PROFIT, REPUTATION, CASH FLOW

"INCENTIVIZING" — AN EFFECTIVE MOTIVATOR?

Grappling with Defense Contractor Incentive Issues

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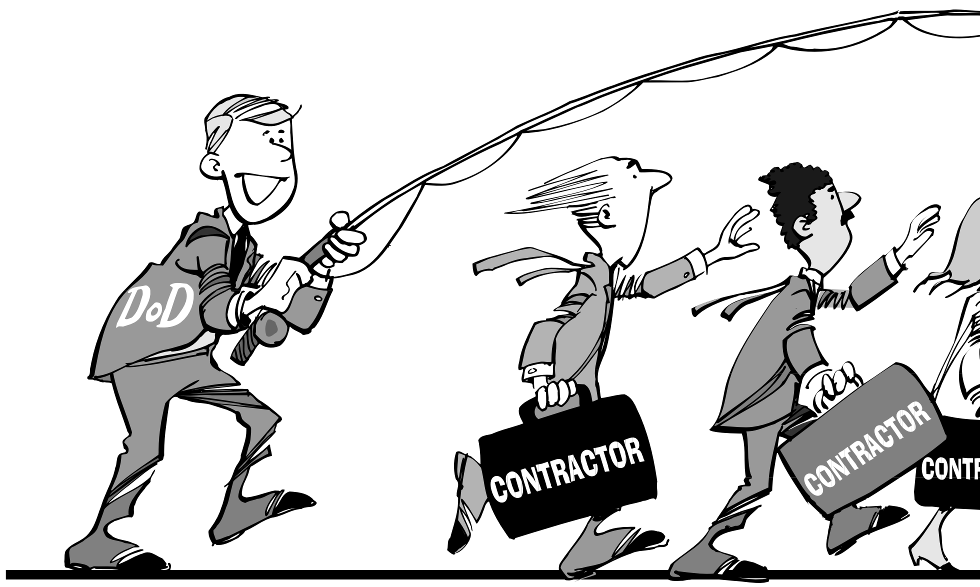
What motivates defense contractors to perform government work at a high level of quality, while simultaneously controlling cost and delivering on schedule? If the government knew the answer to this question, it could concentrate on those motives. However, what motivates an individual contractor is not an easy question to answer.



During my career, I worked for a defense contractor and the government, on both the administrative and buying sides of acquisition. In addition, I spent the last 8 years at the Defense Systems Management College grappling with some of these issues. From these experiences, I drew certain conclusions that will be the focus of this article. First, I'll discuss what I perceive as motivators for defense contractors, and then discuss how effectively the Government capitalizes on those motivators.

What Motivates Defense Contractors?

The natural tendency for many government personnel is to come to the obvious conclusion that **profit** is the dominant motivating force. And yes, this is eventually true of all contractors. I can't imagine too many companies in business not looking to make a profit. However, on individual contracts, which is where I'll focus this article, profit may not be a significant incentive or an incentive at all. I contend that other issues need to be considered.

Follow - On Contracts

Many contractors took on government development contracts in the past with the goal of ultimately receiving the production contract. This is especially true in a competitive environment. In most systems acquisitions, several contractors are involved in the development phase of a weapon system. Normally, only those that are participating in the development will be considered for selection as the production contractor. Production of a system is where the largest potential exists for a return on investment. Therefore, if a contractor hopes to win the production contract, its involvement with the development is critical. This rather than profit then, is sometimes the true motivation at the development phase.

Survivability

Cash flowing through a company generated by sales is the life blood of the company. If sales are not generated, normally assets must be reduced for the company to survive in the

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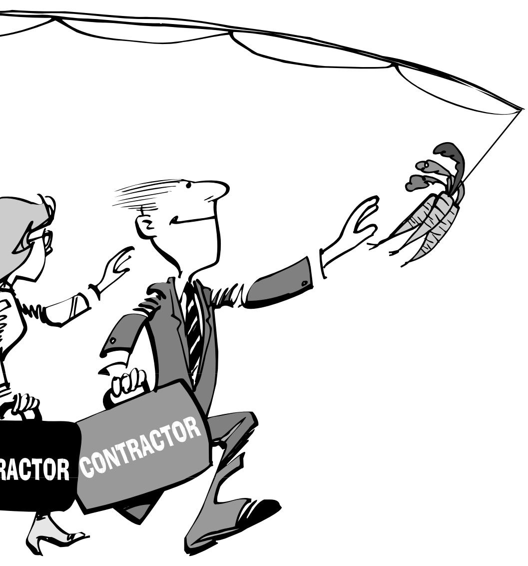
short run. Many times, a reduction in the labor force is the first asset reduced. These ups and downs can affect morale, training dollars, hiring and recruitment and overall capability. Thus, government contractors bid and perform these contracts at low or negative profit margins in order to sustain cash flow. The company survives for the near term with its workforce positioned for future business opportunities.

Overhead Cost

Defense contractors are generally able to allocate allowable overhead cost to all their government contracts.



The more government contracts a contractor has on the books, the larger the base that these costs can be spread against, thus reducing the overhead rates. With lower overhead rates, a contractor is more competitive on bidding future business. Also, on fixed-price work already under contract, overhead costs are reduced, thus creating a potential for additional profit. Therefore, capturing additional government contracts at low or no profit is another potential motivator for a defense contractor.

New Technology

Using a government contract to gain a new capability or technology constitutes another motivator. This is especially true when the contractor anticipates generating business through other government sales, Foreign Military Sales or commercial sales. Through a government contract, the contractor acquires a new capability. The contractor does not have to expend its own funds to obtain this capability. Therefore, profit is not the dominant motivator.

Reputation

If a contractor is unknown to government procurement personnel, establishing a good performance record on a government supply or service could earn future business. With the new added emphasis on past performance in source selections, this would also hold true for known contractors.

Eliminate Competition

A contractor might be motivated to outbid his competition on a particular item to capture the market. Thus, on future acquisitions, that contractor would be in a dominant or sole-source position. In this type of environment, a contractor will most likely accept a reduced profit margin or a net loss in the short term to realize larger profits in the future.

Changes

A contractor might be motivated to "buy-in" on an ill-defined contract in order to generate profit on change activity while in a sole-source bargaining position. In the past, this was typical of many fixed-price development contracts, with limited definition resulting in substantial cost growth.

Government Guidance

Before analyzing how effectively the government capitalizes on contractor motivators, a review of the government's published guidance on the subject of incentives is important. The primary guidance for all government acquisition personnel is the Federal Acquisition Regulation (FAR) system. It consists of the FAR, which is the primary document, and agency regulations that supplement the FAR.

A second key document is the *Armed Services Pricing Manual* (ASPM), designed to guide Department of Defense (DoD) personnel engaged in the analysis and negotiation of contract prices. A third document, *Incentive Contracting Guide*, developed by DoD and the National Aeronautical and Space Administration, is probably the premier document on incentive contracting. However, it was last published in 1969, which limits its accessibility. To date, few acquisition personnel have copies.

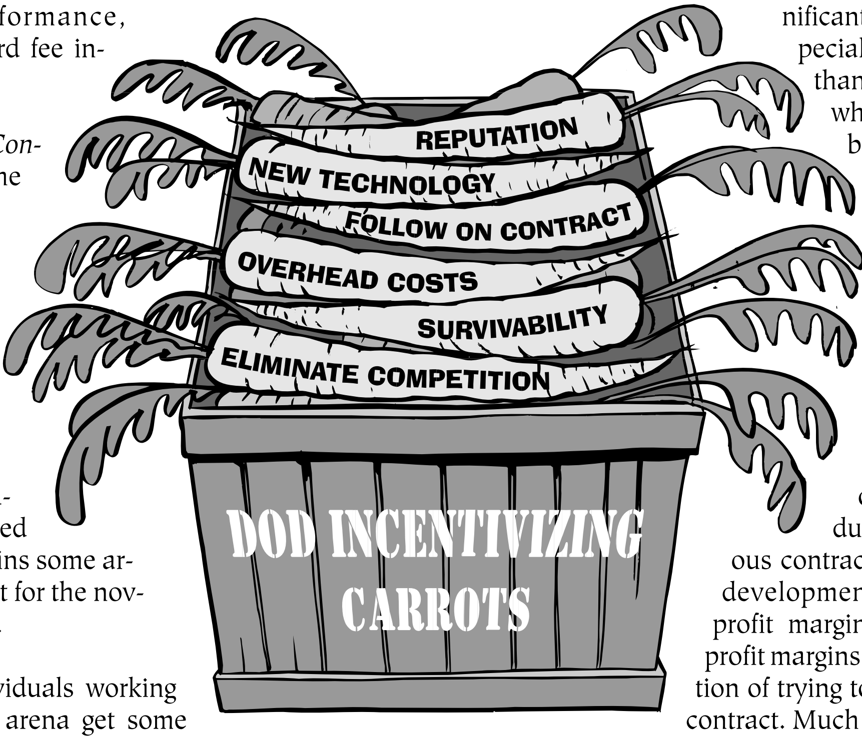
The FAR goes through a description of contract types with emphasis on the profit motive. Most of the contract types authorized by the FAR have structures that place incentives on the contractor's ability to control cost. The contractor has the opportunity to earn additional profit margin (percentage of cost) if total costs are less than a predetermined estimated cost, target cost or fixed price in the case of a firm, fixed-price contract.

The FAR also mentions the use of technical performance and delivery incentives for use with fixed-price incentive contracts and cost-plus incentive fee contracts. It also describes the use of cost-plus award fee contracts and award fee provisions by inducing the contractor to improve poor performance or to continue good performance in subjective areas that cannot be measured.[1]

These contract types, described in the FAR, are designed to increase or decrease the contractor's profit margin, as determined by performance against pre-set objectives — predominantly cost objectives. The FAR does not advise the contract administrator on how to structure these various types of contracts; however, the Defense Federal Acquisition Regulation Supplement does provide some guidance on the use of award fees.

The ASPM gives limited guidance on how to structure cost-only incentives, but does not give guidance on structuring performance, schedule and award fee incentives.

The *Incentive Contracting Guide* is the most comprehensive in describing how to structure cost, performance and schedule incentives. But as I mentioned earlier, the Guide is not in the hands of most contract administrators, was last updated in 1969, and contains some areas that are difficult for the novice to comprehend.



Almost all individuals working in the contracting arena get some type of training early in their careers, encompassing contract types and the use of incentives. For the most part, this training falls far short of sufficient comprehensive tools for structuring effective motivators for contractors.

Government's Use of Incentives

Many individuals within the government recognize that motivators other than profit affect cost, schedule and performance. However, they also realize the illusiveness of trying to measure the impact of these type motivators. Therefore, the underlying philosophy associated with how to motivate a contractor is the application of increasing or decreasing the profit potential.

The government refers to or expresses profit as a percentage of cost. A contractor, on the other hand, does not use this as a measurement of profitability. The contractor would evaluate profitability as Return on Investment, Return on Sales, Return on Assets or Return on Equity.

Let's look at the Return used most frequently by contractors: Return on Investment (ROI). This is calculated by multiplying profit margin (net income/sales) by asset turnover (sales/total assets). The first half of this equation is very similar to the government's definition of profit, but the second half is mostly overlooked in determining contractor motivators. It deals with how efficiently and effectively the contractor uses its assets to generate sales.

If a contractor has breaks in production, idle facilities, inefficient production quantities, stretch-outs, layoffs, strikes, excessive rework and repair, or any other inhibitor to using assets effectively, its profitability is negatively affected. Therefore, government personnel need to assess the entire aspect of profitability if they truly want to effectively motivate defense contractors.

Although the majority of governmental incentives were centered around profit, reputation is growing as an effective motivator. With more emphasis placed upon contractor past performance in selecting contractors for future business, good cost, schedule adherence and performance on existing contracts now becomes a significant motivator. This is especially relevant in other than sealed bid awards where selection is made based on the best value for the government, not on lowest bid price.

Another previously mentioned motivator, which the government has used effectively in the past, is the lure of the follow-on production award. Numerous contractors have preformed development contracts at low profit margins, or past negative profit margins with the sole motivation of trying to win the production contract. Much of this was done under firm, fixed-price contracts. Therefore, the contractor winning the follow-on award needed to maximize its profit potential on the production contract to reduce losses sustained during development. The contractor or contractors losing the follow-on could face significant financial difficulties.

Looking Forward

The government uses incentives to motivate its contractors, but perhaps we need to do more in assessing how best to tailor incentives to individual contractors. Taking a harder look at profitability instead of just profit margin would enhance the effectiveness of the incentive structure. When you evaluate contractor motivators, consider survival, follow-ons, overhead and competition. The brightest spot, from my perspective, is the emphasis on past performance. Reward those contractors that perform well on government contracts with future work — and that, ultimately, will prove to be the truly *effective* motivator.

Reference

Federal Acquisition Regulation 16.404-2.