A frequently heard question is “How much profit should I expect on my contract?” It comes up during preparation of the initial cost proposal; it comes up during negotiations; and it comes up when companies are considering entering the Federal marketplace to sell their goods and services.

What’s a fair profit?

As you might expect, government negotiators and contractors differ with respect to their answers to that seemingly straightforward question.

Here is what the regulations say:

It is in the Government’s interest to offer contractors opportunities for financial rewards sufficient to stimulate efficient contract performance, attract the best capabilities of qualified large and small business concerns to Government contracts, and maintain a viable industrial base. Both the Government and contractors should be concerned with profit as a motivator of efficient and effective contract performance. *Negotiations aimed merely at reducing prices by reducing profit, without proper recognition of the function of profit, are not in the Government’s interest.* Negotiation of extremely low profits, use of historical averages, or automatic application of predetermined percentages to total estimated costs do not provide proper motivation for optimum contract performance. (FAR 15.404-4(a).)

(Emphasis added.)

Right away, it is clear that the government expects a contractor to propose, and actually make, a reasonable profit on the work performed. That’s the official policy, as expressed in the FAR.

However, when cost analysis is performed, a contracting officer must evaluate the contractor’s proposed profit using a technique called “structured approach” that ensures a consistent methodology in that evaluation. According to FAR 15.404-4(d), the structured approach should consider the following factors:

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The complexity of the work and the resources required of the prospective contractor for contract performance.

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The degree of cost responsibility and associated risk that the prospective contractor will assume as a result of the contract type contemplated and considering the reliability of the cost estimate in relation to the complexity and duration of the contract task.

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The degree of support given by the prospective contractor to Federal socioeconomic programs, such as those involving small business concerns, small business concerns owned and controlled by socially and economically disadvantaged individuals, women-owned small business concerns, veteran-owned, HUBZone, service-disabled veteran-owned small business concerns, sheltered workshops for workers with disabilities, and energy conservation.

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The contribution of contractor investments to efficient and economical contract performance.

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Measures taken by the prospective contractor that result in productivity improvements, and other cost-reduction accomplishments that will benefit the Government in follow-on contracts.

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Recognition of independent development efforts relevant to the contract end item without Government assistance.

Those are the FAR-based factors to be considered. The Department of Defense has developed its own structured approach to profit analysis, called the “weighted guidelines” method. The contracting officer’s analysis is documented in Form DD 1547 (Record of Weighted Guidelines Method Application). According to DFARS 215.404-71, the weighted guidelines method focuses on four factors—

1. Performance risk

2. Contract type risk

3. Facilities capital employed

4. Cost efficiency

The methodology for applying the weighted guidelines profit evaluation is explained in the DFARS as follows—

The contracting officer assigns values to each profit factor; the value multiplied by the base results in the profit objective for that factor. Except for the cost efficiency special factor, each profit factor has a normal value and a designated range of values. The normal value is representative of average conditions on the prospective contract when compared to all goods and services acquired by DoD. The designated range provides values based on above normal or below normal conditions.

Seems simple enough, right? There are four factors; each factor has a range from low to high. The contracting officer puts in a number for each factor and then adds all the numbers up to get to the profit that has been determined to be fair and reasonable. (But note that the number is only a prenegotiation objective; the actual value will depend on how negotiations go.)

It seems simple, but if you look at the actual factors in the DFARS, you see subfactors and weightings and it turns out to be fairly complex and not very simple at all. For example, with respect to contract type risk, the contracting officer is directed to offer 5.0% (as much as 6.0%) for a firm, fixed-price contract; whereas a cost-plus-fixed-fee contract has a contract type risk maximum of 1.0%, with 0.5% being the standard.

We made a simple Excel model following the DFARS rules, and it looks to us as that if the contracting officer maxed-out every possible factor and subfactor in the contractor's favor, the maximum amount of profit that would be considered to be fair and reasonable would be 15%. *T hat's it.*
If the standard values were used, the profit rate looks to be in the neighborhood of 10% (FFP) or 6% (CPFF). So those become a DCMA contracting officer's prenegotiation objectives and the expectations for "success" at the bargaining table.

Thus, while the DOD is not applying predetermined profit percentages (which would violate the FAR policies quoted above), it is certainly applying predetermined profit *ranges* that, depending on your point of view, might not be super attractive. With that said, of course, one needs to factor in cash flow and, typically, the Federal government is a good customer with respect to cash flow. Over in the commercial world, it does no good to make a 50% profit if your customer never pays you. The complete story, then, is not solely about profit; but profit is what we are talking about today.

The story of profit does not end with the FAR and DFARS rules about "structured approach" and "weighted guidelines," because there are also some FAR-based rules (implementing statutes) that put a hard limit on the amount of profit (expressed in percentages of estimated cost) that may be paid. (See FAR 15.404-4(c)(4).) Contracting officers simply cannot exceed those statutory limits. *Period.* The limits are:

1.

For experimental, developmental, or research work performed under a cost-plus-fixed-fee contract, the fee shall not exceed 15 percent of the contract's estimated cost, excluding fee.

2.

For architect-engineer services for public works or utilities, the contract price or the estimated cost and fee for production and delivery of designs, plans, drawings, and specifications shall not exceed 6 percent of the estimated cost of construction of the public work or utility, excluding fees.

3.

For other cost-plus-fixed-fee contracts, the fee shall not exceed 10 percent of the contract's estimated cost, excluding fee.

So, other than the three specified profit limits above, the sky's the limit (officially) with respect to profit limitations. The contractor is permitted to propose as high a fee as it thinks it can support. The contracting officer will use "structured approach," including "weighted guidelines," to evaluate the proposed profit. To be clear: if you are not proposing a CPFF contract or an A/E contract then, in theory, you could propose 1000% profit on your estimated costs.

Of course, a proposed profit of 1000% is going to present a challenge for your contracting officer, especially if that contracting officer works for DCMA and has to fill out a DD 1547 and your proposed profit blows all the predetermined ranges out of the water.

If that's the situation, it is for sure going to be an *interesting* negotiation.

But we're not done yet.

The Department of Defense Office of Inspector General (DoD OIG) has its own viewpoint with respect to the profits a defense contractor should be earning. Would you be interested to know that the DoD OIG believes that a reasonable profit should never, ever, exceed 15 percent of costs, regardless of what the FAR might say the government policy is or what the DoD "weighted guidelines" might say the appropriate profit should be?

If you would be interested, then keep reading. Otherwise, see you later.

On February 25, 2019, the DoD OIG published Report No. **DODIG-2019-060** , entitled, "Review of Parts Purchased from TransDigm Group, Inc."

Bottom-Line Up-Front: The audit report concluded that TransDigm "earned excess profit on 46 of 47 parts purchased by the DLA and the Army."

Important factual detail: "contracting officers followed the FAR and Defense Acquisition Regulation Supplement (DFARS) allowed procedures when they determined that prices were fair and reasonable for the 47 parts at the time of contract award. … Contracting officers used FAR and DFARS-allowed pricing methods, including historical price analysis, competition, and cost analysis to determine whether prices were fair and reasonable for the 47 parts."

Another important factual detail: OIG auditors "used 15 percent as a reasonable profit and determined any profit over 15 percent to be excess profit." In other words, if TransDigm made more than 15 percent of its costs, that was judged to be excessive. Even though "TransDigm was the only manufacturer at the time for the majority of the parts competitively awarded, giving TransDigm the opportunity to set the market price for those parts." In other words, it was "buy from TransDigm or go fabricate your own parts." DoD chose to buy TransDigm's parts – and forego the costs of fabricating its own parts (assuming it even could do so) – and thus had to pay the price at which TransDigm offered those parts.

This situation made the DoD OIG unhappy. It is almost as if the DoD OIG is not a proponent of free market capitalism.

We could rant on other topics related to this so-called "audit report," but the conclusion would still be this: ***A fair and reasonable price is the one at which the seller agrees to sell and the buyer agrees to buy.*** *Period.* Contracting officers have Certificates of Appointment (warrants) because they have been trained to analyze prices in order to determine whether the Federal government is willing to be a buyer at those prices. That's their job. They don't need second-guessers criticizing them—especially when the second-guessers start the criticism with admitting that (1) the contracting officers followed all the rules and regulations, and (2) any profit greater than 15% is excessive (which violates the FAR policy we quoted at the beginning of this article). When the Monday-morning quarterbacks support their criticism by such admissions, we believe those conclusions are unwarranted. Taking it a step farther, we believe those criticisms are unworthy of professional auditors.

TransDigm had the parts. The DoD could choose whether to buy those parts, or not, at the prices set by TransDigm. Admittedly, this is a bit of a role reversal, because normally the DoD has all the negotiating power and the contractor has almost none. Competitive pressures usually push contractor profits down to the bare minimums; and if they don't, then the "weighted guidelines" will. But in this case, the contractor set the price and the DoD had to accept it, or walk away. It chose to accept the pricing and now the OIG is upset at the unfairness of it all.

That's not how the free market works.