

The New World Order

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As the dust settles from the collapse of the iron curtain and the euphoria subsides from America's cold war victory, a new battle looms large on the horizon. Without a global adversary, America's priorities will likely shift to domestic issues, leaving the strength of the defense industrial complex to atrophy and perhaps even ultimately to collapse. Since the void left by the once potent Soviet Union will surely be filled by other menaces, the nation's current challenge is how to preserve the defense industrial base until it is again needed to protect American interests abroad.

The Current Battle Plan

Ideas for preserving the defense industrial base are numerous, but many of the popular ideas share a recurrent theme. Essentially, these ideas envision a five-pronged attack.

- First, large-scale production will be diminished. Research and development (R&D) efforts will consume the bulk of defense procurement dollars. In most cases only working prototypes of weapons systems will be built
- Second, as a result of the shift from production to R&D a corresponding shift in funding techniques will also occur. Consequently, flexible cost type contracts will replace inflexible fixed-price contracts.
- Third, increased foreign exports of military hardware will be encouraged to compensate for diminished demand in the domestic arms market.
- Fourth, increased standardization between commercial and military components will reduce the economic barriers between commercial and military manufacturing. Furthermore, if commercial products are used more in military applications, many of the financial hardships caused by complex regulations governing pricing, costing, and billing can be avoided.
- Finally, defense companies will be encouraged to adopt flexible, commercial production techniques that will permit a quick switch to military manufacturing should the need arise.

If it Works

Although the final battle plan has yet to be determined, the above elements will undoubtedly affect contractors significantly. In the first place, many manufacturers will have to redirect their business strategies from manufacturing to engineering. This change in strategy will inevitably require a change in the way industry views technical data rights. In the past, engineering effort was frequently given away so that prime contractors and their subcontractors could retain the technical data rights and thus secure their future production market niches. Under the proposed plans, the role of engineering as an investment will diminish and those companies that use engineering as an investment rather than a commodity must change or be forced from the industry. Thus, if these new plans are implemented, business managers will have to formulate strategies that transform engineering into a breadwinner rather than a loss leader.

In the second place, the change in funding techniques to effect more cost type contracting will provide two obstacles for many companies. One problem will be the need for sophisticated cost accounting systems. Many companies, including many Fortune 500 companies, have inadequate accounting systems for cost type contracting. Yet, the level of system sophistication necessary for cost type contracting will become a necessity for many businesses wishing to remain in defense contracting.

Even if the system deficiencies are corrected, another significant problem is that cost type contracting increases a company's risk associated with performing government contracts. The spirit of government contracting is becoming increasingly adversarial and many of the government's financially oriented retaliatory forces are tied to cost type billings. With fixed-price contracts, even with progress payments, the government's financial leverage could be minimized through careful contract formation. With cost type contracts, however, many of the techniques for minimizing a company's exposure are rendered useless. As a result, cost type contracting makes contractors more vulnerable and more susceptible to the whims of the government's oversight officials.

Neither of the aforementioned risks is new to defense contracting. In recent years many companies have chosen to minimize these risks by refusing to contract directly with the government. Obviously this trend can be expected to continue if not to accelerate.

Another way contractors will be affected is that, implicit with standardization, flexible manufacturing, and increased foreign arms sales, defense manufacturers may no longer be stand-alone entities. Rather, they may be forced to cohabit with the other ventures of contractors including commercial and foreign sales. Indeed, for many companies domestic military sales may become only a byproduct of the company's other ventures.

Cohabitation provides at least three challenges for contractors. For one, it exposes a contractor's other ventures to investigation and scrutiny by government oversight agencies. Another problem involves the allocation of cost to keep commercial products cost competitive, contractors have frequently segregated commercial and military operations. But clearly this is a cost allocation problem that should be remedied through better cost accounting procedures. Thus, segregated facilities are creatures of convenience and not of necessity.

Yet another allocation problem brought by cohabitation is the issue of allocability and cost allowability. All too often organizations such as the Defense Contract Audit Agency (DCAA) question costs as being unallowable, particularly indirect costs, when the costs were associated with a contractor's commercial operations or other ventures. The organizations question these costs on the basis that they are not allocable to a government contract and thus are not allowable costs of a government contract.

The test of allocability, however, is a three pronged test. Costs must (1) be incurred specifically for the contract, (2) benefit the contract and other work, or (3) be necessary for the overall operation of the business. Virtually any cost that is not expressly made unallowable can be justified under one of these three tests.

In the past, government contracts certainly would have received the benefit of an increase in the allocation base brought by the contractor's commercial operations and other ventures. In the future, however, the contractor's commercial and other ventures will certainly be necessary for the overall operation of the business. After all, without these efforts the contractor might not even exist. Thus, allocability need not be a deterrent for cohabitation of a contractor's defense, commercial, and other ventures.

A final dilemma for cohabitation is whether commercial manufacturing is compatible with defense manufacturing. Certainly there are not too many commercial electronic systems that can withstand multiple G forces or other hostile environments such as operating temperatures ranging from subzero to more than 150 degrees. So there are certain engineering requirements that are not similar for commercial and military applications. Yet, from an operational standpoint, there is no reason that the two environments cannot cohabit

As an example, the accounting rules for defense contracting are frequently characterized as arcane. In reality, however, the commercial world is only now catching up with defense contract costing. The actual cost, job order costing, and manufacturing systems often used by defense contractors are much more commonplace in the commercial environment now than they were 10 years ago. Similarly, the concepts of activity-based costing, while new for commercial contractors, are nothing new for defense contractors.

Certainly organizations such as the DCAA have imposed their own strict interpretations of the regulations, which in many cases have disabled the usefulness of contractor cost accounting data and systems. In recent years, however, organizations like the DCAA have opened the door by embracing Advanced Cost Management Systems (ACMS) for contractors to return to costing philosophies that reflect the intent of the regulations and are compatible with many modern commercial costing practices.

Can it work?

The effect on contractors of these current plans to maintain the defense industrial base is not dependent on whether they will actually work. Unfortunately, though, there are many aspects of the current plans that are just not workable.

Preserving the industrial base through R&D is simply not the inexpensive, cost-effective solution it is believed to be. In 1987 the defense procurement budget was \$90 billion, with another approximately \$35 billion going toward R&D. For 1993 the total defense procurement budget may be as low as \$50 billion, with R&D representing about \$36 billion. In times past, however, many businesses were giving away their R&D efforts in order to capture the more lucrative production work. Thus, in a future having a drastically reduced production budget, companies will have to recover all their R&D expenses through the R&D budget, which will have to grow considerably if the government expects to compensate its contractors.

In addition, the idea that foreign military sales will buttress the defense industrial base is illusory. With the fall of the iron curtain there was a corresponding fall in defense budgets for many of the industrialized nations. In many respects the foreign military market is as soft as the U.S. market. At the same time many of these other countries are struggling to buttress their own manufacturing capabilities by not importing arms from outside sources and by looking aggressively to the same international markets as the United States in order to save their own industries. How will foreign military sales support the U.S. industrial base unless the technology being produced is being sold? If the United States is not selling what it is producing, then it is actually maintaining two industrial bases. In essence, the idea that foreign sales can support the U.S. defense manufacturing capability is more smoke and mirrors from political leaders accustomed to thinking that someone else can foot the bill.

Standardization is a move in the right direction, but much more is needed. More specifically simplification, deregulation, and an end to the adversarial nature of defense contracting is mandatory. Historically military applications often expanded the technological state of the art, but in recent times, military technologies have started to trail their commercial counterparts. The regulatory complexity, intrusive oversight, and the adversarial nature of defense contracting has forced many companies to stop doing business with the Pentagon. Thus, what is essential to preserving the U.S. defense industrial base is a healthy partnership between government and industry and not some kind of dysfunctional codependency. The partnership is also necessary if foreign sales are ever to contribute toward maintaining the industrial base. The Carter administration's "leprosy" letter is still firmly implanted in the minds of U.S. Foreign Service Officers.

Summary

Clearly the future holds many significant changes for contractors. Although the proposed battle plan seeks to preserve a U.S. technological advantage, even this objective may not be realized. Businesses are an investment just like real estate, stocks, or certificates of deposit. Investments are attractive only if their returns are attractive relative to other investment opportunities. Without the chance of lucrative production contracts, the Pentagon and its pitiful profit policies may not be able to keep the necessary engineering talent from being lured away by commercial market manufacturers.

Even if there is no brain drain and this country retains its technological superiority, the current battle plan cannot ensure that the production capacity necessary to field that advantage will be readily

available when needed. The excess production capacity created by “downsizing” simply cannot be absorbed nor maintained with prototype development efforts. So, although the decade of the eighties was a period of merger mania for commercial companies, the nineties will be a period of merger mania for defense firms.

Thus, a new world order is at hand. Consolidation is inevitable. Despite that the Pentagon may see only a cloudy sky, over the next few years a thousand points of light will be permanently extinguished until the next big bang.