



2019 GAUGE REPORT

Industry Roadmap of Benchmarks and Trends for
Government Contractors

CohnReznick 
ADVISORY • ASSURANCE • TAX

Unanet
Projects, People & Financials

September 2019, 3rd edition

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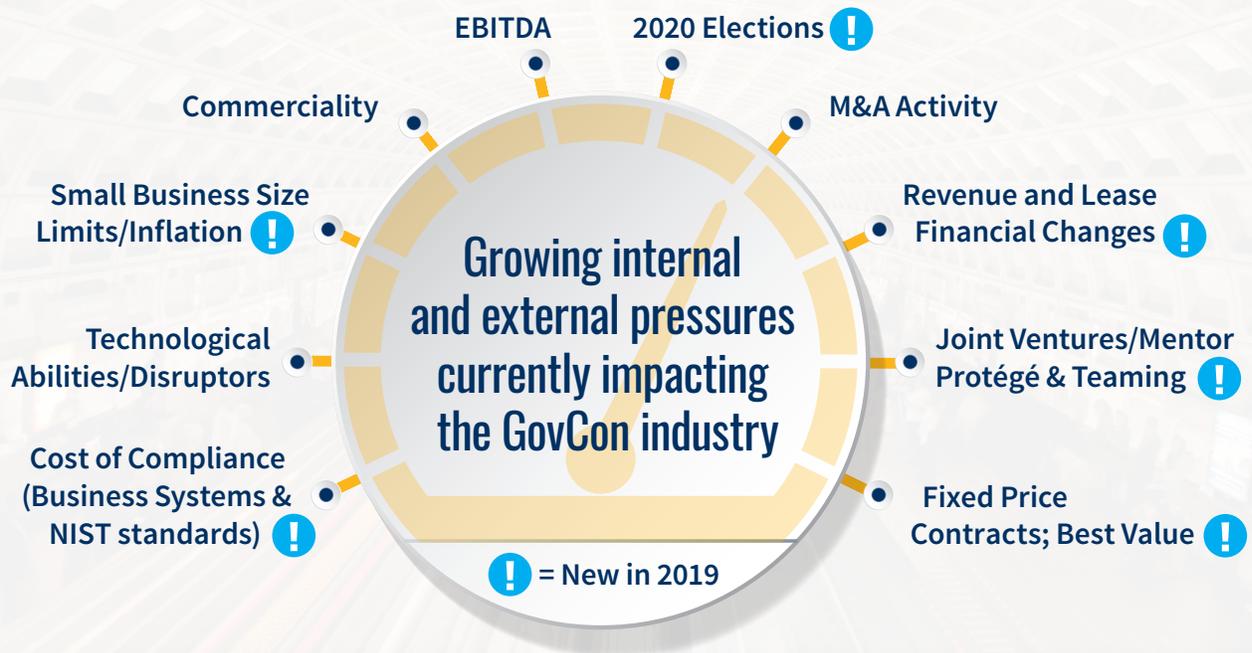


👍 New This Year!
Check out our “100 Top Tips” for GovCons

GAUGE

Government Contract Compliance Accounting Utilization Growth Efficiencies

MAJOR CHALLENGES GOVERNMENT CONTRACTORS FACE TODAY



EXECUTIVE SUMMARY

The 2019 GAUGE Report is a valuable benchmarking tool for GovCons who seek deep insights into industry practices and metrics. In the following pages, we share results from our third annual survey of government contractors to help you address current challenges, identify key performance indicators, and help you benchmark your organization among your competitors.

It is an exciting time to be a government contractor as the government is embracing new technology and gaining ground in allowing new and innovative companies to enter the marketplace. This year's data reveals that companies, with continued optimism, are focusing on acquiring and retaining talent, growing their business, and increasing EBITDA.

Further, 2019 government spending created a frenzy of proposal writing and contract modifications, as agencies and departments raced to the end of the government fiscal year to spend the fiscal 2019 appropriations before a continuing resolution could begin in fiscal 2020. As a result, the GovCon community has seen an uptick in contract vehicles, with 45% of our survey respondents saying they have been awarded an IDIQ (Indefinite Delivery-Indefinite Quantity) contract, which makes up the majority of their revenue.

Survey results from this year's GAUGE Report indicate optimism among those working with the federal government. 70% of respondents hold optimistic views, 18% hold neutral views, and 12% hold pessimistic views of the current contracting environment. This high level of optimism is encouraging given that the survey was completed during the longest government shutdown in history. 45% of survey respondents were somewhat affected by the government shutdown, while 6% experienced negative disruptions to their operations during the shutdown.

Government contractors are a special breed. They are continually on heightened alert to obtain new business, keep the cost of compliance reasonable, maintain adequate personnel levels, and manage to budget constraints. We hope the information in this report can serve as a useful guide to help you navigate these unique challenges and drive future growth.



Christine B. Williamson

Christine Williamson
Partner,
CohnReznick



Kim Koster

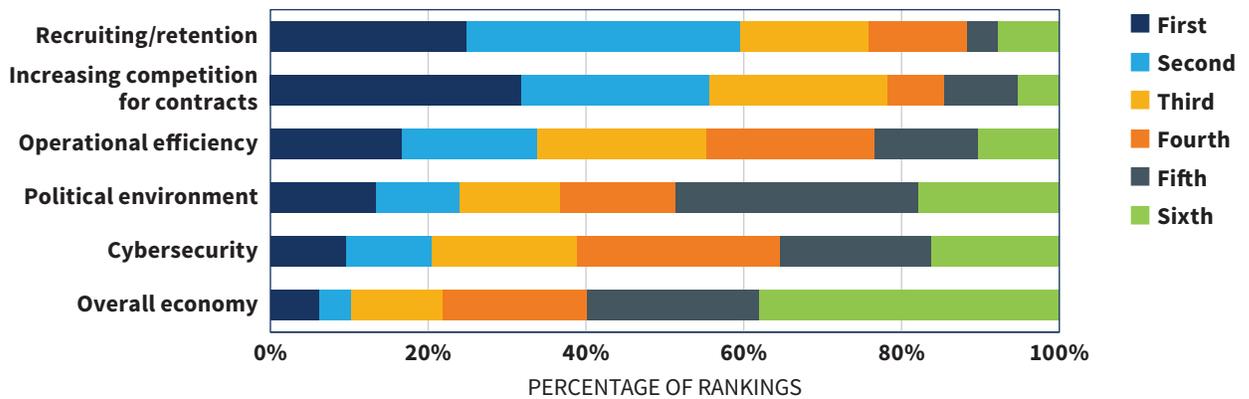
Kim Koster
VP of Product Marketing,
Unanet

Use this edition of the GAUGE as a tool for internal control best practices and industry standards. Keep your business above the rest!

REPORT HIGHLIGHTS

WHAT ISSUES ARE KEEPING YOU UP AT NIGHT?

The No. 1 ranked issue for respondents is increasing competition for contracts; therefore, winning and keeping existing business is top of mind. 35% of the respondents noted that the No. 2 overall issue is recruiting and retention. Operational efficiencies round out the third ranked item as companies focus on project execution and profitability.

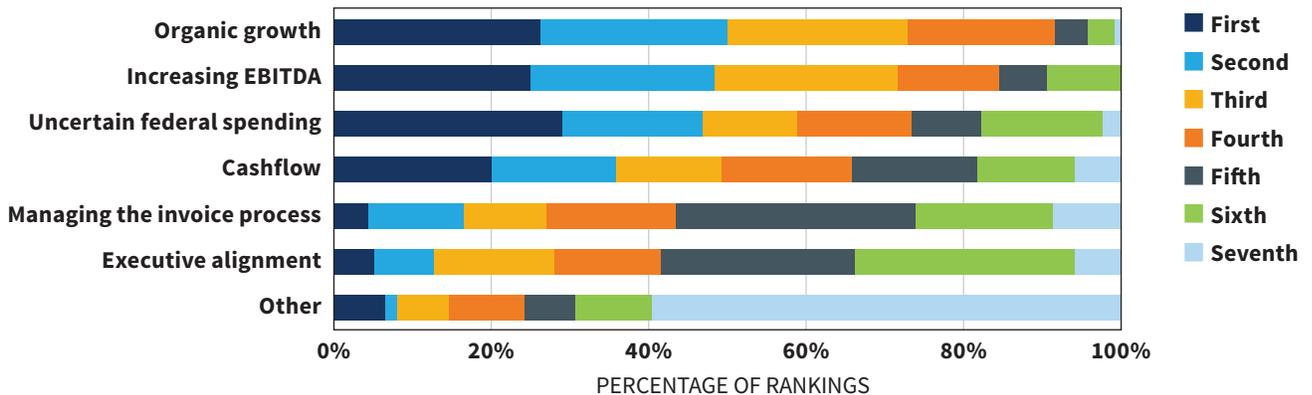


What are the largest financial challenges facing GovCons today?

1. Uncertain federal spending

2. Organic growth

3. Increasing EBITDA



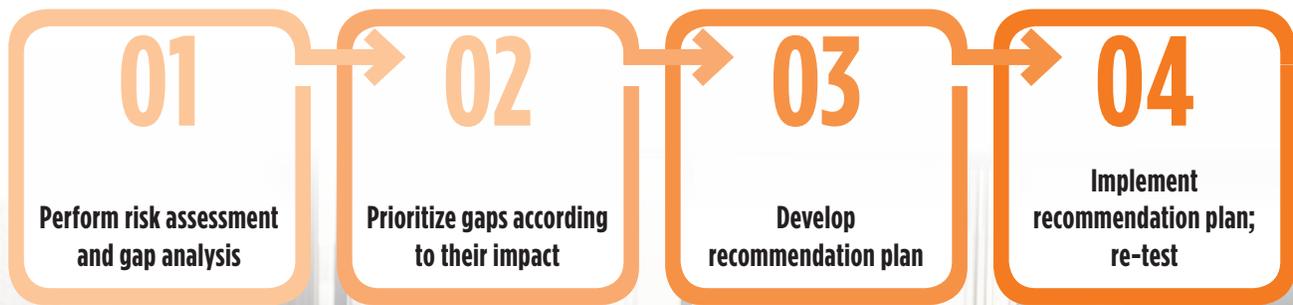


USING THE GAUGE REPORT

Each year we select a theme for the report. This year's report focuses on internal controls, following previous themes of budgeting, in 2017, and moving from a subcontractor to prime contractor, in 2018. To support this year's theme, we sprinkle insights throughout the report to help you create a roadmap for establishing or managing internal controls within your organization.

Having a system of internal controls is more than just ticking off compliance boxes or satisfying external auditors. It's about making sure there are procedures in place across the enterprise to help a company achieve its objectives and protect itself from a myriad of risks—both internal and external. An internal control risk review provides a level of assurance to investors, acquirers, and other stakeholders. A strong system of internal controls is paramount to good governance.

The four-step process below shows how the risk roadmap is iterative and meant to be repeatable. A company should initially perform a risk and gap assessment and then prioritize identified gaps based on low or high risk to the entity and shareholders. Based on remediation recommendations, a company will then make corrections according to the remediation plan. Once the company completes the implementation of its recommended internal controls, then the testing should begin again the following quarter to re-test the effectiveness of the plan.



GETTING STARTED WITH INTERNAL CONTROLS:

The nature and complexity of an internal control system can be dictated by multiple factors, including the type, size, industry, and location of the business. The development and implementation of internal controls begins by evaluating the company's assets and overall business objectives. While internal controls monitoring should be an ongoing process, our four-step process assists in identifying and prioritizing risks, determining the tasks required and the timing of these tasks, and ensuring that internal controls are in place and operating effectively in time for an audit or assessment by investors, government auditors or acquirers of the organization.

The process of improving an internal controls program should begin by identifying current weaknesses and opportunities for improvement as well as the checks and balances required to meet an organization's financial and business needs. This includes identifying areas and tasks of responsibility, the person(s) responsible for each task, timing of each task, and to whom each person reports. A key area on which to focus is the financial close process. For example, in many organizations we see an over-reliance on spreadsheets. This can cause delays in the timing of the close, jeopardize data accuracy, and increase the potential for unauthorized access to confidential information. Sometimes a solution can be as simple as restricting access to the spreadsheets and clearly defining roles and responsibilities. Other times, the remedy may involve the implementation of a financial application that links business units.

Companies often falter with the remediation effort, so strong project management skills are required. In remediating internal control gaps, it is important to ensure plans contain accountability—including assigning responsibility and compliance with budget and timeframe. When designing and implementing internal controls, consideration should be given to their scalability. Well-designed internal controls can potentially provide the framework that enables business processes to expand in proportion to the growth objectives of the organization. For example, when a new IT system is being rolled out, pre- and post-implementation reviews should be performed to ensure that the internal controls are functioning as anticipated and can support future expansion efforts and accommodate increases in growth. **Internal controls are not completely elastic; they require periodic review and retesting to ensure that no gaps have been introduced as a byproduct of growth.**



THE UNIVERSE OF RISK ROADMAP

While the universe of risk is broad and varies based on industry, risks generally fall within certain categories or classifications, with some risks straddling several categories. The table below is meant to illustrate the depth and breadth of risks a company needs to consider when designing, implementing, or enhancing its system of internal controls.

OPERATIONAL RISK

Arise from people or a failure in systems, processes, or controls

- ▶ Third-party and vendor relationships
- ▶ Network and system application security
- ▶ Cybersecurity
- ▶ Regulatory and legislative compliance
- ▶ Segregation of duties
- ▶ Corruption and bribery
- ▶ Social media sentiment
- ▶ Policies and procedures
- ▶ Business continuity and disaster recovery planning
- ▶ Change management
- ▶ Supply chain management
- ▶ Reputational
- ▶ Computer operations

STRATEGIC RISK

Arise from fluctuations in the economic, political, or competitive environment

- ▶ Market environment
- ▶ Mergers and acquisitions
- ▶ Research and development
- ▶ Product development
- ▶ Restructuring
- ▶ Market or geographic expansion
- ▶ Political environment
- ▶ Economic environment
- ▶ Natural or man-made disasters
- ▶ Demographic fluctuations
- ▶ Industry trends
- ▶ IT governance
- ▶ Strategic planning

FINANCIAL RISK

Arise from market, credit, or liquidity risk or a failure of systems, people, processes, or controls

- ▶ Financial close and reporting process
- ▶ Data reliability and integrity
- ▶ Credit
- ▶ Liquidity
- ▶ Controls over management override
- ▶ Interest rates
- ▶ Pension liability
- ▶ Fraud prevention and detection
- ▶ People, processes, and systems
- ▶ Market volatility
- ▶ Account reconciliation
- ▶ Credit card payment and processing
- ▶ Asset impairment

BUSINESS/ENTITY RISK

Arise from a lack of board and senior management oversight, policies, and procedures or tone setting

- ▶ Board structure and oversight
- ▶ Management oversight
- ▶ Succession planning
- ▶ Tone from the top
- ▶ Governance, risk, and compliance
- ▶ Internal and external communications
- ▶ Whistleblower hotline
- ▶ Change management
- ▶ Hiring and retention practices
- ▶ Performance metrics
- ▶ Code of business conduct and ethics
- ▶ Executive compensation
- ▶ Board/audit committee reporting
- ▶ Enterprise risk management



“Government contractors trust the GAUGE to provide them with insight and perspective, especially in the areas of overhead & wrap rates, number of FTEs to fuel the indirect teams, and maturity. The yearly themes make the GAUGE a ‘must have’ for government contractors looking to grow and compete within our robust market!”

—Fran Craig, Founder, Unanet

“The 2019 GAUGE Report is a valuable resource and critical benchmarking tool for the government contracting industry. The GAUGE provides deep insights to help you stay up to date on industry trends and ahead of your competition.”

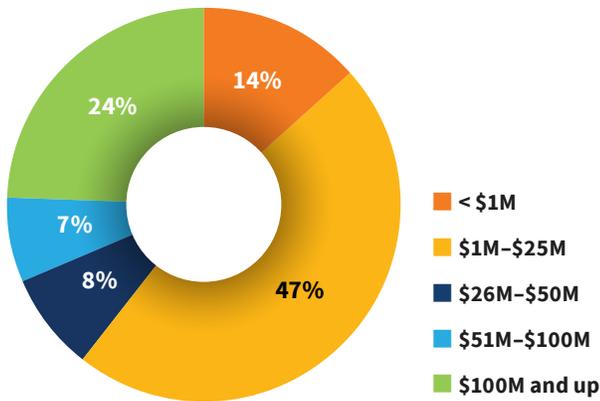
—Kristen Soles, Partner, CohnReznick, Government Contracting Industry Leader

GAUGE SURVEY RESPONDENTS

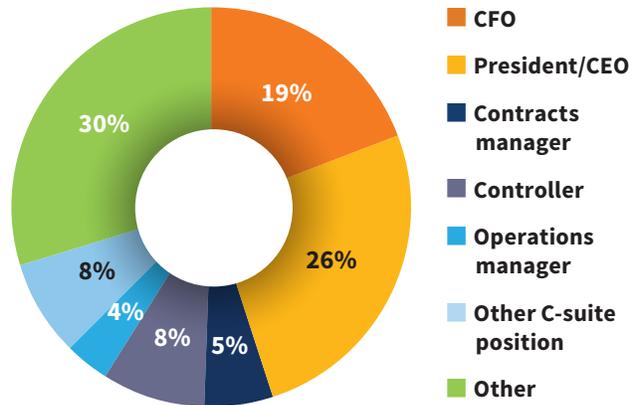
DEMOGRAPHICS:

The 2019 survey, conducted from January 2019 to May 2019, had over 1,250 contributors representing a wide array of government contractors across the U.S. within various industries. We received a cross-section of respondents with titles from C-suite to mid-level management, giving the report balanced input.

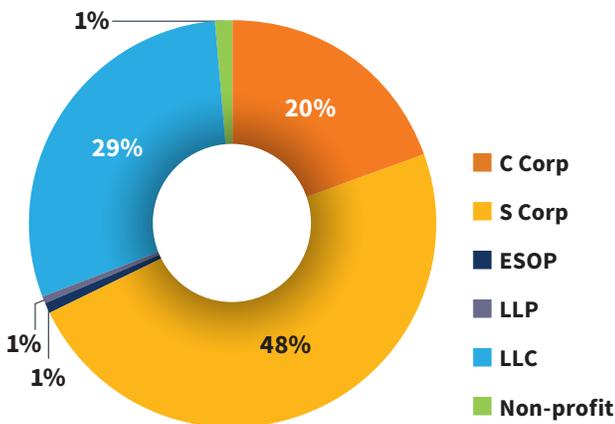
Respondents by Annual Revenue



Title of Respondents



Entity Structure

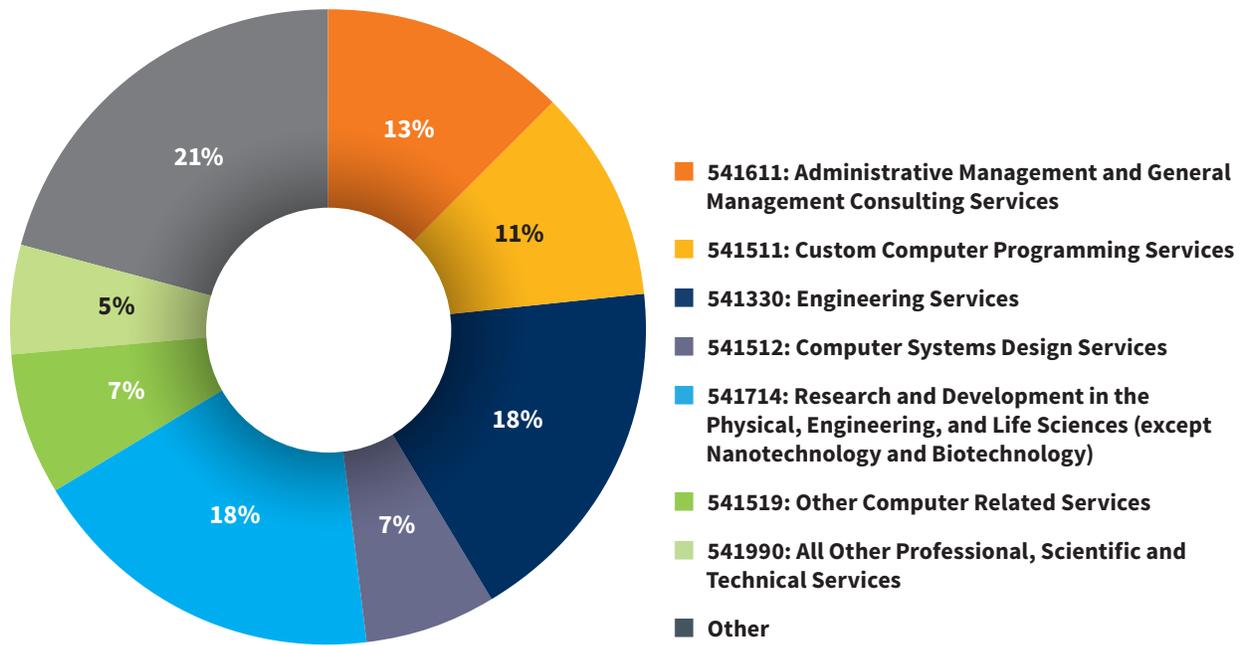


RESPONDENT TYPES

Survey respondents fell into four broad categories based on company revenues:

- ▶ Up to \$25M
- ▶ \$26M—\$50M
- ▶ \$51M—\$100M
- ▶ \$100M and up

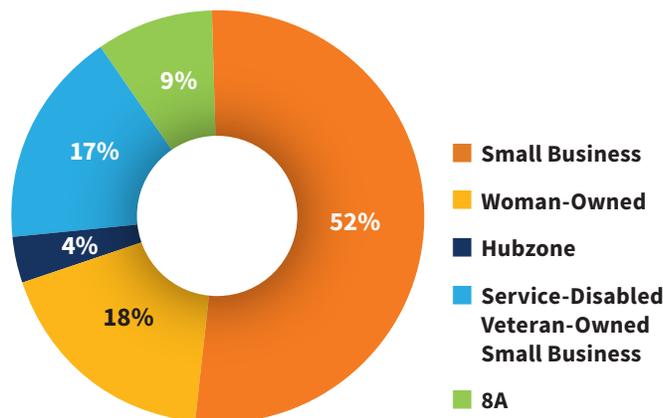
Primary NAICS Codes of Respondents



NAICS codes are an important means for helping the government contracting industry bid; determine size, team, type of work; and to understand how contractors are defined by the IRS for all industries.

Set-asides help the government level the playing field by providing contracts to businesses that can have a variety of designations such as small, woman-owned, veteran, or disadvantaged. Our respondents win points in contract evaluations if they hold one or several of these designations. The survey proved to have a good mix of these types of businesses and might explain why 43% of our respondents have increased their federal revenue by more than 10% -20% from their previous year. Also 18% of the respondents participated in a Mentor-Protégé program.

Set-Aside Designations



GOVERNMENT CONTRACT COMPLIANCE

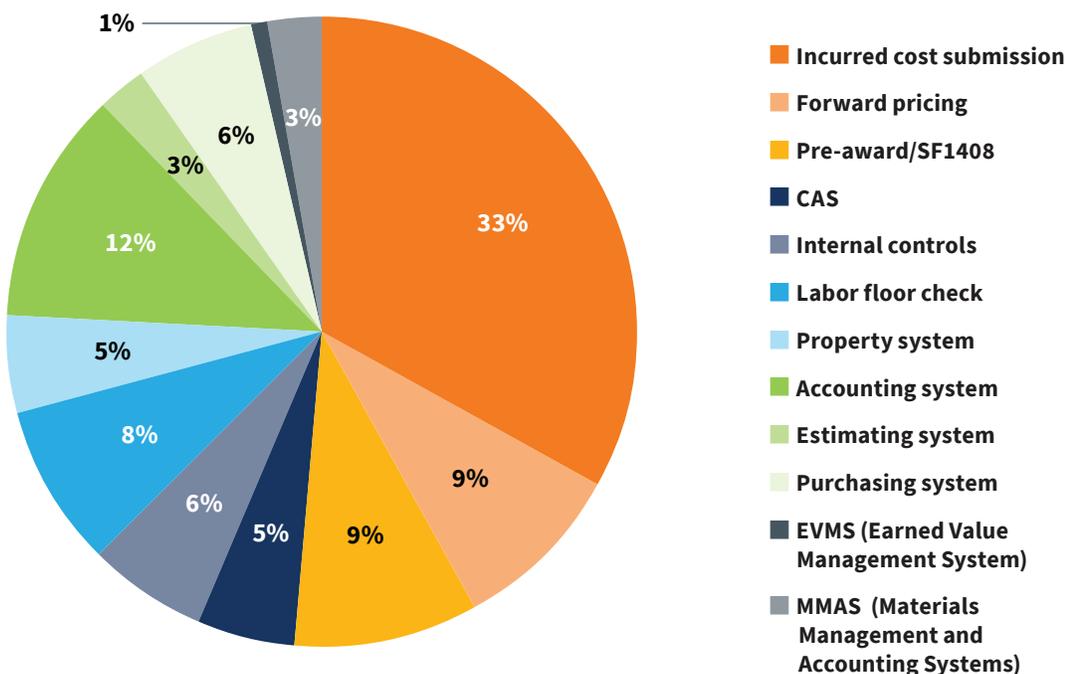
SUMMARY

- ▶ Incurred Cost Submissions lead the way again this year as the No. 1 audit performed on contractors as DCAA's backlog has severely diminished
- ▶ More than a quarter of respondents said their government oversight is increasing, 6% more than last year
- ▶ Indirect rates are still the top compliance challenge for contractors, followed closely by billing, then timekeeping
- ▶ Questioned incurred costs between \$50,000–\$100,000 rose more than 25%, indicating that prior year results could have been an exception, as this year's audit dollar values are higher

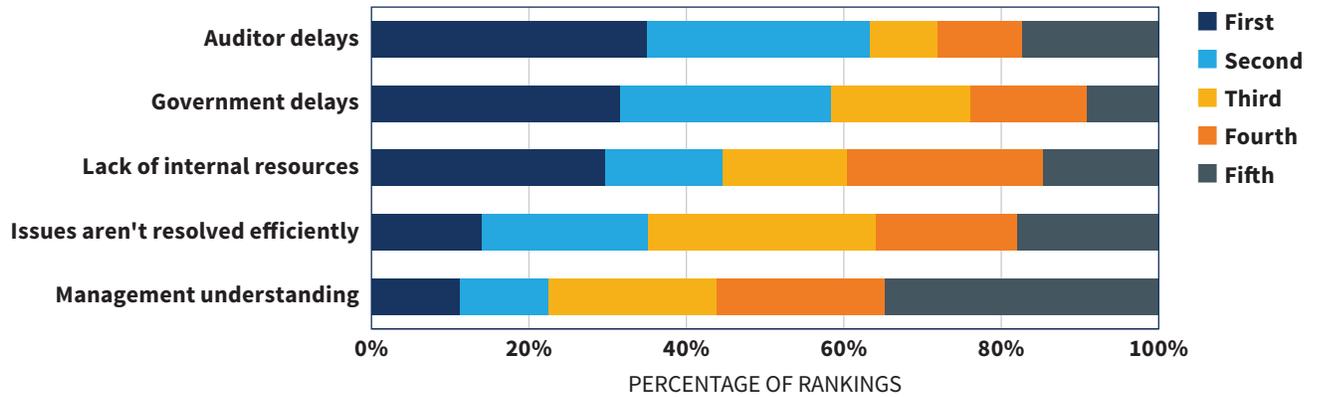
CONSIDERATIONS FOR THE COMING YEAR

- ▶ DCAA expects to be in full compliance with the National Defense Authorization Act (NDAA) 2018 requirements to finish incurred cost audits within 12 months of receiving a contractor's adequate proposal
- ▶ Review the DCAA.mil website for the DCAA Report to Congress, as it will provide clues and information about what DCAA is looking to do in the coming year
- ▶ Cybersecurity could be considered a direct cost; therefore, contractors should consider estimating these costs and determining allocation methods to include the cost in their bid pricing
- ▶ Section 809 Panel implementations have stalled (due to lack of funding) which has quieted those recommendations
- ▶ Other Transaction Authority agreements (OTAs) are still a hot topic for small, innovative, non-traditional GovCons

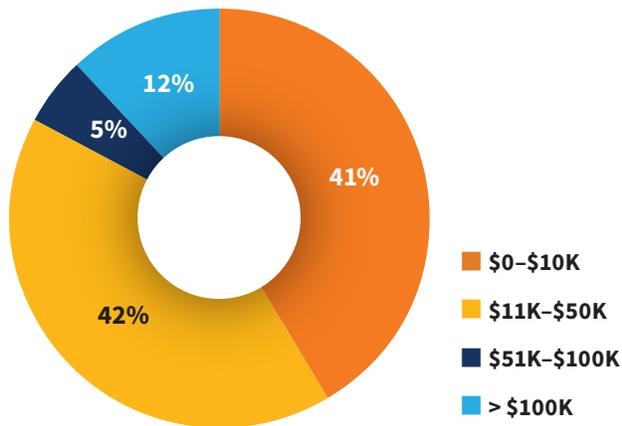
Types of DCAA Audits



What is Delaying the Completion of Incurred Cost Audits?



Dollar Value of Questioned Costs from your Last Incurred Cost Submission

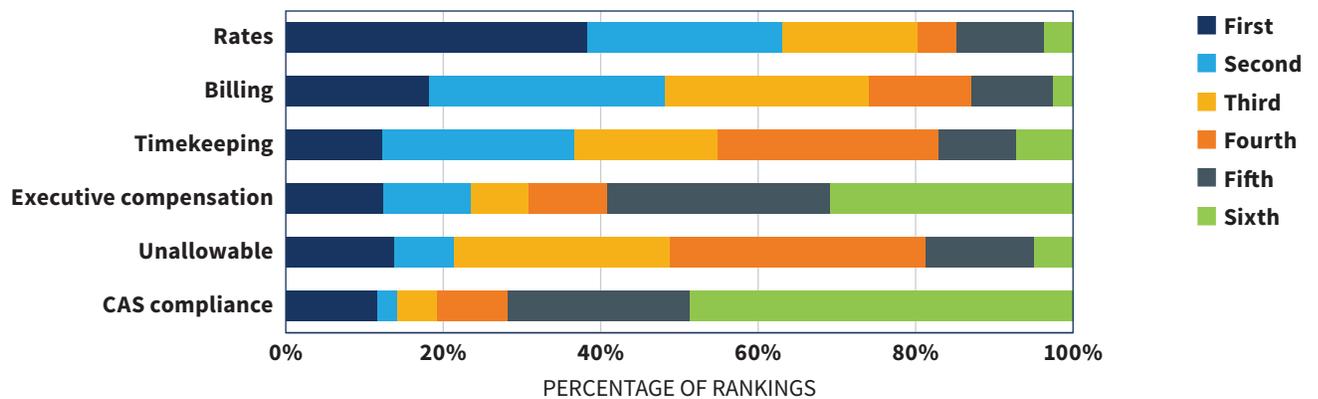


DCAA Compliance Trends to Expect

Expect to see a more balanced mix of audits to include:

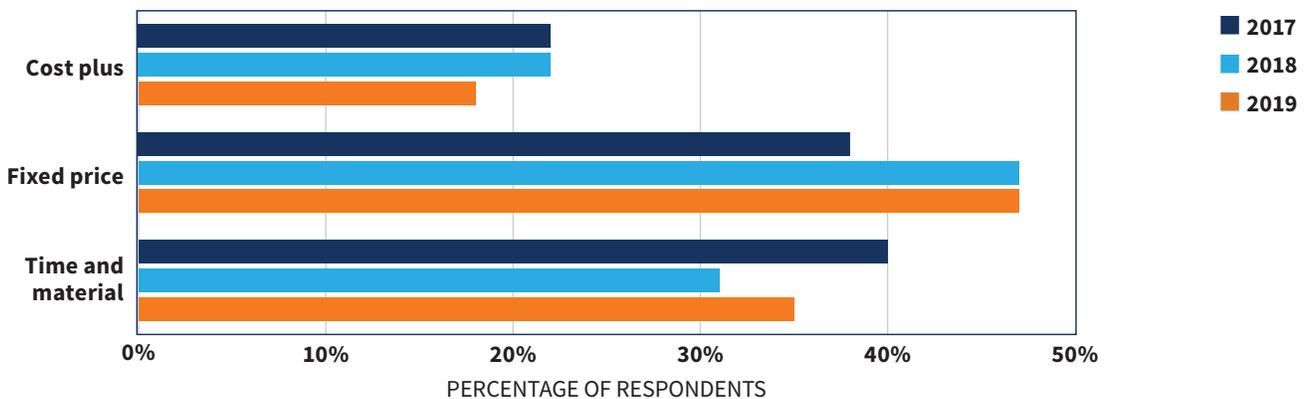
- ▶ Business Systems
- ▶ Truth in negotiations
- ▶ Cost Accounting Standards (CAS)
- ▶ Pre-award surveys
- ▶ Claims
- ▶ Terminations

Top Compliance Challenges



Fixed price (FP) contracts will continue to be the preferred contract type especially by respondents who work with DOD now that the agency has issued the final ruling stating the preference for use of FP contracts under \$50 million. Special approval for certain cost-reimbursement contracts is now in place. OTAs were seen by 1% of our respondents as the Pentagon is on track to obligate more than \$7 billion via OTA in fiscal 2019.

Contract Type Held Year over Year



How is your internal audit function perceived?

How much an organization values the internal audit function reflects its emphasis on responsibility, accountability, and commitment to accomplishing objectives and maintaining effective internal controls. An internal audit department provides independent and objective assurance, adds value, and assists an organization in achieving its objectives.

As expectations for internal audit are increasing, internal auditors should be viewed as an asset. This sets the tone that internal audit is an in-house, consultative, trusted advisor. The first step in creating an effective internal audit function is to understand how the function is perceived and if resources are adequate to provide exceptional services to critical areas in the organization, such as:

- ▶ Assisting in due diligence, system implementation reviews, and new regulation readiness
- ▶ Rationalizing and reinforcing effective internal controls and process improvement opportunities
- ▶ Identifying root causes of, and resolution, to key business problems and systemic issues
- ▶ Determining organization-wide business improvement opportunities
- ▶ Oversight of subcontractors

INTERNAL CONTROL TIP

REGULATORY COMPLIANCE

- ▶ Stay current on interim Federal Acquisition Regulation (FAR) clauses and NDAA changes.
- ▶ Understand the difference between commercial, non-commercial and micro-purchases per FAR.
- ▶ Prepare to follow Public Law requirements when purchasing goods or services (TINA, CAS, FFATA, etc.), or risk failing the government’s purchasing system audit.
- ▶ Understand the record-keeping requirements in FAR 4.7.
- ▶ Utilize quick closeouts (FAR 2708) whenever possible as it is usually in your company’s and the government’s best interest.
- ▶ Don’t let the government de-obligate funds until you are certain there will be no additional costs.
- ▶ Establish predetermined mitigation strategies to avoid conflicts of interest.
- ▶ Document closeout processes and negotiations held at closeout.
- ▶ Work with contracting officers to help ensure your CPARS are fully representative of your performance.

DCAA & DCMA INTERACTIONS

- ▶ Cooperate and communicate often with federal auditors.
- ▶ Review work programs utilized by DCAA/DCMA to help ensure you’re ready for an audit (types of reports required, necessary support, etc.)

- ▶ Insist DCAA hold entrance and exit conferences.
- ▶ Develop a good relationship with your ACO.
- ▶ Know which types of audits you are subject to and be prepared.
- ▶ Choose a point of contact to be a liaison with your auditor.
- ▶ Get outside assistance with contract compliance audits when necessary.

SUBCONTRACTING GOALS & PARTNERING

- ▶ Close out subcontracts and purchase orders in real time when possible.
- ▶ Avoid audit of subcontractor costs when possible.
- ▶ Explore Mentor-Protégé programs for new customers or potential acquisition targets.
- ▶ Partner with companies you trust which can improve past performance ratings, enhance capabilities, and increase your chances of winning the contract.
- ▶ Understand the regulations, responsibilities, and the increasingly competitive marketplace before making the jump from sub to prime contractor.
- ▶ Anticipate the need for negotiating “advance agreements” with contracting officers to avoid disputes during audits.
- ▶ Beware of onerous or erroneous clauses in subcontract agreements and the cost to implement.

What is an OTA?

- ▶ A legally binding procurement instrument called Other Transaction Authority
- ▶ A term that refers to 10 U.S.C. 2371 and 10 U.S.C. 2371(b) authority to enter in to these agreements
- ▶ A flexible business arrangement to acquire research and development to support technology advancement or quickly develop a prototype by the Federal Government

ACCOUNTING

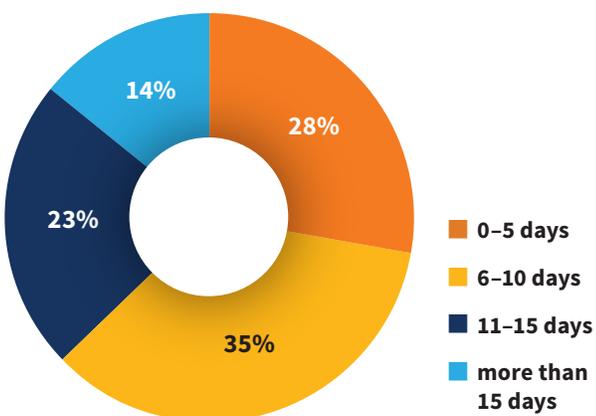
SUMMARY

- ▶ Cash is king and contractors are focused on reducing Days Sales Outstanding (DSO) which marks improvements from last year in the <45 days category
- ▶ Invoice cycles are 12% better in the <10 days category which signals a concentration on process and tool selection
- ▶ Indirect rates continue to be a strategic differentiator for organizations and there are widely varying ways to break out overhead pools by function, geography, customer or product/service
- ▶ Nearly three-quarters of respondents said there will be a small tax benefit, up from 66% last year, from the Tax Cuts and Jobs Act

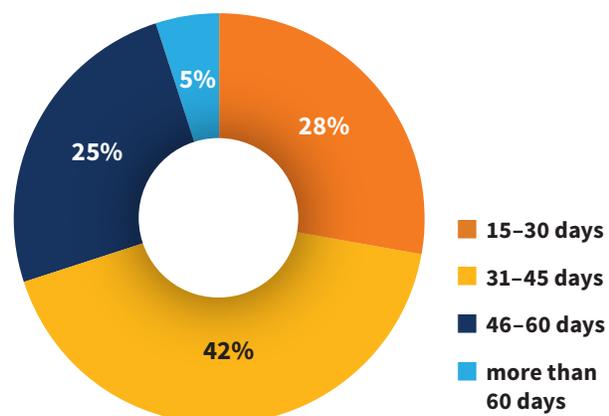
CONSIDERATIONS FOR THE COMING YEAR

- ▶ A lessee will be required to recognize assets and liabilities for leases with terms of more than 12 months. The ASC 842 lease standard has now been delayed to 2021 for non-public companies but public companies are still on the hook. Public companies have found the implementation of this standard harder than expected so the FASB postponed it for non-public organizations
- ▶ Companies will have to report useful information about the nature, amount, timing, and uncertainty of revenue from contracts with customers under the new standard ASC 606. Public companies were required to apply the new revenue recognition standard in 2018, and private companies have to adopt in 2019
- ▶ Documentation is the biggest step in meeting both lease and revenue recognition standards so it is important to start as soon as possible
- ▶ Begin creating a remote work policy as companies are occupying less space and allowing more workers to remote work at least one or two days per week
- ▶ Mergers & Acquisitions are in high demand as more than 25% of respondents are in the market to make a strategic acquisition

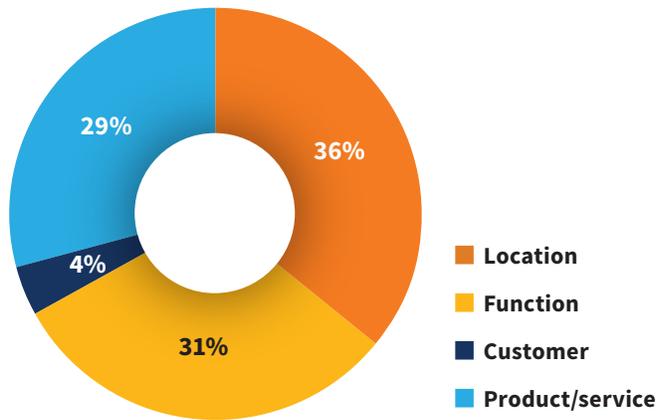
Invoice Cycle



Days Sales Outstanding

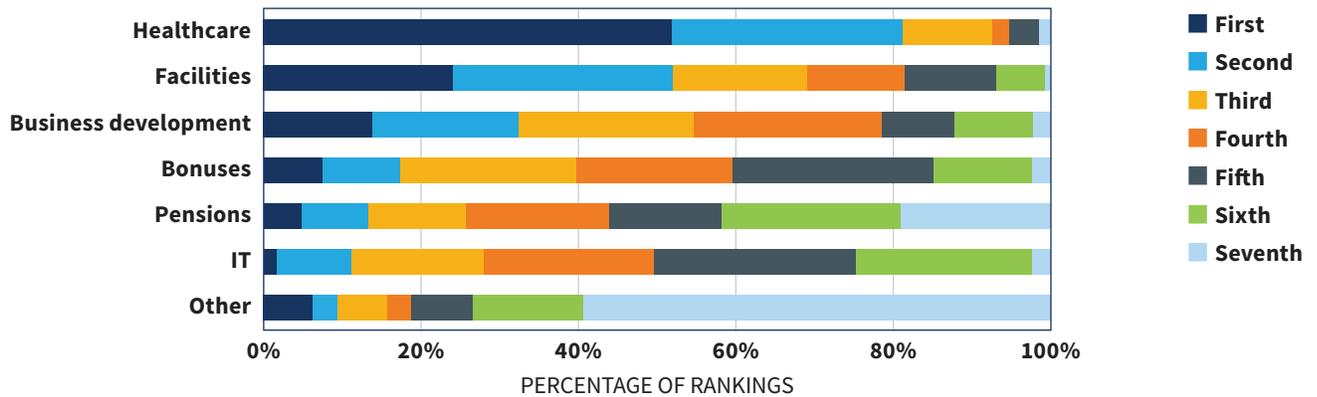


Overhead Rate Base



Controlling costs in both healthcare and facilities will be important in the coming years. Get creative and balance employee welfare with your ability to compete. How will you adjust your healthcare benefits while keeping up with recruiting and retaining talent?

What are Your Largest Indirect Costs Other than Labor?



Invoice cycles for companies with up to \$25M of annual revenue surpass the other revenue bands in the survey:

0-5 days – **32%**

11-15 Days – **21%**

6-10 days – **34%**

More than 15 days – **13%**

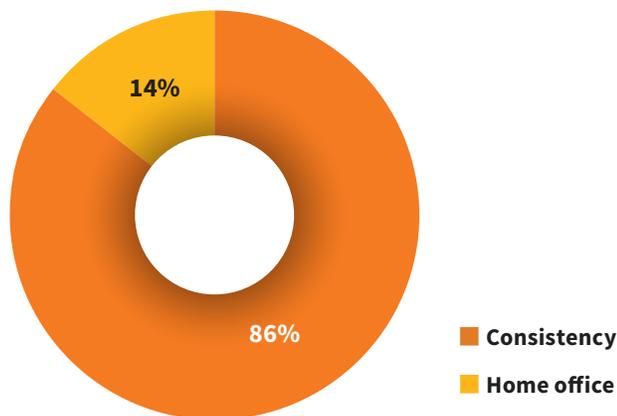
For each type of risk identified, there are various internal controls designed to mitigate such risk. The goals of your internal controls program should be to:

- ▶ Safeguard assets
- ▶ Achieve strategic business objectives
- ▶ Comply with applicable laws and regulations
- ▶ Facilitate timely and accurate financial reporting
- ▶ Protect confidential data
- ▶ Promote efficient operations
- ▶ Prevent or detect fraud
- ▶ Ensure adherence to established management policies and procedures

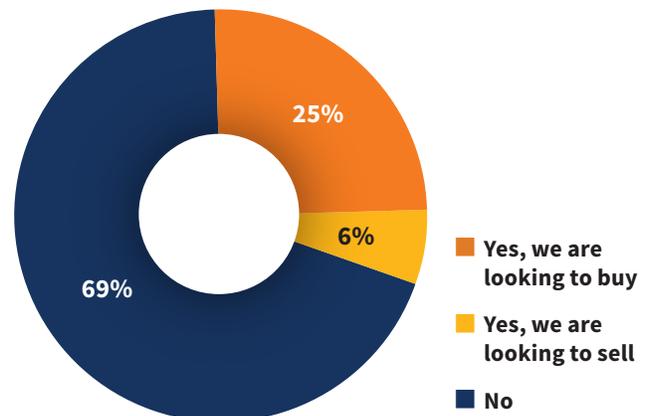
If M&A is a future possibility for you, what typical controls are examined?

When performing due diligence of a potential target, an investor or acquirer will assess how effective the target's internal controls are related to key risks. An investor or acquirer typically examines the target's controls regarding its 1) financial processes, 2) information technology, 3) third-party onboarding practices, and 4) regulatory compliance efforts.

CAS Audit Concerns



Do you Plan to Buy or Sell in the Next 12 Months?



FINANCIALS & ERP SYSTEMS

- ▶ Understand the impact of ASC 606, the new revenue recognition standard and related financial footnote impacts on your company.
- ▶ EBITDA—Calculate it, understand it, and create a goal for it!
- ▶ Familiarize yourself with the new lease accounting standard, ASC 842, which could affect your debt covenants.
- ▶ Understand what is in your unbilled accounts receivable and the collectability thereof.
- ▶ Have an ERP system that handles cost pools and allocations.
- ▶ Understand funded versus unfunded backlog.
- ▶ Complete your timesheet every day.
- ▶ When preparing expense reports, use location specific per diem rates that comply with the allowable rates prescribed.

BUSINESS SYSTEMS

- ▶ Create policies and procedures that are both compliant with federal government regulations and practical for your business.
- ▶ Review policies annually to see if they are being followed which may prevent future regulatory and audit issues.
- ▶ Perform Business System readiness assessments and proactively address any gaps in compliance.
- ▶ Use CohnReznick’s checklist to understand when your company is subject to Business System criteria.

- ▶ Invest in IT/data security internal controls no matter what services you perform for the federal government. Cybersecurity will increasingly be a rated factor in competitive procurements, particularly within DOD.
- ▶ Develop policies and procedures related to your Business Systems. Ensure your business continues to operate the way you want it to and establish policies and procedures for your employees to follow.
- ▶ Understand the difference between an SF 1408 pre-award survey and accounting system review.

COST ACCOUNTING STANDARDS & ADVANCED KNOWLEDGE

- ▶ If you make a change in an accounting practice, get help preparing a cost impact analysis before talking with your customer.
- ▶ Get help with the items you don’t handle very often, e.g. termination claims, cost impact studies, etc.
- ▶ Create a tracking system for your CAS covered contracts.
- ▶ Read and understand the CAS preambles. They provide valuable insight into each standard.
- ▶ Understand and follow the requirements of CAS 403, Allocation of Home Office Expenses to Segments, if you have home office costs that are allocated to segments.
- ▶ Understand full vs. modified CAS coverage.
- ▶ If you are awarded a CAS covered contract, make sure you understand the timing of when you are required to file a disclosure statement.

UTILIZATION

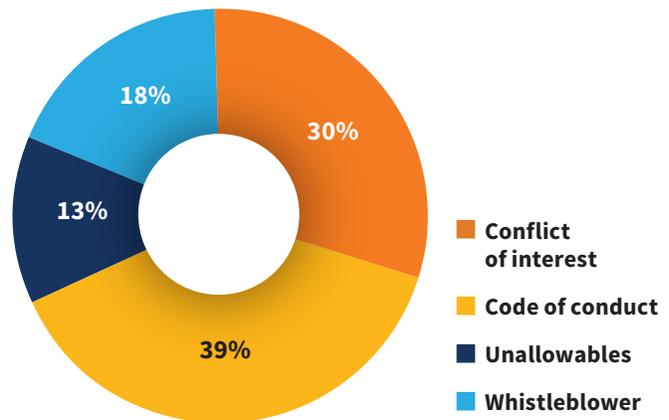
SUMMARY

- ▶ The hiring and government spending spree continues, 73% of the respondents say they will hire slight or significant additions to their workforce in the next 12 months
- ▶ Technical and STEM jobs are hard to fill as talent is in short supply; federal policies could worsen the talent crisis
- ▶ More than half, 57%, of companies report that >75% of their projects across the enterprise are on cost and 69% report that >75% are on schedule. This points out that the evolution of project management still needs attention

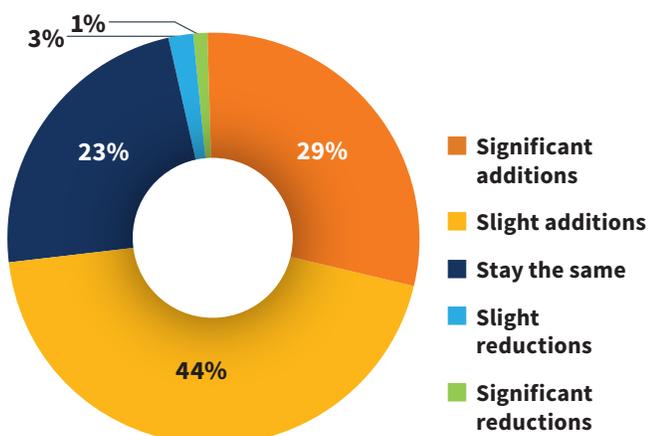
CONSIDERATIONS FOR THE COMING YEAR

- ▶ Review your staffing plans carefully and allow enough lead time to hire specialty resources; use our eight strategy tips for resource management
- ▶ Managing resources can improve your project performance and profitability. Almost half, 49%, of respondents believe their resource planning is mature but that is less than the reported percent last year
- ▶ Continue to focus on project execution, it creates opportunities for new wins
- ▶ Review the FTE headcount by functional group and compare it to your company
- ▶ Perform annual training for code of conduct, unallowables and conflict of interest to protect your employees and the company

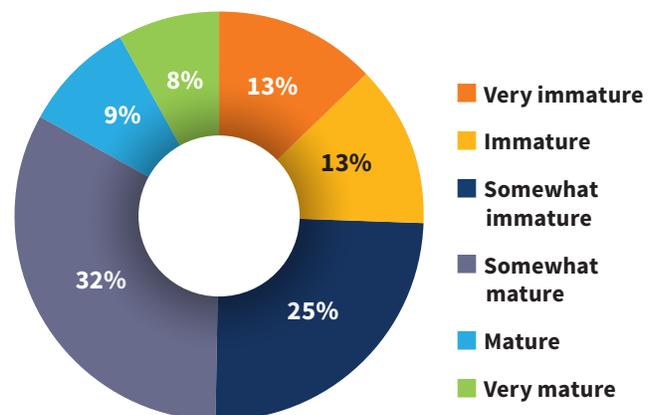
Annual Training Policies



Workforce Expectations in the Next 12 Months



How Mature is Your Resource Management Practice?



8 STRATEGY TIPS FOR RESOURCE MANAGEMENT

- 1** Make disciplined resource management a priority. Many companies could manage their resources better, and the goal is worthwhile, given that resources are generally the main generator of revenue in a services contractor.
- 2** Concentrate on finding key skills and resources that drive the execution of projects. Make sure a core group of skilled resources is in place and engaged. This group will likely be the most expensive. You will need to plan around their schedules and coordinate with other project managers to make sure the right skills are in the right place at the right time.
- 3** Allow resources to focus as much as possible. They may be spread thin across many tasks and distracted by emails, instant messages, and other notifications. Make every effort to minimize concurrent tasks for resources and avoid unnecessary meetings.
- 4** Establish and enforce policies and procedures for the organization. Make sure that all resource consumers understand the rules of engagement. A documented process and an established recurring business cadence will make it easier on all project stakeholders.
- 5** Plan all work: direct (projects) and indirect (leave, training, etc.). Resource planning should start in the proposal phase and continue throughout the project lifecycle. Document and communicate critical skills to all stakeholders as soon as possible, so that schedules can be adjusted and recruitment notified of the skill need. Planning for indirect work is equally as important. Having a system that lets all functions of the organization know who is taking leave is critical for accurate resource planning. You don't want to plan a critical activity when your best research analyst is on PTO.
- 6** Walk the tight rope of managing capacity and demand and establish a methodology for settling resource disputes. Keeping people off the bench while making sure you have the skills needed is an art. Scheduling tasks with start and stop dates will help identify and manage resource demand.
- 7** Manage resource assignments in the near-term; detailed planning by task and by person is critical (hard bookings). In the out years, summary planning with a TBD resource with a certain skill/qualification will inform the enterprise about future needs and timing (soft bookings). The concept of soft and hard bookings should be a part of your overall process and an automated tool can support that capability.
- 8** Utilize a resourcing tool that is integrated with your time sheet application. An integrated system allows time tracking to feed the resource plans and vice versa. Comparing actuals with budgets, plans, and variances gives project managers unparalleled insight into their projects.

FTEs PER FUNCTION

Accounting, HR, Recruiting, Contracts, and Business Development

Revenue Scale	Accounting	HR	Recruiting	Contracts	Business Development
Up to \$25M	2.0	1.3	1.3	1.9	2.1
\$26M-\$50M	4.6	2.6	2.1	2.3	4.0
\$51M-\$100M	5.1	3.1	3.3	2.6	5.0
\$100M and up	14.7	7.5	4.1	8.9	7.8

FTEs PER FUNCTION

Project Controls, IT, Compliance, Internal Audit, and In-House Legal

New in 2019

Revenue Scale	Project Controls	IT	Compliance	Internal Audit	In-House Legal
Up to \$25M	1.6	2.7	1.0	.8	0.7
\$26M-\$50M	2.8	3.1	1.3	1.0	1.2
\$51M-\$100M	2.0	2.8	1.3	1.0	1.0
\$100M and up	8.5	12.9	2.3	1.7	2.1

Have your business area owners review these FTEs for differences and similarities. Ask them to explain why their numbers might be inconsistent. Companies differ so use these figures as a guide. Inefficiencies may be driving up FTEs in certain areas.

INTERNAL CONTROL TIP

4 WAYS TO INCREASE COMPANY VALUE

Investors and acquirers are becoming increasingly more sophisticated, informed, and risk-averse. Due diligence procedures being performed while making a decision to invest or acquire your organization are deeper than ever before. Here are four opportunity areas your organization may use to increase its value.

1 Management Review Controls (MRCs)

Investors and acquirers are looking for more than signatures or initials as evidence that management reviews key company financial information related to a potential purchase. Investors and acquirers want to know what is involved in management's review, what it actually entails, and what value the review provides. Does management review supporting documentation related to a key reconciliation, look closely at variance analysis, review resolution efforts, perhaps perform a key calculation, and meet with various relevant process owners to gain an understanding of information being provided for review and approval.

2 System Interfaces

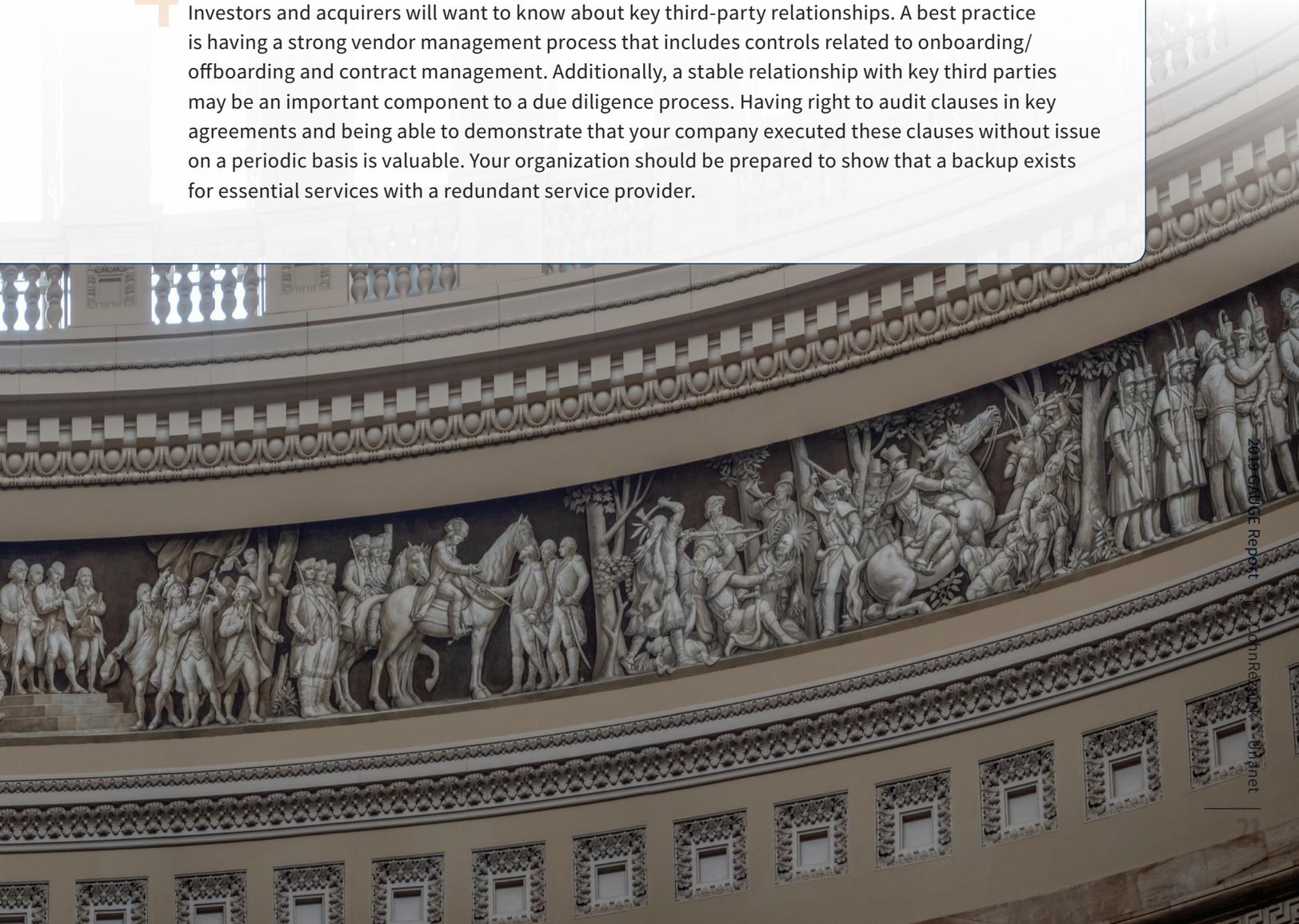
Today's organizations are driven by technology. It is important to understand how data is flowing between systems in your organization and demonstrate that effective controls are in place to ensure accurate data is flowing between systems. As a result of attrition or change in personnel, organizations are struggling with the loss of corporate knowledge related to prior system implementations and interfaces and the cost of a lack of institutional knowledge could be significant to an acquirer.

3 Controls Around System Implementations

Most investors would be concerned about recent significant system implementations. Your organization should be able to demonstrate that an implementation was subjected to a formal, monitored implementation process that was tested before the system went live. This establishes comfort that the system is operating as intended and information from the system is accurate.

4 Third-Party Relationships

Investors and acquirers will want to know about key third-party relationships. A best practice is having a strong vendor management process that includes controls related to onboarding/offboarding and contract management. Additionally, a stable relationship with key third parties may be an important component to a due diligence process. Having right to audit clauses in key agreements and being able to demonstrate that your company executed these clauses without issue on a periodic basis is valuable. Your organization should be prepared to show that a backup exists for essential services with a redundant service provider.



INVESTMENT IN EMPLOYEES, MANAGEMENT, & ADVISORS

- ▶ Invest in your employees through a Corporate Wellness program that is an allowable cost.
- ▶ Be thorough and accurate with your documentation regarding employee incentive compensation payments. This can be an area of auditor scrutiny.
- ▶ Consider hiring or outsourcing a Compliance Officer.
- ▶ Know how many back-office personnel are needed to run your business. Use the GAUGE Report!
- ▶ Understand billable vs. non-billable utilization.
- ▶ Know which method of growth is best for your business: organic, M&A, etc.
- ▶ Establish a corporate culture of ethical compliance from the top down.
- ▶ Make sure your advisory team understands government contracting rules. Ensure your CPA firm, bankers and lawyers are talking to one another.

- ▶ Spend significant time developing and implementing a formal business plan. Doing so will pay dividends later.

TRAINING

- ▶ Broaden your technical offerings, capabilities, and competitiveness by attending webinars, seminars, conferences, and other reading to keep up with the ever-changing government contracting landscape.
- ▶ Attend CohnReznick and Unanet Lunch & Learns regularly. Check out GovCon360.com for continued government contracting education.
- ▶ Develop an extensive pool of qualified staff and subject matter experts, even if they are consultants.
- ▶ Consider investing in a project management training program and treat project management as a discipline.
- ▶ Train all employees on timekeeping policies at least annually and regularly emphasize the consequences of non-compliance.
- ▶ Provide annual training on Code of Conduct and Conflict of Interest.



GROWTH

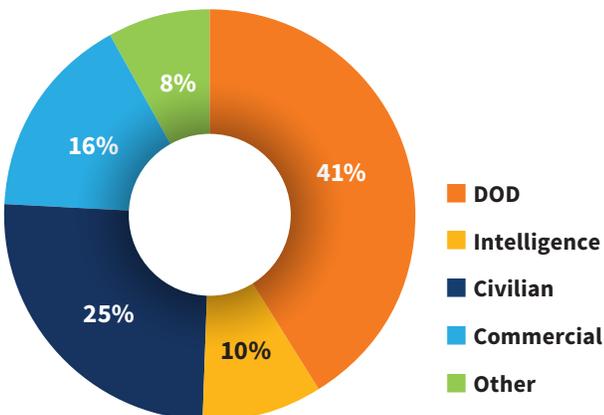
SUMMARY

- ▶ Organic growth is top of mind as this year it came in second among challenges for GovCons while uncertain federal spending garnered first place
- ▶ Increasing competition was the top contributor to sleepless nights
- ▶ Even with budget uncertainty GovCons are bullish on growth in 2020 with 72% of respondents expecting to increase revenue more than 10%
- ▶ Lack of business development funds and resources was the most pressing concern last year, but this year even more respondents, 60%, rank it No. 1
- ▶ Just under one-third, 31% reported win rates greater than 50% and 17% are predicting a growth rate of 25-50% in the upcoming year

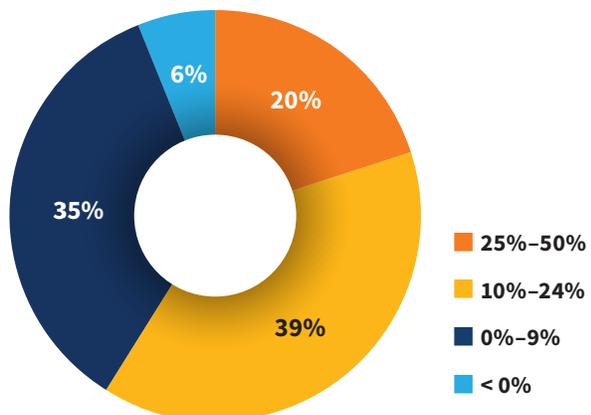
CONSIDERATIONS FOR THE COMING YEAR

- ▶ DOD competition is stringent; consider looking at opportunities from the civilian agencies and intelligence community
- ▶ Best Value is continuing to grow as LPTA awards have receded and contributed to a lack of innovation
- ▶ It remains to be seen whether PALT (Procurement Administrative Lead Time) will push Contracting Officers to award contracts more quickly
- ▶ Investing in project management discipline can help grow your business and be a differentiator. OASIS (full and open or small) scoring used EVMS and Purchasing as one of the scoring criteria for contractors
- ▶ Mature your project management process

What Agencies Are You Doing Business With?



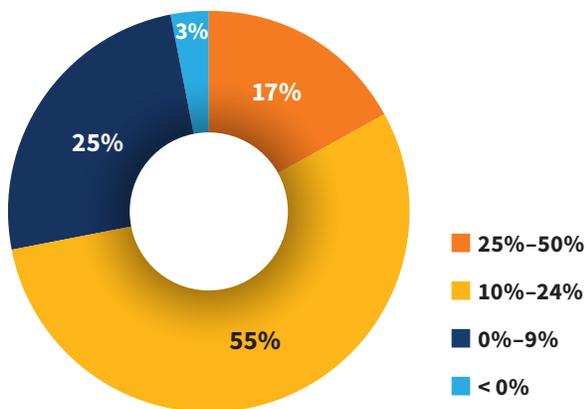
Current Growth Rate



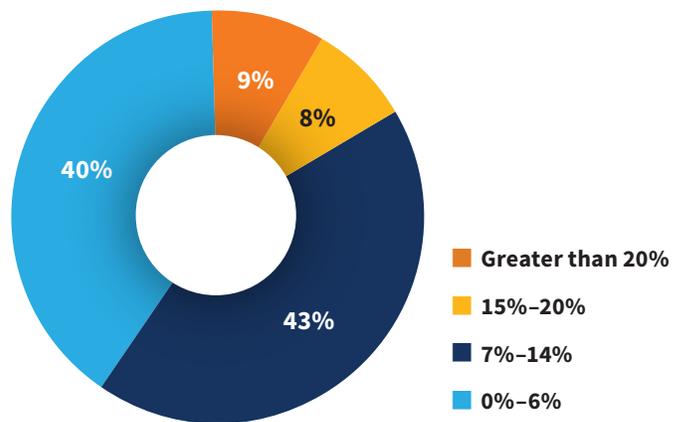
TQ, or “technology quotient,” is a person’s ability to adapt, manage and integrate technology based on the needs of the organization or the project. The term is not new, but it’s taking on new urgency as people and companies search for digital sustainability, the capacity to adapt to the constant whirl of change brought on by technology advances. Coupled with the changing nature of work from “job for life” to “portfolio of projects,” these factors are increasing demand for TQ combined with project management, or PMTQ.

—Pulse of the Profession 2019

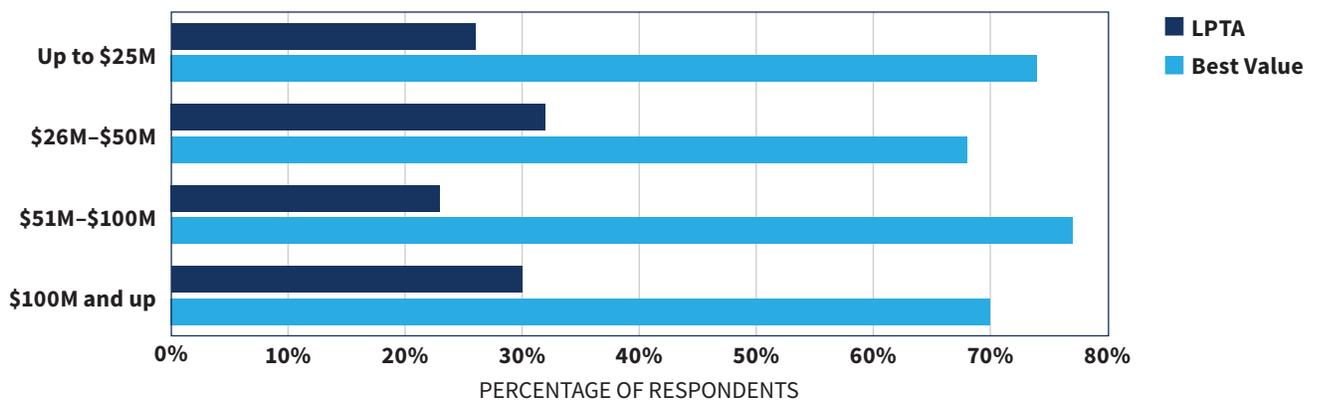
Projected Growth Rate



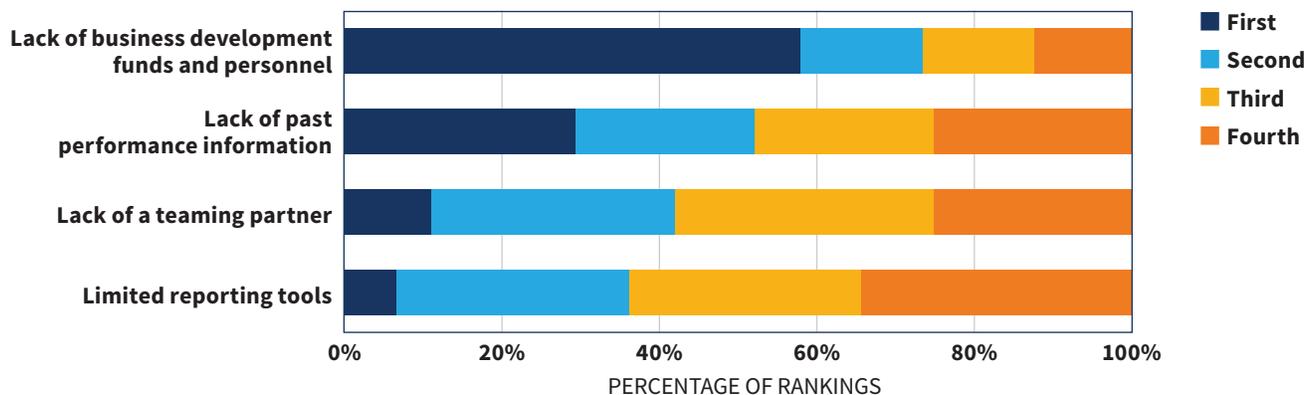
Profit Rates in 2019



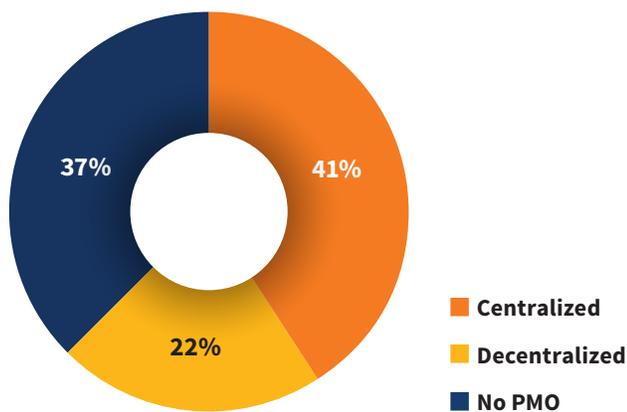
2019 Bids



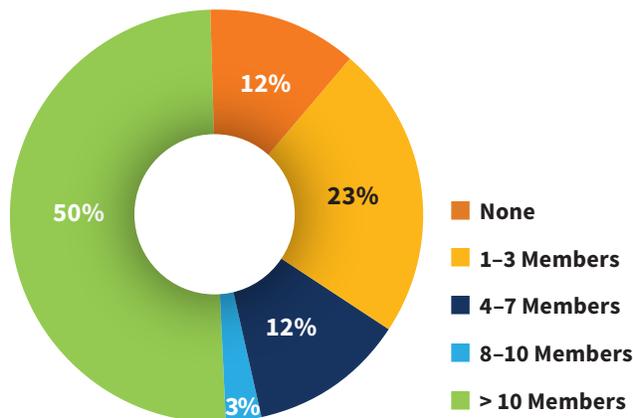
Business Development Challenges



Is Your PMO Centralized or Decentralized?



Board of Directors Size



Oversight and accountability from boards or other type committees

Although many smaller companies lack a formal audit committee, they can form a quasi-committee to serve as the company’s oversight function on risk and internal control. Committee members can be owners, members of senior management, independent third parties, or other stakeholders. They should meet regularly to assess the company’s internal control program, ensure accountability and make recommendations. Consider a board of directors or an advisory board to help guide your decisions at any level of company maturity.

INTERNAL CONTROL TIP

PROPOSALS & PIPELINE

- ▶ Research government agency needs. Ask yourself, “Have you ever met or talked with the customer?” “What problem or pain point is the customer looking to resolve?”
- ▶ Conduct market research for commercial items or services and document your findings with your estimates.
- ▶ When you market your company to government agencies, choose the agencies that are most likely to use what your company offers.
- ▶ Don’t be afraid to push back on RFP requirements during the draft RFP process. This is your chance to craft the RFP to your advantage.
- ▶ Attend pre-solicitation conferences.
- ▶ Have a documented capture process. Keep continuity in the teams from capture, proposal, and, at a minimum, into the initial planning phase of execution.
- ▶ Follow the RFP instructions. Write winning proposals by providing government agencies with all the information they request, highlighting your strengths.
- ▶ Write proposals from the agency’s perspective. Most contract proposals are won or lost based on how well you understand the agency.
- ▶ Talk to agency evaluators about what they like and dislike in the proposals they see.
- ▶ Carefully watch pipeline. Establish a pipeline review cadence and keep the opportunities up to date.
- ▶ Fully assess the Probability of Win (Pwin). If that probability is low, do not waste your valuable B&P dollars.

- ▶ Listen to your customer. Instead of talking about how great your company is, ask questions and actively listen to customer needs.
- ▶ Know which contracts you are bidding on and why. Ensure your sales team agrees on the type of contracts you will pursue.
- ▶ Review your win/loss ratio regularly.
- ▶ Recognize that in adequate price analysis, words are more important than numbers. Provide written detail on why the subcontractor’s price was found fair and reasonable, even when competed.
- ▶ Understand Other Transaction Authority (OTA) agreements and the opportunities associated with them. Gain advantage over the competition.
- ▶ Diversify your agency concentration, if possible.

BUDGETING

- ▶ Kick-off the budgeting cycle by providing a timeline, parameters, guidelines and overall goals. Include all stakeholders in this session.
- ▶ Use a tool that provides all stakeholders with the visibility and control they need over the budget and allows for “what-if” scenarios to include information by month, quarter, and year.
- ▶ Align budgets to the timing of the work. Begin by understanding the full scope of your projects.
- ▶ Hold monthly budget reviews throughout the year to review the budget and make course corrections and update at mid-year for any significant business changes.
- ▶ Perform the top highly paid compensation analysis annually and at budget time.

EFFICIENCIES

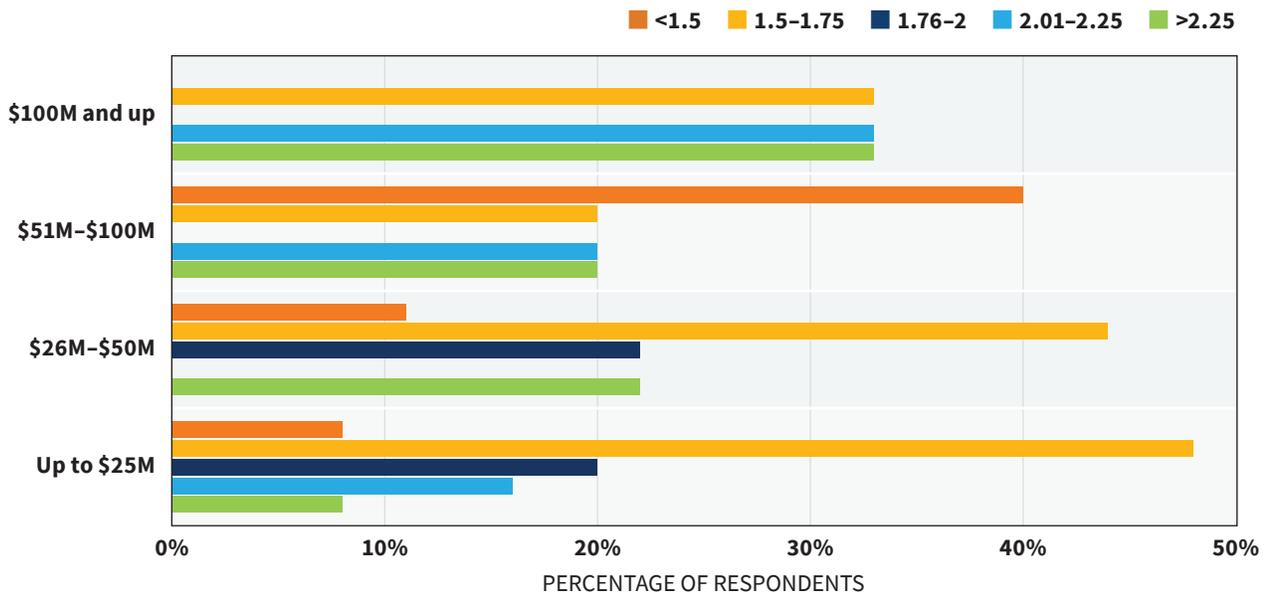
SUMMARY

- ▶ Forecasting is the biggest challenge for our respondents this year related to the project management discipline
- ▶ Budget and forecast preparation touches more departments and causes more stress than almost any other business process
- ▶ Resource management emerges again in this section, as well as the prior one. It is a discipline that has not yet come into its own. It is still performed ad-hoc and project by project
- ▶ Inexperienced project managers are still a critical issue, but dropped from being the leading issue

CONSIDERATIONS FOR THE COMING YEAR

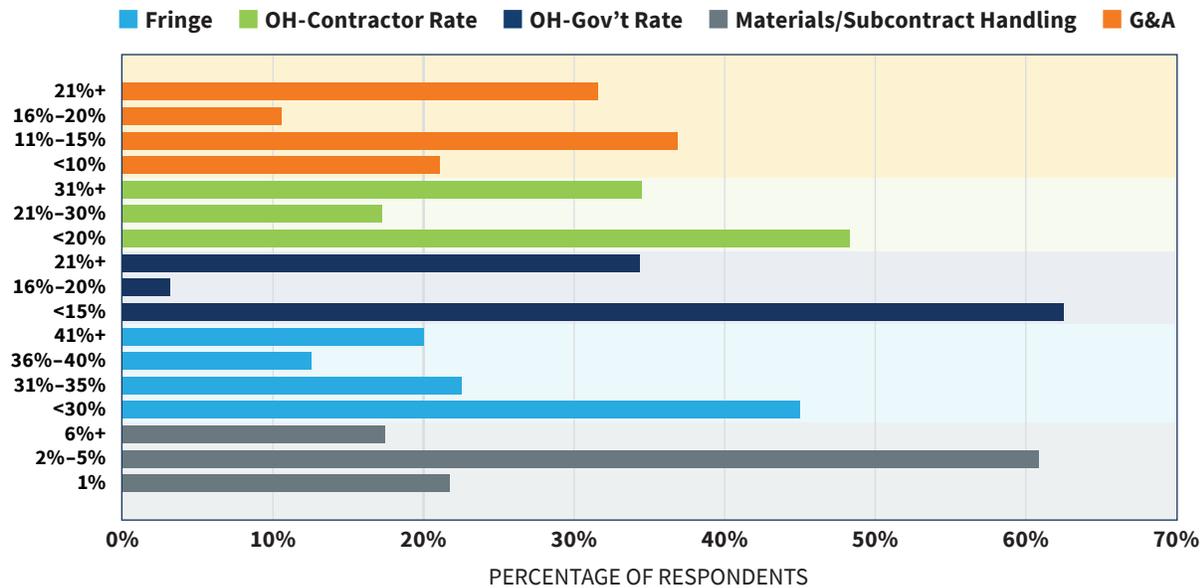
- ▶ Have a disciplined strategy for indirect rates and review your wrap rates monthly with your management team

Wrap Rates by Revenue Scale



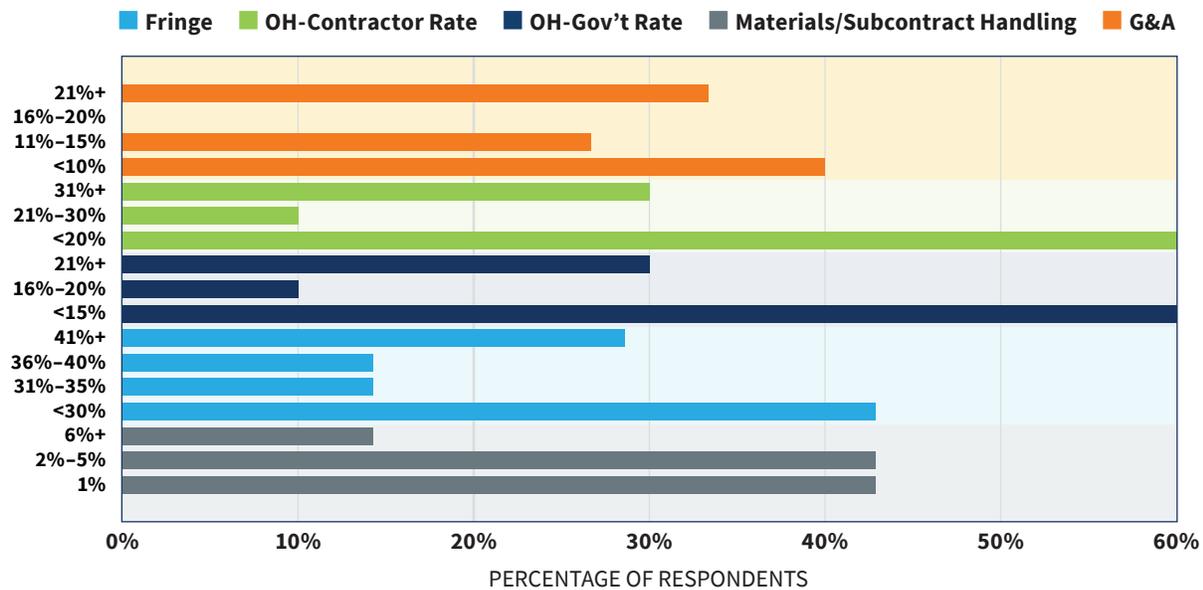
- ▶ The management of indirect rates can make a difference between winning or losing a bid, making a profit, and growing the business. It is critical to look both at actual rates being charged as well as bid rates to determine profit by resource. Use the above wrap rate chart to see how you stack up against others in your revenue scale.
- ▶ Invest in your project and resource management practices and tools. They can be strong differentiators for growing and thriving your GovCon business.

Fringe, OH, Materials/Subcontract Handling, and G&A Rates for Companies with Revenue up to \$25M



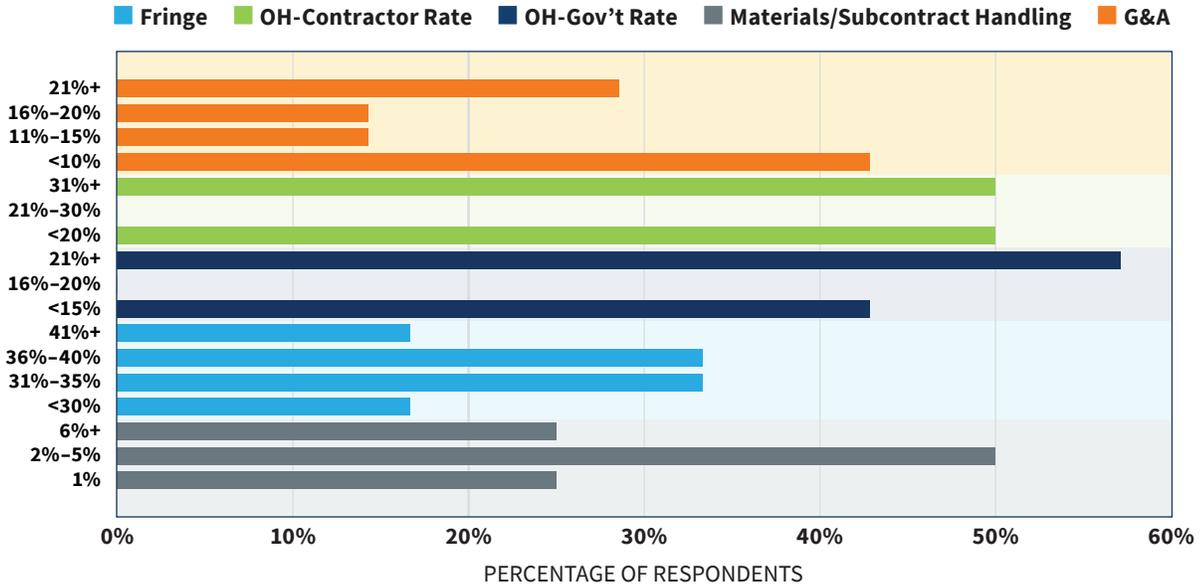
Note: average wrap rate without fee 1.85

Fringe, OH, Materials/Subcontract Handling, and G&A Rates for Companies with Revenue from \$26M-\$50M



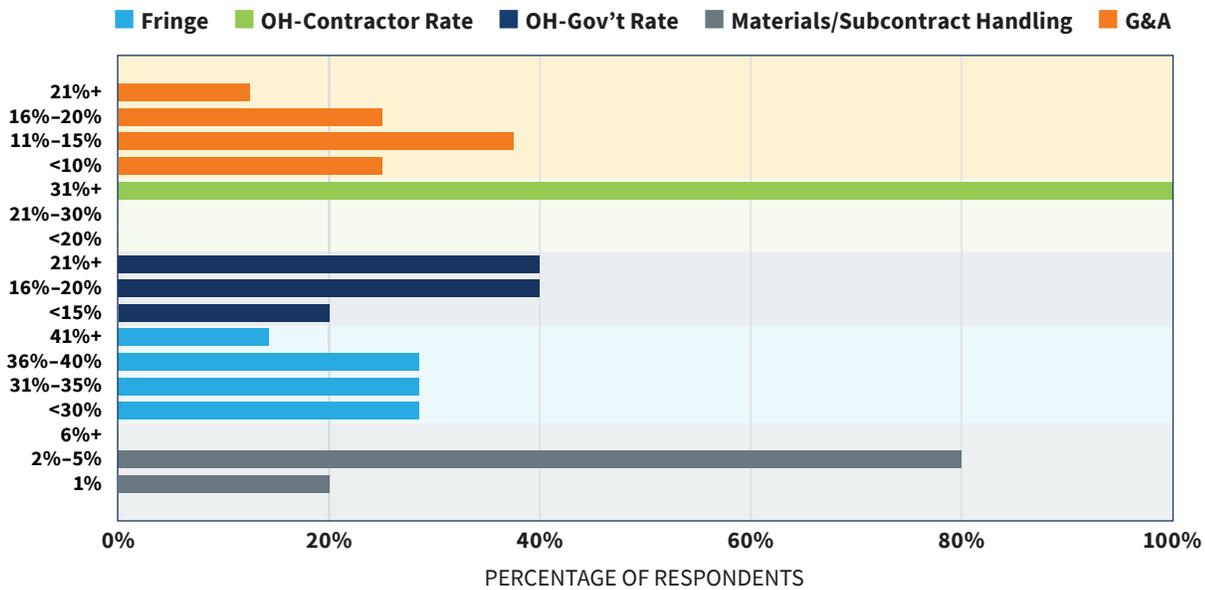
Note: average wrap rate without fee 1.93

Fringe, OH, Materials/Subcontract Handling, and G&A Rates for Companies with Revenue from \$51M-\$100M



Note: average wrap rate without fee 1.78

Fringe, OH, Materials/Subcontract Handling, and G&A Rates for Companies with Revenue of \$100M and up



Note: average wrap rate without fee 2.1

INDIRECT RATES & SUBMISSIONS

- ▶ Review contract profitability and indirect rates monthly.
- ▶ Know your wrap rate and compare it to others' rates.
- ▶ Understand all requirements of FAR 52.216-7 (Allowable Cost and Payment clause), and if your contract contains this clause which imposes requirements for the content and timing of your annual incurred cost submission.
- ▶ File your incurred cost submission six months after your company's year-end and perform an adequacy check before submitting.
- ▶ Know your rate variances and rate ceilings, whether they are OH, G&A, MSH, or GSA labor rates.
- ▶ Periodically review your indirect rate structure for competitiveness.
- ▶ Perform 941 payroll reconciliations quarterly to limit problems when you complete your annual ICE submission.
- ▶ Do not overcomplicate your rate structure as it can become difficult to monitor and manage.
- ▶ Utilize a G&A base that adequately represents the total activity of the business unit. This often results in the use of either a Total Cost Input (TCI) or Value Added (VA) allocation base.

FLOWDOWN CLAUSES

- ▶ Know which flowdowns are mandatory; don't waste time trying to negotiate them.
- ▶ Understand contract flowdown requirements to subcontractors to mitigate risk and achieve compliance with prime contract requirements.
- ▶ Consider pushing back on non-mandatory flowdowns.
- ▶ Beware of language incorporating all prime contract requirements.
- ▶ Monitor the addition of new clauses in modifications.
- ▶ Create a flowdown matrix that identifies flow-down requirements specific to each contract based on subcontract value and type.
- ▶ Determine which non-mandatory clauses are necessary to mitigate risk (terminations, changes, etc.)
- ▶ Read your contract.
- ▶ Ensure there are no penalties for conflicts of interest disclosure. This promotes full disclosure while allowing for mitigation.

INTERNAL CONTROL TIP

Can You Afford Not to Have Robust Internal Controls?

The cost of developing and implementing an internal control system is difficult to quantify. Sometimes the cost of implementation is easier to quantify when weighed against the risk of not having internal controls in place. So, what might be at stake?

- ▶ Reputational Risk
- ▶ Lack of Board Confidence
- ▶ Higher Audit Fees
- ▶ Audit & Board Risk
- ▶ Personal Liability
- ▶ Increased Audit Scrutiny



INDUSTRY INSIGHTS

PREPARING A GOVERNMENT TECHNOLOGY SOLUTIONS COMPANY FOR M&A BY KIPPSDESANTO & CO.

Since 2017, on average ~90 M&A transactions have occurred each year within the government technology solutions market. More favorable federal budgetary and capital market dynamics, combined with tax reform and continued low interest rates, have driven market activity up along with valuations. This has caused the marketplace to become increasingly crowded as more sellers are looking to take advantage of their own financial momentum and the broader market environment.

An M&A event is arguably the most important business transaction that government technology solutions business owners will experience during a company's life cycle. Given the importance of such transactions, it is critical that business owners properly prepare BEFORE embarking on the M&A journey. Strategic planning and preparation can increase value and certainty of closing, reduce potential diligence challenges, and limit management distractions during an M&A process. Key areas of preparation include investing in growth, developing a strong management team, practicing financial discipline, and maintaining up-to-date internal records.

INVEST IN GROWTH

Growth is one of the most important themes in the context of M&A. Buyers traditionally acquire companies that they believe provide growth opportunities post-closing. Whether it is a strategic buyer, that may desire a selling company's specific customer set, contract portfolio, or core capabilities, or a private equity (PE) buyer that believes that the selling company provides opportunities to be a successful platform investment, buyers want acquisitions that provide access to growth. And buyers pay more for businesses that they believe provide greater growth opportunities. As such, business owners that are contemplating a near to medium-term

sale should consider investments that they can make to drive growth in the years leading up to a transaction as well as in the years following a transaction.

There are several different strategies that successful government technology solutions companies employ to drive growth. These include, but are not limited to, the following:

- ▶ **Capabilities/Customer Sets:** Building domain knowledge and past performance across in-demand areas, such as NextGen IT (cyber, mobility, cloud, biometrics, artificial intelligence, DevOps, data analytics, etc.) and advanced engineering, drives value as it aligns business characteristics to what most buyers want. That said, whether in those areas or others, differentiated technologies and offerings drive buyer interest as they promote customer "stickiness" and barriers to entry. Additionally, buyers remain focused on well-funded and highly sought-after agencies, such as those within the Department of Defense and the Intelligence Community.
- ▶ **Bid and capture:** Effective bid, capture, and proposal practices and resources promote active and hopefully successful bidding efforts. In addition, effective pricing is critical in today's marketplace given increased competition.
- ▶ **Pursuing In-Demand Vehicles:** Today, more than ever, government agencies rely on multi-billion-dollar contracts for key procurements. Holding Full & Open positions on sought-after and well-funded GWAC and IDIQ vehicles provides companies with limited-competition "hunting licenses" on which to pursue new business opportunities. Additionally, these vehicles often increase the inherent enterprise value of the prime contract holder, as strategic buyers often "buy" their way on to such vehicles. Examples of in-demand vehicles include Alliant 2, ITES-3S, OASIS, E-SITE, RS3, and Encore III.

DEVELOP A STRONG MANAGEMENT TEAM

While it may seem like an obvious suggestion to encourage government technology solutions businesses to invest in senior management, we often encounter business owners who are reluctant to spend money on developing senior talent and/or are reticent to make changes at the senior level because of loyalty to legacy members. Strong management teams shape strategic direction, develop successful cultures where key talent can be retained, ensure customer satisfaction, and ultimately drive growth and profitability.

A credible and growth-oriented management team is particularly important when thinking about a potential PE buyer, as PE buyers typically aim to invest alongside a strong management team. Over the past several years, PE has become increasingly active in the government services landscape. Since the beginning of 2017, PE firms making new portfolio investments represented ~25% of all transactions in the government technology solutions space, while add-on acquisitions to existing portfolio companies represented another ~15%. This marks a considerable increase from 2016, in which PE firms were the buyer just 23%, as compared to the combined 40% in recent years. PE firms look to partner with management

A credible and growth-oriented management team is particularly important when thinking about a potential PE buyer, as PE buyers typically aim to invest alongside a strong management team.

teams that they believe will drive continued growth and company success. This often includes a “buy and build” approach to augment organic growth efforts by making several follow-on acquisitions to add scale, capabilities, customer sets, and vehicles. In order to successfully execute on a “buy and build” strategy, PE

owners require capable management teams that can navigate supercharged growth and cultural integration associated with M&A.

Regardless of whether the buyer is PE or strategic, when you sell a business, one of the most important opportunities to drive interest in the company and therefore to maximize value, is during management presentations. By putting your best foot forward at this stage, sellers can get buyers excited about the growth opportunities of their business and positively impact valuation. In addition, if the selling shareholder(s) is looking to transition out of day-to-day operations, then having a second layer of management prior to embarking on an M&A process provides succession planning and gives buyer comfort that the business will continue to be successful without oversight from the departing shareholder(s).

PRACTICE FINANCIAL DISCIPLINE

Annual financial statement audits add significant credibility to a business’s reported financial position and performance, as audits are performed by independent and accredited auditing firms and indicate financial statements have been produced in accordance with generally accepted accounting principles (GAAP). In the context of an M&A event, annual audits help to reduce risks associated with historical financial performance, such as improperly recognizing revenue and expenses. Reduced financial risk benefits both types of buyers, as they have greater confidence in the ongoing profits of the business, and sellers, who have less indemnification exposure related to preclosing financials.

In recent years, and in response to increasingly intense buyer diligence protocols and rising valuation multiples, we have seen an increase in buyers conducting third-party quality of earnings (QofE) assessments on businesses that they acquire. This trend has partly been driven by an increase in leverage used to fuel M&A activities as lenders typically require a QofE before they will fund an acquisition. This has become particularly standard practice for PE buyers, given their reliance on third-party leverage. However, it

We encourage sellers to create a bottom-up forecast that begins with specific revenue and gross margin assumptions for existing contracts, expected recompetes, and probability-weighted new business opportunities (i.e., a contract waterfall), with indirect assumptions layered on top, to provide granular support for expected performance.

is also quite common for strategic buyers to hire third parties to complete financial diligence.

Another trend that has gained significant momentum in response to buyer QofE reports is sellers preempting buyer diligence and obtaining a sell-side QofE report at their expense. A key benefit of having completed a QofE prior to starting a sale process is that it significantly reduces the likelihood of a buyer finding anomalies with accounting practices and adjusting normalized earnings during confirmatory diligence. This reduces the likelihood of a buyer reducing the purchase price. Additionally, by obtaining a sell-side QofE report, sellers can reduce the time needed to close a transaction as certain buyers may decide not to perform their own QofE. Or if they still conduct a QofE, associated diligence will likely be shorter since they can leverage the work that was already done as part of the sell-side QofE.

In addition to historical financial diligence, buyers are heavily focused on an acquisition target's ongoing profitability and sustainability of cash flow. As a result, it is critical for selling businesses to develop credible and defensible forecast models that project revenue, gross margins, and EBITDA for several years in to the future. We encourage sellers to create a bottom-up forecast that begins with specific revenue and gross margin assumptions for existing contracts, expected

recompetes, and probability-weighted new business opportunities (i.e., a contract waterfall), with indirect assumptions layered on top, to provide granular support for expected performance. A comprehensive contract waterfall analysis also helps owners to determine optimal timing for a sales transaction as it highlights upcoming recompetes and timing of material new business pursuits. Buyers are more comfortable acquiring businesses that have limited near-term material recompetes as it reduces near-term cash flow risks. As a result, timing a potential sales transaction around key contract milestones can be critical and impact valuation.

MAINTAIN UP-TO-DATE INTERNAL RECORDS

During a corporate sale process, businesses are required to compile copies of all key documents related to operations for review by the buyer as part of their diligence process. When a deal finally closes, these online repositories can reach 20,000 pages or more. Gathering files for the dataroom can be extremely burdensome if companies do not maintain internal documents in a well-organized fashion. For example, if a business keeps their contract files organized and up-to-date, the process can be as simple as dragging and dropping folders to the dataroom. But if executed copies of each active contract and modification need to be located (and potentially scanned), the process can take days. By maintaining organized records, business owners can save management significant time in developing the data room and getting ahead of the diligence process.

When a deal finally closes, these online repositories can reach 20,000 pages or more. Gathering files for the dataroom can be extremely burdensome if companies do not maintain internal documents in a well-organized fashion.

By maintaining organized records, business owners can save management significant time in developing the data room and getting ahead of the diligence process.

KEY BUYER DILIGENCE AREAS:

- ▶ **Corporate:** Articles of incorporation, bylaws, board of director (BoD) meeting minutes, capitalization tables, legal organization charts, and various other shareholder agreements and documents.
- ▶ **Employees:** Complete census with titles, status, start dates, clearance and education levels, annual salaries and bonuses, and location, as well as handbooks, turnover stats, offer letters, benefits and bonus documents, Forms 5500, VETs, and 401(k) audits.
- ▶ **Financial information:** Annual audits for three years, historical internal monthly financials and contract Job Summary Reports, three- to five-year detailed forecasts built up by program and contract, aged accounts receivables and payables schedules, CapEx and fixed asset schedules, etc.
- ▶ **Pipeline:** Detailed schedule of all identified new business opportunities to include information regarding program, customer, period of performance, expected size and start date, prime versus sub, probability of win and other relevant information.
- ▶ **Contract documentation:** Fully executed, both prime and subcontractor, base contracts and task orders as well as all modifications, incurred cost submissions and provisional rate schedules, third-party consultant agreements, and other active contract documents.
- ▶ **Infrastructure support:** IT related items, lease agreements, export licenses, system certifications, set-aside documentation if applicable, corporate security and DD-52s, insurance items, etc.
- ▶ **Intellectual property:** Trademarks, patents, confidentiality agreements, etc.
- ▶ **Taxes:** All federal, state, local, and sales tax filings and associated documentation.
- ▶ **Legal:** Historical legal documents as well as information regarding any ongoing or pending lawsuits or government audits, previous acquisition files, etc.

It is as important as ever for government technology solutions business owners to spend the time and resources in advance of pursuing an M&A transaction to ensure that their companies are properly positioned to maximize value and reduce the burdens associated with diligence. By investing in internal operations and growth strategies, as well as partnering with established and credible advisors, business owners can make smart decisions that can pay dividends in a sale process by making their companies stand out in a crowded marketplace and garnering maximum value.

About KippsDeSanto & Co. *KippsDeSanto & Co. is an investment banking firm exclusively focused on serving leading, growth-oriented Aerospace / Defense, Government Services and Technology companies. We are focused on delivering exceptional M&A and Financing transaction results to our clients via leveraging our scale, creativity and industry experience. We help market leaders realize their full strategic value. Having advised on over 100 industry transactions, KippsDeSanto is recognized for our analytical rigor, market insight and broad industry relationships. There's no substitute for experience. For more information, visit www.kippsdesanto.com.*

A very special thank you to our respondents and contributors for participating in our third annual survey and for providing valuable insights and suggestions for the GAUGE Report. We continue to listen to our readership, incorporate feedback and stay up-to-date with current events for the report. We hope that you find the report useful to benchmark your company and gain insights into future strategies.

If you have any questions or feedback regarding the 2019 GAUGE Report, and how to participate in the 2020 survey, please contact:

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About CohnReznick

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