Although revenue from these sources has always been relatively small compared with revenue from the federal government, there's no doubt that the trend over the past several surveys has shown a steady decline. Revenue from state and local government and commercial clients as a percentage of total revenue was 21% in the 10<sup>th</sup> annual survey, 16% in the 11<sup>th</sup>, 12% in the 12<sup>th</sup>, 10% in the 13<sup>th</sup> and 14<sup>th</sup>, 9% in the 15<sup>th</sup> and 6% in the 16<sup>th</sup>. It seems highly unlikely that this long-term upward trend toward revenue from federal contracts will change anytime soon. The economic downturn in the overall economy has severely limited business opportunities in those sectors, while federal government spending seemingly always grows year over year, regardless of what is happening in the overall economy.

Figure 3: Annual revenue



Figure 4: Revenue by market



# Financial statistics and company cost structures

In this section of the survey, we present financial and other information that illustrates the financial condition of the survey respondents as well as their approach to several sensitive cost accounting issues.



## Profit rates before interest and taxes

We asked surveyed companies to provide their profit rates before interest and taxes as a percentage of revenue and the results from the 17<sup>th</sup> annual survey and the three prior surveys are shown in Figure 5. It's very clear from the information presented that, although profits have increased somewhat on an overall basis when compared with profit rates in prior annual surveys, government contracting is not a high-profit business.

The latest survey shows that 37% of surveyed companies did not make a profit or posted a profit at 1-5% of revenue. The profit picture for this group of companies is exactly where it was in the 14<sup>th</sup> annual survey, but is a significant improvement over the 50% and 45% reported in the 16<sup>th</sup> and 15<sup>th</sup> annual surveys, respectively, for this group of companies.

Profit in the 6-10% range was reported by 37% of the respondents, which is a slight improvement from the 35% reported in the 16<sup>th</sup> annual survey. The percentage of companies reporting profit rates of 11% or more soared in the 17<sup>th</sup> annual survey to 26%, which is a dramatic increase from the 15% reported in the previous two surveys.

While the increase in profit rates is likely caused by several factors, it is very possible that the government's greater reliance in recent years on multiple-award indefinite delivery/indefinite quantity (IDIQ) contracts may be a significant factor. Two motivations for the increased use of IDIQ contracts are to improve the efficiency of the government procurement process and reduce the frequency of bid protests, which historically have delayed the procurement process even after source selection was made. There is little doubt that the amount of true competition for task orders in many IDIQ contracts is far less than was the case before IDIQ contracts became so prevalent. This lessening of competition in the pursuit of efficiency is likely a contributor to higher profit rates.



The profit rates in Figure 9 are calculated before interest and taxes, and therefore do not reflect the total cost of doing business. For companies that make a profit and finance their working capital, the profit rates are approximately 35% lower than those listed in Figure 9 after considering interest and taxes.

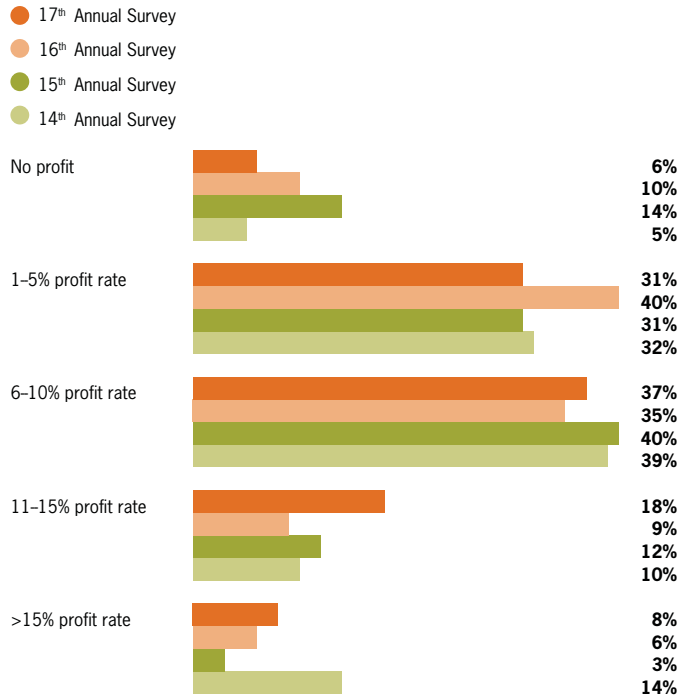
Government contracting can be a very high-risk business considering the complex noncommercial regulations that govern the procurement process and the tendency of many government officials to function unreasonably, inefficiently or unprofessionally. Far too often, the procurement process is adversely impacted by the whims and indecisiveness of the contracting officer or auditor dealing with a particular issue rather than the merits of the issue itself. To compound the problem, government procurement has been severely and negatively impacted by the politicization of government contracting. The overall impact of these negative influences is that routine issues that were formerly efficiently resolved through the contract administration, audit and negotiation process have suddenly become the basis for procrastination, investigation and accusation. While government contracting is normally a growth business, the profit rates are very modest given the unique business risks that often accompany the performance and administration of government contracts.

### Current ratios

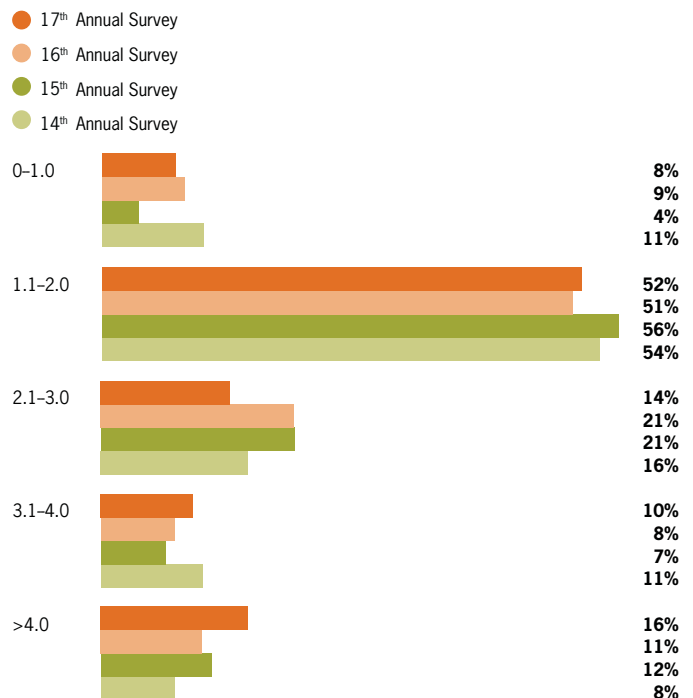
The current ratio is a financial measurement that is computed by dividing the total current assets by the total current liabilities. A current ratio of 2 to 1 or more is generally considered an indicator of a financially healthy company.

Current ratios from the 17<sup>th</sup> annual survey and the prior three surveys are shown in Figure 10. For the third consecutive survey, 60% of respondents reported a current ratio of 2.0 or lower. It is almost certain that the low profit rates previously discussed are a major contributor to the low current ratio as well as the adverse impact of the inefficient and often inequitable approach taken by government officials when dealing with contract issues.

**Figure 5: Profit rates before interest and taxes**



**Figure 6: Current ratio**



# Government contracts

## Proposal win rates

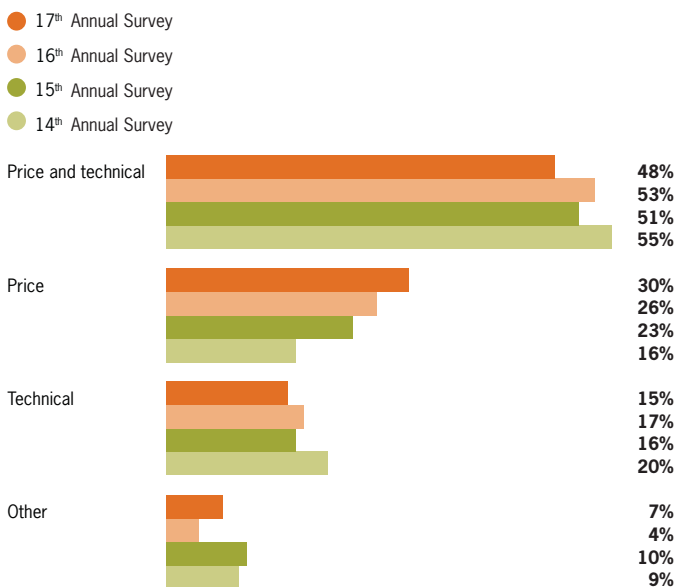
Surveyed companies were asked to provide information about their win rates when pursuing non-sole sourced government contracts. The results are presented in Figure 23 along with the results from the three previous surveys. The 30% win rate is consistent with the rates shown from past surveys.

We also asked for information regarding the main reasons for losing competitions. The results are shown in Figure 24 along with the responses from the three prior surveys. Of the reasons shown, price is the only factor for losing that has consistently increased over the past four years, growing steadily from 16% to 23% to 26% to 30% from the 14<sup>th</sup> through the 17<sup>th</sup> annual surveys, respectively. We will monitor this trend in future surveys to see whether price is taking precedence over the quality of past performance in government source-selection decisions. Past performance was made a key source-selection evaluation metric several years ago to provide the government more flexibility in source-selection decisions and to limit the impact of lesser qualified companies from trying to buy the contract. It appears from the results of our survey that price is becoming of greater importance and that trend could well continue as the government attempts to deal with budget deficits.

**Figure 7: Proposal win rates**



**Figure 8: Reasons for losing competitions**

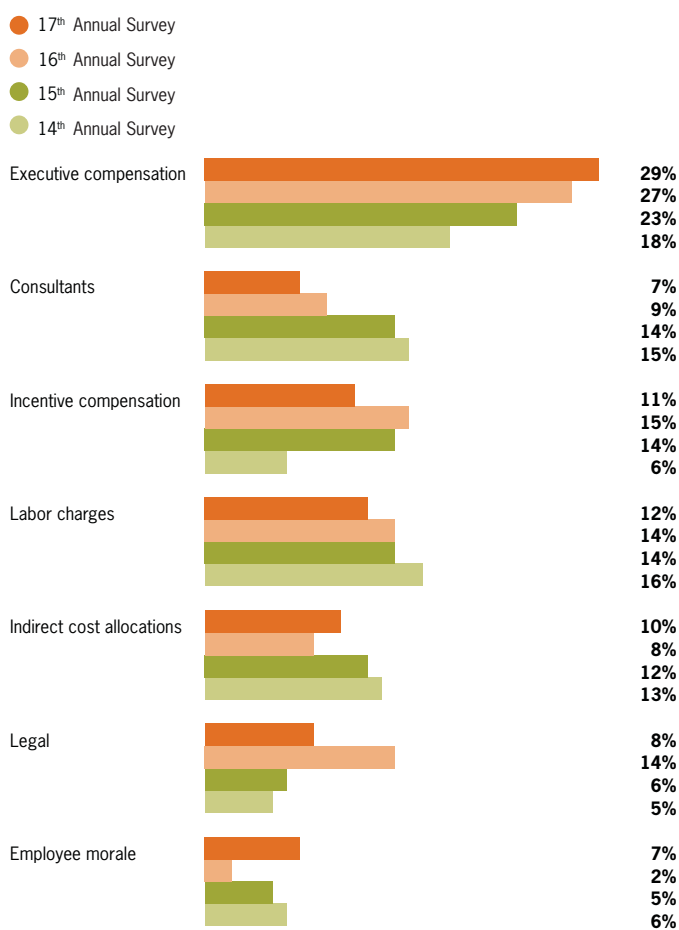




# Dealing with the government

While government contracting has never been a model of efficiency, it is our view that the decline in efficiency and business relationships during the past few years can be traced directly to changes in DCAA policy adopted after the GAO reports were issued in July 2008 and September 2009. Unfortunately, the GAO criticized the DCAA for having a management and agency culture that focused on a production-oriented mission, emphasizing the need for timeliness in supporting the needs of contracting officers in the procurement process. Rather than praise the DCAA for its production-oriented culture, the GAO unfortunately chose to severely criticize the DCAA for a perceived lack of independence from contractors and insufficient documentation and audit testing in the work-paper files to support the audit opinion. The DCAA took these criticisms to heart, and has adopted policies that increase its independence, expand its audit testing, increase the standards required for accepting costs or business systems, and significantly delay the issuance of audit reports. Further, in our view, the quality of the audit reports being issued by the DCAA under the new policies is far lower than was the case prior to the GAO reports. It appears that the net result from the GAO reports is that the DCAA's production-oriented culture has been replaced by a system in which the DCAA takes far longer to issue lower quality reports to a contracting officer who must seek DCAA concurrence before conceding some of the DCAA's positions in negotiations with the contractor. A possible remedy for the current inefficiencies that plague government contracting would be a statement of the basic principle that an audit report must be completed in a timely fashion if it's going to be useful as part of an efficient and cost-effective procurement process.

**Figure 9: Most frequent cost issues**

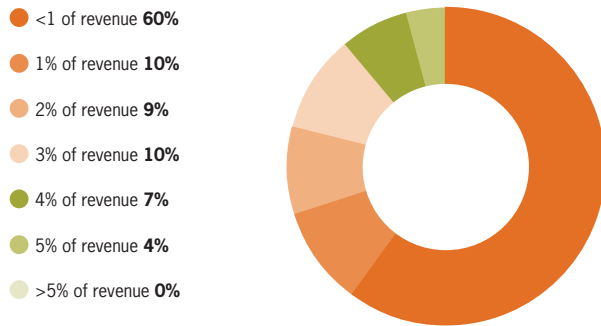


\*Respondents were given the option to make more than one selection if applicable.

**Table 1: Most frequent CAS issues**

CAS issue type	17 <sup>th</sup> Annual Survey frequency cited	16 <sup>th</sup> Annual Survey frequency cited	15 <sup>th</sup> Annual Survey frequency cited	14 <sup>th</sup> Annual Survey frequency cited
CAS 401 consistency	16%	10%	16%	8%
CAS 403 home office	4%	7%	13%	7%
CAS 405 unallowable costs	4%	7%	16%	11%

**Figure 10: Costs questioned as a percentage of revenue**



**Costs questioned as a percentage of revenue**

We asked surveyed companies to provide the amount of DCAA-questioned costs as a percentage of revenue. The results are shown in Figure 38. The amount of costs questioned is very paltry, with 70% of respondents reporting questioned costs of 1% or less. Also, it should be noted that even this small amount is overstated when one considers that questioned costs are often not sustainable in negotiations with the contractor.

The government spends hundreds of millions of dollars per year for auditors to conduct incurred cost audits, and far more for contractors to support those audits. In spite of this major investment of time and money, the government is typically four or five years behind or more in conducting incurred cost audits and, as shown in Figure 38, questions very minor amounts for the effort. It is unfortunate that the GAO did not focus its attention more closely on the way the DCAA allocates its resources rather than criticizing the DCAA for a perceived lack of independence or inadequate documentation in the work-paper files. Had the GAO focused on substance rather than form, their report could have had a positive impact on the procurement process. Instead, after implementing the GAO’s recommendations, the DCAA’s value to the procurement process seems to have been further diminished.

**Most frequent CAS issues**

When asked about CAS coverage, 37% of surveyed companies reported that they are subject to full CAS coverage and have filed disclosure statements describing their cost accounting practices.

Companies subject to full CAS coverage identified the CAS standards where the DCAA has raised compliance issues, and the results are shown in Table 1, along with the results from the three prior surveys. The most frequently cited CAS compliance issues relate to CAS 401—consistency in estimating, accumulating and reporting costs. While each situation may

# Workforce compensation and fringe benefits

### Incentive compensation and fringe benefits

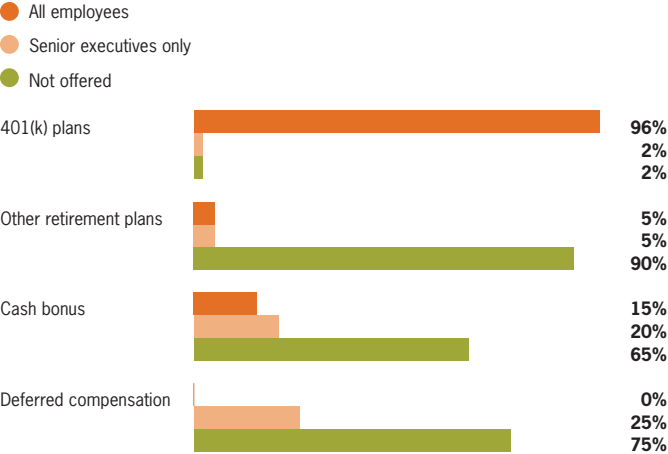
In the questionnaire for the 17<sup>th</sup> annual survey, we identified a short list of fringe benefits and asked whether they were provided by the company. If a benefit was provided, we also asked the respondent whether the benefit was available to all employees or only senior executives. The results are shown in Figure 40.

Practically all companies offer 401(k) plans to all employees. Other types of retirement plans, such as defined benefit plans, have all but disappeared from the government contracting industry and are being offered by only 10% of surveyed companies.

Cash bonuses are being paid by only 35% of surveyed companies, which is the same percentage reported in last year’s survey. Twenty percent of respondents pay cash bonuses only to senior executives, while 15% pay bonuses to all deserving employees.

Deferred compensation plans are in effect at only 25% of surveyed companies, which is consistent with the 24% reported in last year’s survey. In the 17<sup>th</sup> annual survey, those companies with deferred compensation plans make them available only to senior executives.

Figure 11: Fringe benefits



### Health insurance benefits

Surveyed companies provided their health insurance costs as a percentage of labor costs, and the results are shown in Figure 41. Also shown are the results from the prior three surveys, which are presented for comparative purposes.

We also asked whether the companies' percentage contributions to the 401(k) plan had changed during the past year. Eighty-five percent of respondents reported no change, 11% reported the contribution had decreased and only 4% reported the contribution had increased.

### Wage increases

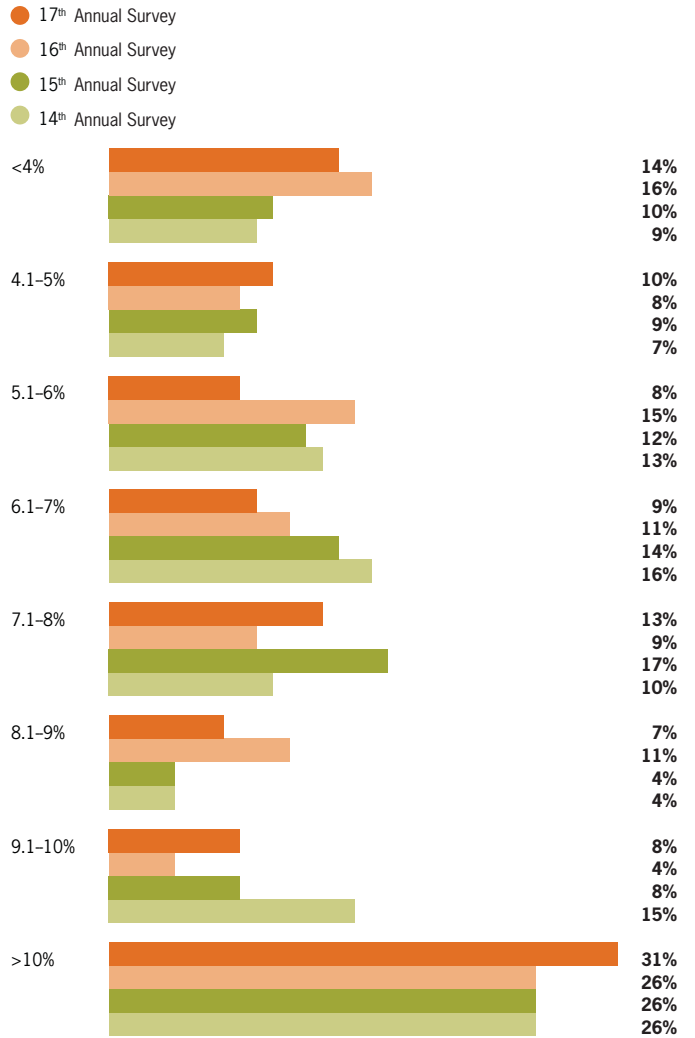
This year, surveyed companies reported average wage increases of 2.6-3.0%, which is consistent with the results from last year's survey. It seems clear that low average wage increases are a consequence of low inflation and the negative economic circumstances in the economy as a whole.

### Compensation premiums for security clearances

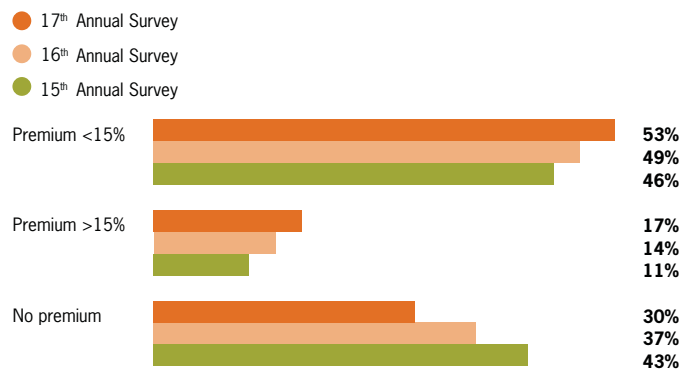
Many government contracts require that employees who work on those contracts possess security clearances because some or all of the contract work requires access to information classified for national security reasons. Depending on the level of security clearance required, the standards for granting access may be very extensive and thus significantly limit the number of employees eligible to work on the contract.

We asked surveyed companies whether their companies paid compensation premiums for security clearances and, if so, the premium percentage paid. The results are shown in Figure 43 along with the results from the two previous surveys. The percentage of companies that pay no compensation premium is 30%, which continues the downward trend from 43% two years ago and 37% last year. The remaining 70% of respondents with classified contracts pay compensation premiums for security clearances.

**Figure 12: Health insurance as a percentage of labor costs**



**Figure 13: Compensation premiums for security clearances**



# Business strategies

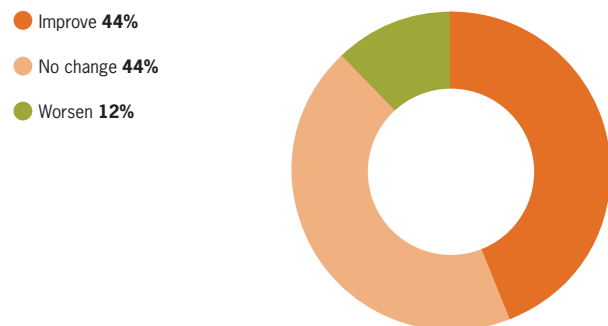
In this section of the survey, we address the respondents' business exit strategies, with a particular focus on mergers and acquisitions. We also provide information on contract novation and raising capital, along with issues facing small businesses.

## Merger and acquisition (M&A) environment

In previous surveys, we have reported that mergers and acquisitions are the favored strategies for either exiting the business as a seller or growing the business as a buyer. The number of business combinations in the government contracting industry has accelerated during the past two decades, beginning with the consolidations that occurred in the industry at the end of the Cold War with the former Soviet Union. The increase in the use of IDIQ contracts since the procurement streamlining in the 1990s has also contributed to an increase in M&A activity by forcing companies to work together on large teams and reducing the number of new business opportunities from non-IDIQ orders. Further, the fluctuating value of the dollar has helped make government contractors attractive targets for foreign companies, particularly when the dollar is weak in comparison to currencies from other countries. Finally, the intrusion of politics into government contracting has resulted in many contractors being unfairly and publicly demonized, which for some companies, is a major disincentive to continue supporting government agencies as a primary customer.

We asked surveyed companies about their expectations for the M&A environment over the next 12 months, and the results are shown in Figure 44. An overwhelming 88% of respondents expect the M&A environment to improve or at least stay the same, while only 12% expect it to worsen. This result is almost identical to last year's survey.

**Figure 14: Expected change in the environment for mergers and acquisitions in the next 12 months**





### Exit strategies

Surveyed companies were asked to provide their planned exit strategy from the government contracting industry. The results are shown in Figure 45 along with the results from the prior three surveys provided for comparative purposes. Sale of the company continues to be the most-favored exit strategy by far, with a public offering of stock the least favored. The exit strategy findings from this year’s survey are very consistent with the prior three surveys.

We also asked how soon the companies intend to exit the business. Twenty-eight percent intend to exit within the next two years, 36% within three to five years, and 36% in six years or more.

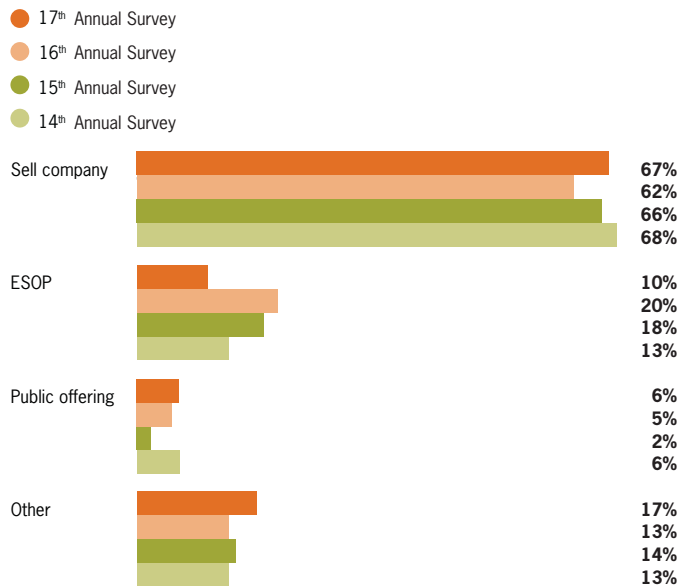
The most frequently cited reasons for exit are private shareholder liquidity needs (54%), market opportunities (32%), return of capital (6%) and other factors (8%).

### Mergers and acquisitions during the past year

Twelve percent of surveyed companies were involved in mergers and acquisitions during the past year, which is double the 6% reported in last year’s survey. Of these M&A transactions, 75% involved the purchase or sale of the entire company, while the remaining 25% involved only specific contracts.

We asked respondents to provide the primary business motivation for merging with or acquiring government contractors. Sixty-five percent of respondents cited penetrating new markets as their primary motivation, while 19% cited expanding business opportunities with an existing customer.

**Figure 15: Exit strategies**



# Executive compensation

The reasonableness of executive compensation is a primary DCAA focus during its audits of incurred costs at small to medium-sized government contractors. Executive compensation is much less of a DCAA audit focus at large companies because the compensation for top executives at those companies can reasonably exceed the statutory cap on executive compensation specified in the procurement regulations. In this section of the survey, we present executive compensation information provided by surveyed companies, and also discuss the DCAA's standard audit approach. We also present what we believe are effective means of rebutting a DCAA challenge to the reasonableness of executive compensation.



### Effective responses to DCAA challenges to executive compensation

We are frequently asked to assist clients whose executive compensation is being challenged by the DCAA. As previously stated, it is our view that the statistical analysis techniques used by the DCAA are severely flawed and difficult for the DCAA to defend when effectively challenged. Given the inherent weaknesses in the DCAA's methods, we have found a comprehensive response to the DCAA's findings to be the most effective rebuttal approach. This response should cite each of the statistical deficiencies in the DCAA's analysis. Depending on the circumstances, the rebuttal should include some combination of the following:

- (a) Questioning the DCAA's failure to adequately benchmark the positions in the surveys to the positions in the contractor's organization
- (b) Pointing out the disparity in the medians from the various surveys being averaged by the DCAA
- (c) Questioning the validity of the data in the surveys when there are a small number of data points in the survey for the industry and revenue range used by the DCAA
- (d) Criticizing the DCAA's failure to use data by geographic location despite the express requirement in the procurement regulations to consider geographic location
- (e) Questioning the regulatory basis for fragmenting revenue by division for the company being audited and challenging the DCAA to prove that the data in the surveys has also been fragmented by division
- (f) Relating the current-year executive compensation to prior-year compensation levels that were not challenged by the DCAA
- (g) Pointing out the very poor correlation between revenue and compensation in the survey data, and questioning DCAA's failure to heed the cautions in Appendix E of its own contract audit manual
- (h) Questioning the adequacy of the 10% range of reasonableness adjustment when the correlation in the survey data is very poor
- (i) Questioning the reasonableness of categorizing the company under audit at the median when its financial and nonfinancial achievements merit a higher rating

In practically all cases, we have found the DCAA to be flexible and willing to modify its position when faced with a convincing argument. It's been our experience that the flexibility is most often shown in a willingness to rate a company's performance significantly above the median in order to reduce or eliminate the cost disallowance. This type of concession does not require the DCAA to compromise its basic analytical techniques, flawed as they may be. In those rare cases where the DCAA was unwilling to change its position, the issue was successfully resolved at the contracting officer level.

# Delays and terminations

## Stop-work orders

We asked surveyed companies whether they had received stop-work orders during the past three years, and 35% responded in the affirmative. (See Figure 50.) We then asked respondents who received stop-work orders whether they submitted requests for equitable adjustment, and the results are shown in Figure 51. Surprisingly, only 30% of the respondents requested equitable adjustments even though they were clearly entitled to an equitable adjustment by the terms of the stop-work clause. We can only speculate why more companies did not request equitable adjustments, but it's safe to assume that customer relations must have been the primary motivation.

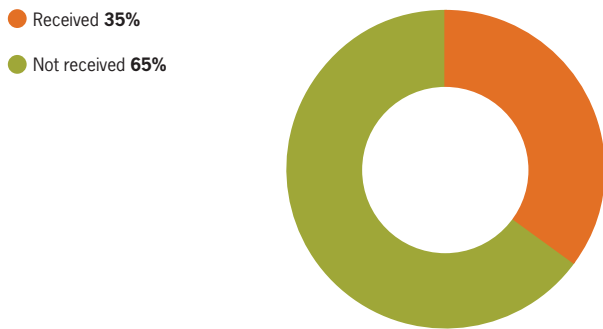
In the questionnaire for this year's survey, we listed the types of equitable adjustments that are commonly requested in connection with stop-work orders. Companies receiving stop-work orders were asked whether they had requested equitable adjustments for each of the impacts listed, and whether the government accepted liability for each of the impacts. The results are shown in Figure 52.

The cost of idle time resulting from a stop-work order is recoverable in an equitable adjustment. Seventy-five percent of surveyed companies that requested an equitable adjustment asked for reimbursement of idle-time costs, and the government accepted in every case.

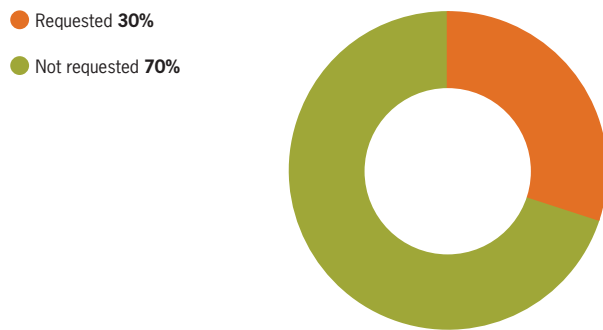
The costs of facilities that were idled as a result of a stop-work order are also normally compensable in an equitable adjustment. The results reported were the same as for idle time. Seventy-five percent requested idle facilities costs, and the government accepted every time.

When a stop-work order is received, a contractor must manage the stop-work in a variety of ways, including communicating with the government, redeploying resources, and managing the effect on suppliers and subcontractors. All surveyed companies that filed a request for equitable adjustment for a stop-work order requested this cost, and the government accepted it every time.

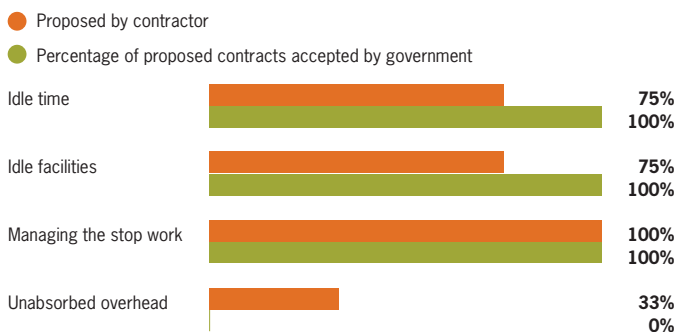
**Figure 16: Stop-work orders received during the past three years**



**Figure 17: Equitable adjustments requested for stop-work orders**



**Figure 18: Equitable adjustments requested and government acceptance**





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## 2012 Predictions

**John C. Hagan**

Head of Aerospace, Defense & Government Services Investment Banking

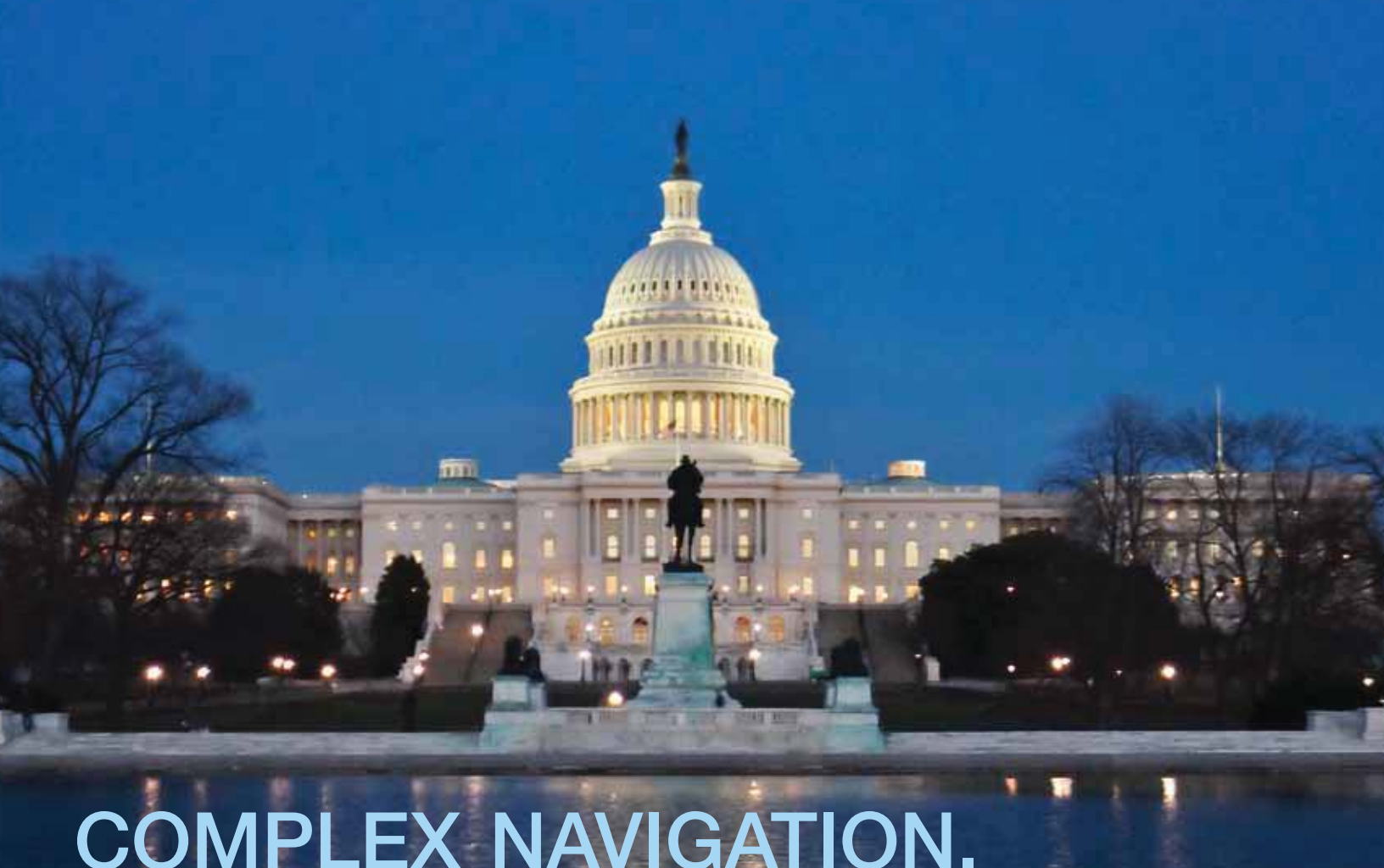
The market for mergers and acquisitions (“M&A”) in the government contracting arena for 2012 promises to be very dynamic. If there were one word to highlight the global environment surrounding the industry today, it would be “uncertainty”.

Is the industry facing \$500 billion in cuts over the following decade or a more draconian \$1 trillion based on sequestration? Given fierce competition and the government customer’s emphasis on reducing costs, companies (and their shareholders) are uncertain as to where profit margins will settle on newly awarded contracts. In addition, with “best price” versus “best value” becoming the overriding criteria for award by many agencies, assessing the probability of future contract wins is an increasingly uncertain prospect. On top of all of this uncertainty, owners and shareholders are also contemplating the uncertainty surrounding future tax policy. Will the Bush tax cuts expire? Will additional tax hikes be levied? If there is anything the public markets like less than bad news, it is uncertainty, and these pressures are reflected in the current historically lower valuation multiples for publicly-traded companies in the industry.

Given the current uncertain environment, investors/owners with a shorter investment time horizon will be positioning for liquidity sooner rather than later. Some will be looking to exit ahead of potential capital gains tax rate increases. Others will be seeking to exit before valuations (and possibly revenues and profits) decline further. The good news is that the many buyers in the market have access to capital at attractive costs, despite industry-wide uncertainty, so many high profile transactions continue to take place. Strategic buyers will continue to aggressively seek niche acquisitions that will help them grow organically. In addition, the large number of private equity firms interested in this market will continue to seek to deploy capital through platform and add-on acquisitions, taking advantage of favorable debt market dynamics.

Companies that are focused in niche growth areas such as cyber security, C4ISR, predictive analytics, cloud computing, and health care are in high demand from buyers. Budget growth and company specific organic growth tend to be much stronger than the overall market in these segments. Even in an age of uncertainty, sophisticated industry investors/participants have identified these segments and are intent on taking advantage of an uncertain market to position their shareholders for long-term growth. For example, Raytheon Corporation recently announced its acquisition of Henggeler Computer Consultants (“HCC”) (represented by BB&T Capital Markets | Windsor Group) for its tenth cyber-related acquisition in the past three and a half years. HCC is a Columbia, Maryland based high-end cyber and software engineering firm focused in the intelligence community. The company is a forefront developer of enterprise architecture, analytics, software, and cloud-based solutions that form the backbone of key intelligence community systems. Companies like HCC will continue to be highly sought after in 2012 and beyond.

As a result, expect 2012 to be as active, if not more active, than most years in terms of numbers of transactions consummated, to possibly even include larger transactions with mid-tier publicly-held contractors. The key to success for sellers in 2012 will be proper positioning, timing and advice. As pressures on valuations mount and buyers evaluate where to deploy capital in this environment, it will be the early movers that accrue the greatest benefits.



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# Interim Rule Authorizes Small Business Set-Asides in Task and Delivery Order Competitions

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Joseph P. Hornyak<sup>1</sup>

On November 2, 2011 -- almost exactly three years to the day after GAO issued its controversial decision in *Delex Systems, Inc.* -- the administration issued an interim regulation amending the Federal Acquisition Regulation ("FAR") to resolve the controversy touched off by that decision.

In *Delex*, GAO held that individual competitions for task and delivery orders among holders of multiple-award indefinite delivery, indefinite quantity ("IDIQ") contracts are subject to the so-called "Rule of Two" in FAR 19.502-2(b). *Delex Systems, Inc.*, B-400403, Oct. 8, 2008, 2008 CPD ¶ 181. That rule directs Contracting Officers to "set aside any acquisition over \$150,000 for small business participation when there is a reasonable expectation that (1) offers will be obtained from at least two responsible small business concerns offering the products of different small business concerns . . .; and (2) award will be made at fair market prices."

The holding in *Delex* meant that, if two or more small business IDIQ contract holders are capable of performing the task or delivery order, the order must be set aside for small businesses. In effect, *Delex* re-wrote the ordering clauses in most multiple-award IDIQ contracts, potentially depriving large business contract holders from competing for many orders. In a subsequent decision, however, GAO declined to extend the holding in *Delex* to task and delivery order competitions among Federal Supply Schedule vendors. *Edmond Computer Company*, 402864, Aug. 25, 2010, 2010 CPD ¶ 200.

In the wake of *Delex*, Congress passed section 1331 of the Small Business Jobs Act of 2010, which directed the Office of Federal Procurement Policy ("OFPP"), Small Business Administration ("SBA") and General Services Administration ("GSA") to issue regulations clarifying that contracting agencies "may, at their discretion" set aside for small businesses parts of multiple award contracts or orders placed against multiple award IDIQ contracts. Pub. L. No. 111-240, 124 Stat. 2504 (Sept. 27, 2010). This is essentially the position that the Navy advocated, and GAO rejected, in *Delex*. That is, that the Rule of Two should be permissive, not mandatory, in task and delivery order competitions among multiple-award IDIQ contractors. The November 2, 2011 interim amendment to the FAR was issued to comply with section 1331. It does so by amending FAR 16.505(b)(2)(i)(F) and FAR 19.502-4(a) to make clear that contracting officers have the discretion to set-aside task and delivery order competitions for small business. It also creates new FAR clause 52.219-13, entitled "Notice of Set-Aside of Orders (Nov 2011)," and amends other existing clauses to correspond to the new rules.

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<sup>1</sup> Joseph Hornyak is a partner with Holland & Knight LLP's National Government Contracts Practice Group.



The interim rule also addresses small business set-asides in task or delivery order competitions under the Federal Supply Schedules program. This was not required by section 1331, but was the subject of GAO's decision *Edmond Computer*. Specifically, the interim rule amends FAR 8.405-5 to expressly authorize ordering agency contracting officers "at their discretion" to set aside orders or blanket purchase agreements for small business concerns and count such orders toward the ordering activity's small business goals. Interestingly, the rule states that "[o]rdering activities should rely on the small business representations made by schedule contractors at the contract level." Currently, SBA regulations permit a contracting officer to either rely on the size representation in the base contract or require contractors to recertify their size status in response to a solicitation for an order. 13 C.F.R. 121.404(g)(3)(v).

According to the preamble to the proposed rule, the FAR councils are coordinating with SBA on the development of an SBA-proposed rule that will provide greater detail regarding implementation of section 1331. Hopefully, the forthcoming SBA rule will give contracting officers more guidance than is provided in the interim FAR amendment regarding the exercise of their discretion to set-aside task or delivery order competitions.

The preamble also states that contracting officers are encouraged "on a bilateral basis" to modify existing multiple award IDIQ contracts with more than six months remaining to include the new or amended FAR clauses set forth in the interim rule. Small business IDIQ contract holders should consider the effect of the new FAR clauses before signing such bilateral modifications.



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# ■ Earnout: Short-Term Fix or Long-Term Problem?



In times of economic depression or recession, one indicator of a possible recovery can be an increase in the number of merger and acquisition transactions. As the number of merger and acquisition transactions increase, disputes arising from these transactions are also likely to increase.

Post-acquisition disputes generally fall into three categories: post-closing/purchase price adjustments; breaches of representations and warranties; and earnout disputes. In this article, we focus on earnout disputes, including the following main topics:

- Definition of an earnout
- Description of the mechanics of typical earnout arrangements
- Types of earnout disputes

## What is an earnout? ■ ■ ■

An earnout is a provision within a purchase agreement, or a separate agreement which is part of a collective body of transaction documents in a merger or acquisition. It makes a portion of the purchase price contingent on the acquired company reaching certain financial or non-financial milestones during a specified period after closing.<sup>1</sup> As discussed further below, the milestones are commonly based on financial benchmarks, which

include but are not limited to revenue, net income, or EBITDA.<sup>2</sup> Buyers and sellers commonly use earnout provisions to bridge the gap between their respective views regarding the value and/or future outlook for the target company. Earnouts can be especially appropriate when the seller will continue to manage the target company and/or the target company will continue to operate on a stand-alone basis during the earnout period.

Earnouts provide potential advantages and potential risks for both sellers and buyers. Potential advantages for the seller can include:

- The opportunity to realize full value or a greater amount from the sale of the business
- When the seller will continue to work in the business during the earnout period, earnouts may provide the seller with some control over possible outcomes
- Potentially increases the salability of the business in periods of economic decline

Potential risks for sellers can include:

- Limited control over the operations of the business during the earnout period
- Restricted access to the records of the business post-closing

<sup>1</sup> The Litigation Services Handbook, Fourth Edition

<sup>2</sup> EBITDA is defined as Earnings Before Interest, Taxes, Depreciation and Amortization

- Potential manipulation of the earnout calculation by the buyer with the seller's ultimate value received
- Potential comingling of the purchased business' interest with other buyer-owned entities during the earnout period

Potential advantages for the buyer can include:

- Aligns the risk of achieving the seller's optimistic projections with the seller's ultimate value received
- Reduces the amount of consideration due from the buyer at closing
- Potentially provides assurance that the buyer has received the bargained for value of the target

Potential risks for buyers can include:

- Potential manipulation of earnout calculation by the seller
- Possibly compensating seller for business improvements made by the buyer post-closing
- If the seller continues to work in the target company, the potential for the seller to sacrifice the long-term interest of the company for short-term maximization of his or her earnout payout

**Earnout Target = 10 million  
Buyer Entitled to 2.5x EBITDA in  
Excess of \$10 million each year**

In addition, there are other considerations relating to the inclusion of an earnout provision in an acquisition transaction that should be considered by both the buyer and seller. These include, but are not limited to, the following:

- Earnouts can be difficult to negotiate and administrate as it can be challenging to account for and appropriately consider all potential circumstances that will affect the earnout calculation and related payout
- Increases the potential for post-acquisition disputes
- In the event the seller and key personnel will continue to be active in the target company post-closing, the likelihood of a successful integration of the seller and key personnel into the buyer's organization

## The Mechanics of an Earnout ■ ■ ■

How does an earnout work? Typically, earnout provisions are structured in the transaction agreements to be predicated upon achieving certain targets or benchmarks over a fixed period post-transaction. If the targets or benchmarks are achieved, an earnout payment is due the seller.

## Benchmarks and Targets

The most common financial benchmark or target in an earnout provision is EBITDA. The following chart provides a simplified example of an EBITDA calculation for purposes of this article:

<b>Sample EBITDA Calculation</b>	
<i>(in 000s)</i>	
Revenue	\$ 20,000
Returns/Allowances	50
Net Revenue	19,950
Cost of Goods Sold	7,500
Gross Margin	\$ 12,450
Operating Expenses:	
Selling	500
Advertising	400
R&D	500
Rent	100
Office Expense	100
Miscellaneous/Other	300
<b>EBITDA</b>	<b>\$ 10,550</b>
Depreciation/Amortization	1,500
Operating Income	\$ 9,050
Taxes	4,000
Interest Expense	400
Income from Continuing Operations	\$ 4,650
Extraordinary Items	-
Discontinued Operations	-
Net Income	\$ 4,650

The seller typically prefers to use a benchmark at a high level of financial reporting, such as gross revenue. This is the measurement in the seller's view that is least likely to be influenced by the buyer's operation of the company post-transaction. The buyer desires a benchmark at the lowest level of financial reporting, i.e., after all expenses, such as net income. In the buyer's view, this target accounts for all the nuances of business operation. EBITDA is, in essence, viewed to be a mid-point in negotiation between the parties, which is why it is a common measurement in earnout agreements.

Benchmarks or targets other than EBITDA, or in conjunction with EBITDA, may also be utilized. These may be industry specific, company specific or other unique measurements important to the parties. Examples include gross or net sales levels, governmental approval for products or product lines, a quantifiable successful launch of a new product, and achievements in research and development.



The term of the earnout agreement is for a fixed post-transaction period. It is typically for a one- to three-year period, which allows the buyer to assimilate the company into its operations, possibly with the seller's ongoing assistance. It is uncommon to extend beyond three years, as at that point, the buyer should be realizing the value of its acquisition and the transitory period is over.

### Calculation of an Earnout

The calculation of an earnout payment due the seller is geared specifically to the achievement of the benchmarks and targets. For instance, the actual payment calculation may consist of a multiple of EBITDA, a percentage of sales, or a fixed amount. In the previous example, the seller was entitled to a payment of 2.5 times EBITDA over \$10 million, measured each year but payable on a cumulative basis at the end of year three. Assuming the company generated \$20 million of EBITDA in year 1, \$8 million in year 2, and \$15 million in year 3, the seller would receive an earnout of \$32.5 million at the end of year three. See the following chart for the calculation.

not met. These disputes fall into three general measurement groupings: operational issues (post-closing); accounting issues (post-closing); and the measurement of the company's post-closing performance as it pertains to the earnout agreement.

### Business Issues (post-closing)

Much of the time, the buyer operates the company independently from the seller's efforts. In an earnout dispute, the seller may have issues regarding how the buyer operated the company post-acquisition, resulting in a lower earnout payout, or eliminating it altogether. Common types of business issues from the seller's viewpoint include the following:

- Intentionally operating the company so as to minimize a possible earnout, i.e., decreasing sales or increasing expenses
- Failure to pursue legitimate or potential opportunities
  - Deviation from pre-acquisition historical or normal practices
  - Loss of customers or a shift of customers to other related entities
  - Discontinuation of the business in whole or in part
  - Failure to obtain governmental approvals
  - Failure to obtain and/or protect intellectual property
  - Failure to adequately invest in operations
  - Employee turnover, especially key employees

In certain transactions, the seller either continues to run the business or provides consulting services to the company during the earnout period. The buyer may have issues with how the seller continues to operate the business if he or she minimizes expenses or overstates revenue. This would inflate EBITDA or the earnout in the short term while potentially harming the company in the long-term. Examples include:

<b>Sample Earnout Calculation</b>				
<i>(in 000s)</i>				
	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>	<b>Totals</b>
Revenue	\$ 40,000	\$ 25,000	\$ 32,500	\$ 97,500
Returns/Allowances	1,000	750	1,000	2,750
Net Revenue	39,000	24,250	31,500	94,750
Cost of Goods Sold	15,000	13,000	12,750	40,750
Gross Margin	\$ 24,000	\$ 11,250	\$ 18,750	\$ 54,000
Operating Expenses:				
Selling	1,000	750	1,000	2,750
Advertising	1,000	750	1,000	2,750
R&D	1,200	750	950	2,900
Rent	100	100	100	300
Office Expense	200	200	200	600
Miscellaneous/Other	500	700	500	1,700
<b>EBITDA</b>	<b>\$ 20,000</b>	<b>\$ 8,000</b>	<b>\$ 15,000</b>	<b>\$ 43,000</b>
Less Target (\$10,000 per year)				30,000
EBITDA for Earnout				\$ 13,000
Multiple				2.5
<b>Total Earnout Due</b>				<b>\$ 32,500</b>

### Types of Typical Earnout Disputes ■ ■ ■

Earnout targets and provisions are defined in the transaction agreements. From our experience, many transactions contain very specific and well-structured targets and provisions, while others are somewhat general. The more the earnout provisions in the agreement are open to interpretation, the more likely a dispute may arise. Earnout disputes can be generally categorized in two ways: Disputes as to whether the targets contained in earnout provision were met; and disputes as to why earnout targets were

- Failure to properly maintain or replace necessary equipment
- Performing out-of-the-ordinary course of business, such as selling assets or failing to invest in R&D
- Failure to retain key customers and suppliers
- Overstating collectible sales
- Inappropriate workforce reductions

## Accounting Issues (post-closing)

Disputes may arise regarding the accounting methodologies used by the buyer post-transaction. Common phrases found in earnout agreements include “in accordance with Generally Accepted Accounting Principles, or GAAP,” and “consistent with historical operations,” or “consistently applied.” These provisions indicate that the company, post-transaction, will continue to apply the same GAAP methodologies in place prior to the transaction, or if the company reports financial results using an allowed deviation from GAAP, the company will continue to use the historical methodology for purposes of determining the earnout.

Disputes arise when the buyer adopts an alternative reporting method that deviates from GAAP or the consistent application of the seller’s historical reporting policies. A second type of dispute may arise when GAAP changes or is modified and whether the buyer applies it or not for financial reporting and earnout purposes.

## Measurement of the Company’s Post-Closing Performance

Disputes often arise as a result of what should or should not be included when measuring the company’s performance post-transaction, and how those measurements impact the earnout calculation. Examples include, but are not limited to, the following:

- Capital investments or divestitures made post-transaction
- Depreciation/amortization expense
- Discontinued operations and extraordinary items
- Goodwill amortization
- Intercompany transactions, especially pertaining to sales and cost of goods sold
- Expense allocations from the parent or other subsidiaries to the financial results of the company

Measurements of the company’s performance post-transaction are the most common types of earnout disputes that arise when combining the company with the buyer’s operations. Any change in financial measurement can affect an earnout calculation predicated on the financial results of the company.

## Conclusion ■ ■ ■

An earnout provision can be a useful tool in a merger/acquisition transaction in bridging the gap between the views of the buyer and seller regarding the value of the target company. However, because of the challenges in negotiation and drafting earnout provisions that encompass all possible variables and earnouts’ inherent vulnerability to manipulation by the buyer or the seller, the calculation and payout of earnouts commonly result in post-acquisition disputes. When disputes relating to earnouts arise, the involved parties should consult with legal and financial professionals as early in the dispute process as possible.

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