

DOD States Contractor Profit Not a Target, While Targeting Contractor Profit

Written by Nick Sanders

Monday, 05 December 2011 00:00

Okay, this one is going to touch on a few seemingly unrelated topics. Bear with us and we'll try to tie it all together by the end. Let's start with the issuance of a DOD policy memo, on November 10, 2011, by Shay Assad (formerly Director, Defense Procurement and Acquisition Policy, and now Director, Defense Pricing, under the Under Secretary of Defense, Acquisition, Technology and Logistics). Mr. Assad's memo was entitled, "Direct and Indirect Charging of Contractor Proposal Preparation and Negotiation Support Costs." ([You can read the memo here](#).)

We don't think that the substance of the memo is particularly controversial. It offered very little novelty in its interpretation of existing regulations. Its guidance was (in our view) entirely consistent with the requirements of the B&P/IR&D cost principle at 31.205-18. It was consistent with the requirements of CAS 402, Interpretation No. 1 as we understand them. It was consistent with the requirements of CAS 420 as we understand them. In most circumstances, the memo would be unremarkable and we'd let it pass without comment.

What makes Mr. Assad's memo worth commenting on is its expressed bias against the direct-charging of proposal preparation costs. The memo stated—

As a matter of policy, contracting officers should minimize the situations where a contractor will be required to prepare proposals for new requirements or to definitize unpriced contractual actions. ... If a contracting officer requires a proposal for a follow-on contract or for new requirements, or determines it is necessary to award undefinitized contractual actions, the Department will often be placed in the position of paying for the proposal and negotiation costs on a reimbursable basis with little or no competitive control over the costs incurred. Contracting officers should avoid placing the Government in that position.

Well, isn't that special. The obvious problem with that policy position, of course, is that the proposal preparation costs that are not charged directly to contracts have to be charged somewhere else. If not direct, then they must be indirect. Thus, if the policy position in the memo is adhered to, then proposal prep costs that might have been legitimate direct contract charges will instead be accumulated in indirect B&P projects, to be allocated back to contracts on the same base as is used for allocating G&A expenses. Instead of being direct contract costs that actually absorb G&A, they will essentially add to contractors' G&A expense pools. In other words, the expressed bias against direct-charging of proposal prep costs will inevitably lead to increases in contractors' indirect costs—specifically, their G&A expense indirect cost rates.

But perhaps Mr. Assad was less worried about indirect costs than he was about direct contract costs. If so, that would be a 180 degree turn from DOD's traditional position, which was that contract cost performance reports and similar Earned Value Management information provided insight into individual contract costs, whereas indirect rates were largely a mystery, denoted by rates/percentages and guarded by DCAA auditors against the prying eyes of DCMA contracting officers.

If we're correct in our assessment, then Mr. Assad's implied policy position—that the DOD

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has more visibility and control regarding contractors' overhead costs than it does regarding contractors' direct costs—would not be inconsistent with past positions Mr. Assad has taken. In fact, Mr. Assad has, in the past, promised increased DOD scrutiny on contractor indirect costs. For example, in June, 2011, when Mr. Assad departed his previous post to accept his current position, [we reported](#) his remarks on contractor indirect costs, which, at the time, we thought portended some important changes in DCMA focus. Among other sources, our article linked to an Aviation Week & Space Technology story that included the following Assad quote---

'The reality is we need to step up our game across the board, and so that's what we're doing,' Assad told reporters. He said unlike profit margins, overhead costs would be fair game. 'That's cost. How do we get that out?' ...

So it's quite possible that Mr. Assad feels his new DCMA pricing team can better control indirect costs than they can direct costs. We are skeptical of DCMA success in that quest; but it is certainly a quest that can be reasonably pursued by Mr. Assad's team. Assisting Mr. Assad on his quest to rein-in contractor overhead (and presumably other indirect costs) will be a revitalized and repurposed acquisition workforce, according to November 16, 2011, report on Federal News Radio. The report stated—

The Defense Department says it's taking several new steps designed to drive toward better business deals. They involve not only rebuilding the acquisition workforce, but also making sure that workforce has the tools to make good decisions. ... Shay Assad, the Pentagon's director of Defense pricing, said the steps are a 'revolutionary approach' to making sure DoD's acquisition professionals get much more skilled in understanding the business deals they make with industry. They center on giving acquisition staff a better view of what's happening across DoD itself. ...

The changes will be led by the Defense Contract Management Agency, the DoD entity that handles administration of contracts, Assad told attendees at a conference of the Government Contract Management Conference in Bethesda, Md.

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Assad said DoD is starting by bringing all of DCMA's administrative contracting officers (ACOs) back into one place after a period of decentralization.

'We're going to have a uniform approach to how we deal with our peers in industry,' he said. 'That change is taking place right now. It should lead to a more consistent understanding of what the government's position is. It should lead to an improved ability for forward pricing rate agreements to come about. We're establishing a fundamental position in the department that says that these corporate ACOs who are responsible for rates will be the contracting officers' central repository of information with regard to rates.'

Second, DoD is piloting a new system called the Contractor Business Analysis Repository (CBAR). The tool is designed to give contracting officers much more insight into DoD's past and ongoing relationships with a particular company they may be dealing with.

'They'll be able to log in and get access to every business deal over \$10 million with that company,' Assad said. 'The ability for contracting officers to have much more awareness of what's happening throughout this very large organization will be provided to them almost instantaneously and in real time. In addition to that, they'll have access to all of the rates that have been proposed, what DCMA's position has been and what the contractor's position has been over time. Our contractors are really excited about having this kind of capability.' ...

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A third initiative is tied to the regrowing of DoD's acquisition workforce. Assad said DCMA has hired 300 price analysts and engineers for one specific purpose, to populate a new effort called ICAT — or Integrated Contractor Analysis Teams. The groups will be able to offer immediate technical and pricing assistance to contracting officers. Similarly, new regional pricing teams will be stood up to help with smaller contracting projects. They'll focus on contracts that are smaller than \$100 million and be available as a resource to help contracting officers who need expertise in figuring out pricing. ...

In a future blog article, we will discuss a recent GAO report assessing DOD's efforts to enhance its acquisition workforce. So stay tuned for that. One additional point from the Assad memo on proposal prep costs. Those who read the entire memo (and if you didn't read it, shame on you) would have noticed a couple of sentences at the very end, which said—

... we will soon be issuing a proposed DFARS rule (Case No. 2011-D042), that will provide a check-list to help gauge the adequacy of a contractor proposal. Such controls like this checklist, once finalized, will help prevent the Department from being billed for a substandard proposal package that will not adequately support negotiation of a reasonable price.

That's an interesting comment on a number of levels. First, we note that DCAA already has such a checklist. (It's called the "Forward Pricing Adequacy Checklist" and is available at the DCAA website). So either the current DCAA checklist is inadequate—or perhaps it's so useful that the DAR Council thinks it should be given the authority of a regulation! The introduction to the DCAA proposal adequacy checklist includes the following statement—

When the proposal is based on information other than certified cost or pricing data, the contracting officer is responsible for obtaining information that is adequate for evaluating price reasonableness. Inadequacies exist when the offeror does not comply with the contracting officer's requirements. *The following criteria, while specifically not applicable to information other than certified cost or pricing data, may provide a guideline to the auditor in reaching an opinion as to the adequacy of the proposal* (CAM 9-208). Consideration should also be given to any specific requirements in the request for proposal (RFP).

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We highlighted in italics an interesting sentence; to wit, that DCAA admits its proposal adequacy checklist is not applicable when TINA applies to a proposal...but auditors should feel free to use on non-qualifying proposals anyway---since it may be a useful “guideline” for auditors. Yeah, we know how that’s going to turn-out, don’t we?

Further, we note that DCAA apparently is misinterpreting the requirements of FAR 15.404-2 when it defines an inadequate proposal one that “does not comply with the contracting officer’s requirements.” In our view, a fair reading of that FAR rule would be that the contracting officer requests “field pricing assistance” (which includes DCAA audit of the contractor’s cost proposal) only when that contracting officer concludes that the contractor proposal, as submitted, is “inadequate to determine a fair and reasonable price.” Thus, by regulatory rule, DCAA would be involved in a cost proposal audit only when the offeror’s proposal had been determined to be inadequate by the contracting officer. In other words, every single proposal that DCAA audited would be, by definition, inadequate under its definition of adequacy. Second—and [as we’ve opined before](#)—the recent emphasis on contractor proposal adequacy is misplaced, or perhaps we should say that it places focus on a symptom rather than the real problem.

We wrote (and reiterated similar thoughts in [a subsequent blog article](#))—

... we wonder if the foregoing Air Force and DCAA direction might not be avoiding addressing the real problem—which is insufficient identification of Government requirements, and subsequent changes to those requirements—which prevents contractors from submitting timely and comprehensive proposals. (See the GAO reports linked above, which show the lack of defined requirements is a much a problem as any lack of cost or pricing data.) Focusing on enforcing timely contractor provision of requested data to support fact-finding and negotiations seems to be a fundamentally misplaced management emphasis...

So we wonder just how important to DOD buying efficiency this soon-to-be-proposed DFARS rule really will be, and how much money DOD really will save from requiring, by DFARS rule, that contractor proposals be “adequate”. Keep your eyes on that DFARS Case and, when it’s issued, then see if you agree with us that it’s likely to turn-out to be a cure in search of a disease.

Mr. Assad has emphasized several times that he’s not looking to impact contractor profitability—just their costs. He’s fine with contractors making a reasonable profit (as he should be, given that it’s official Government policy). He reiterated this position again, quite

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recently, and the MSM and others who follow the defense industry picked-up on his words and reported them (again) as if they were some kind of promise of safe-harbor in the upcoming storm of sequestered DOD budgets. Here's [one example](#) of such "gosh, what wonderful news!" reporting—

Even with the Pentagon looking to make widespread cuts and improve efficiency, profitability is not a target and it may increase, the Defense Department's director of procurement and acquisition policy told an audience of investors Wednesday.

Speaking at the Credit Suisse 2011 Aerospace & Defense Conference, Shay Assad said that the Pentagon is concerned with cost reduction, not margin reduction, and that he would be surprised if profitability went down even as spending is decreased.

'It wouldn't bother us at all if operating margins go up, so long as we're paying less,' he said. 'We want to spend 90 and have them make 15, we don't want to spend 105 and have them make 15.'

Despite Mr. Assad's assertions, it's become apparent that not everybody in DOD shares his point of view. In April, 2011, DPAP issued [policy guidance](#) discussing use of Performance-Based Payments (PBPs). We wrote about our disappointment with the DOD policy position [here](#). Readers should remember that Mr. Assad was still Director of DPAP when this particular piece of pathetic policy was issued. The policy memo asserted that contractors should offer the DOD "consideration" in return for permission to use PBPs—conveniently forgetting that previous DOD policy acknowledged that consideration had already been provided through DOD's lower administrative costs. In any case, the policy memo also directed contracting officers to utilize an Excel-based spreadsheet that determined "a win-win price that equitably accounts for the cost, benefits and potential risk associated with PBPs." That tool can be found at the DPAP website, [right here](#).

The defense industrial base was, quite rightly, concerned with DOD's new PBP policy. The

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Aerospace Industries Association (AIA) went so far as to send a letter to DPAP in September, 2011, expressing its concerns. As one commenter summarized AIA's concerns as follows—

Basically the [DPAP cash flow] tool compares the net present values of the cash flows under progress payments and those with performance based payments. The aim is to assure that the discounted outlay is not higher under performance based payments than under progress payments. The discount rate for the government cash flows (out) differs from the discount rate used for the contractors' cash flows. The tool splits that delta (arriving at the win-win) and calculates a rate of profit that achieves that win-win outlay. The contracting community's major concern has been the discount rate selected and the fact that the tool appears to fly in the face of the preference for performance based payments by making them less attractive.

Clearly, that commenter was far more diplomatic than we have been on this topic. On November 10, 2011, AIA (and other industry associations) met with a DPAP representative to discuss industry's concerns. In that meeting, attendees (and now our readers) learned the following—

- DFARS Case 2011-D045 will reference the cash flow tool and include a cost limitation clause, and guidance for use of the tool. Why this needs to be a DFARS rule and not a revision to DOD's PGI remains to be seen.
- The cost limitation contract clause noted above will limit the value of PBPs to the contractor's actual incurred costs.
- DOD does not like PBPs and feels that they provide no incentive for on-schedule performance.
- DOD does not intend that PBPs be used with competitive awards, because of the expense and delay associated with conducting two negotiations (one for customary progress payments and the other for the price difference associated with use of PBPs).
- DOD believes that use of PBPs requires additional reviews prior to payment, whereas those reviews need not be present to process customary progress payments.
- DOD intends that contractors receive a lower profit rate when PBPs are utilized, notwithstanding the current Weighted Guidelines direction that PBPs are riskier to the contractor than are progress payments.

We are going to gloss-over the level of ignorance and wrong-headedness displayed by the DPAP representative in the foregoing. We are going to gloss-over the fact that progress payments require adequate contractor accounting systems and periodic DCAA audits. We are going to gloss-over the fact that PBPs were imposed by Congress (via FASA) and DOD is clearly violating the will of the Legislative Branch in its recent actions. No, we're simply going to

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note that, while Mr. Assad is assuring industry and media that DOD is looking to reduce contractor cost— but not contractor profits—the words and deeds of his former Directorate demonstrate otherwise.

So let's wrap-up this perhaps overly long survey of recent DOD activities that impact its industrial base. What have we learned?

- DOD is focused on reducing contractors' indirect costs, while at the same time it issues policy guidance that will tend to increase contractor's indirect cost.
- DOD blames contractors for inadequate proposals, while failing to address its own shortcomings that create those inadequate proposals.
- DOD is reorganizing and hiring-up, to provide more opportunities to drive down contractor costs.
- DOD is actively seeking to overturn the will of Congress and, through its actions, reduce contractor profits while creating more workload for DCAA.

And if you don't care for what you've learned, you can point to Mr. Assad as the instigator of most of it.