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Operational Audits

An organized approach to reducing risk and discovering hidden profit potential

Most government contractors focus on having a financial accounting system that accurately accumulates cost by final cost objective (contracts). This focus is not misplaced because a system that fails to properly account for costs is a major weakness both in the eyes of company management and in the eyes of the government.

However, effective and cost efficient contracting requires more than just the mere recordation of cost in an accurate manner. A carefully constructed operational review will focus on the reasons why costs are incurred and ways to maximize completion of the product with the least amount of cost. This review will also allow the company to discover potential operational issues that will impact on its ability to deliver a product on time or at a specific quality level. This careful structured review includes a could be or should be cost analysis with risk management considerations.

Don't be intimidated or turned off by the need for yet another type of audit albeit an operational type audit. An operational audit is in reality a management analysis of the business operation. The focus is on the integration of the supply chain and production process with the cost accumulation process. The rewards for this type of study are cost avoidance and risk mitigation. Identifying and implementing processes that achieve cost avoidance will provide the opportunity for mining hidden profits. Further, a cost efficient process will go a long way to dispel the myth of bloated contractors feeding at the government contracting buffet table at the expense of the taxpayer. Sharing with your customer the fact that you are embarking on a path to streamline your operation will immediately make you a more attractive government contractor.

The ways and means to achieving operational success starts with an audit/ risk management plan. Zero risk projects do not exist and indeed are not desirable. Profits are determined to a large extent by the degree of risk and organization is prepared to confront. The key here is to **MANAGE**. The goal of these operational audits is to leverage Audit relationships with internal and external stakeholders (e.g. Corporate Departments, Governance Owners, Suppliers etc.) to ensure risks and issues are communicated and mitigated to the best extent possible. These audits incorporate best practices both financial and operational.



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The first step is to analyze the major cost drives needed for your company to deliver your product. A labor intensive process may need an added focus on productivity benchmarking while a material intensive process may need a careful analysis of supply chain risks. Of course all contractors struggle to control indirect expenses. It is easy to expend vast amounts of resources to accomplish indirect functions because that is the way we have always done it. However a systemized analysis will identify the value added from the incurrence of all major indirect expenses. Success is achieved with a lean and mean system that still accomplishes its major objectives. Control of indirect expenses is a particularly challenging area because government contracting always requires more reporting requirements than general commercial business.

Let's take a brief look at each cost (material, labor and overhead).

Direct Labor. The focus here is on achieving maximum labor productivity without sacrificing quality. You already know the amount of direct labor expensed to complete your product. You should have sufficient information to identify the amount of profit derived from direct labor. It is computed by comparing the labor portion of your negotiated price to the direct labor incurred to complete the product. Has the unit cost to complete your product steadily increased over the years (negative learning). Does your labor recordation system identify risk areas including rework, out of scope effort required by the customer and downtime? Can you take actions to increase labor productivity without "risking" the quality of the product? Will a performance award system motivate employees to be more productive?

Material and subcontracting. This area is particularly challenging because controlling or minimizing cost is influenced by the efficiency of your vendors and subcontractors. Once again you can start by computing the amount of profit derived from material and subcontracting efforts. Has the cost of material and subcontracts increased steadily over the years? What is the risk associated with identifying new vendors? Does your company routinely perform make or buy analysis. Is information available regarding vendor risk to include failure to deliver product on time, constant price increases and delivery of a defective product? Does your company document cost or price negotiation with your vendors?

Indirect expenses. This is an area that can result in substantial cost avoidance resulting in additional profits. Management analysis in this area is essential to



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controlling/avoiding cost. This analysis starts with a review of the indirect expenses incurred over several years. Correlation analysis is available to help this process. It will identify the expenses items (indirect labor, utilities, marketing etc) and their mathematical relationship to your allocation base. Poor correlation suggests that the expense is out of pattern with changes in your business volume. Direct/ indirect ratios also help to determine if you are maintaining the proper level of indirect labor. Cost such as marketing, product development and bid and proposal expenses should receive additional scrutiny. Has the investment in marketing resulted in new business? Is product development a dumping ground for idle direct or indirect labor? Is your company selective in the when bidding on projects? Are bids submitted for products that are outside the company's field of expertise?

The concepts and analysis shown here must be customized to fit the individual circumstances at your company. You can consider this article yet another in the ever increasing stream of management ideas (management by objective, crisis management etc.) that come and go. However the risk is that failing to perform any type of operational analysis will result in your company falling behind by simply keeping the status quo because 'that's the way we do things around here'.

About the authors of this article

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