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TEACHING NOTE

RELATIONSHIP BETWEEN CONTRACT MANAGEMENT AND FINANCIAL MANAGEMENT

(With Emphasis on Contract Types, Budgetary Implications and Budget Execution)

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INTRODUCTION

For financial management professionals in the Defense Acquisition community, it is essential to have a working knowledge of the relationship between contract management (CM) and financial management (FM). It is a direct relationship important to members of both career disciplines. At both the federal government and DoD levels, one set of laws, regulations and policies govern FM while another set of related documents govern CM; however, both sets tie the two disciplines together in such ways that for the Defense Acquisition community, they can not be separated. FM determines how budgets for acquisition programs are developed, justified, executed and managed; CM determines the most appropriate type of contract to be used for the specific work effort to be contracted out and how that legal document obligating the government should be structured. Viewed from a different perspective, FM justifies and "obtains" the necessary appropriated funds for acquisition programs while CM negotiates and legally "obligates" those appropriated funds on the contracts. FM actions are typically performed solely internally to the federal government while CM actions are performed not only internally to the federal government but also between governmental elements and private industry.

Selecting the contract type is generally a matter for negotiation and requires the exercise of sound business judgment. Determining the contract type and negotiating the price the government will pay for the contracted effort are closely related and should be considered together. There is a wide selection of contract types available for the government to have the needed flexibility in acquiring the large variety and volume of supplies and services required by the various federal agencies. Contract types vary according to (a) the degree and timing of responsibility (i.e., risk) assumed by the contractor for the cost of performing the contracted work effort and (b) the amount and nature of the profit incentive offered the contractor to achieve or exceed specified standards or goals set by the government. The type of contract selected for a particular work effort, including any incentive provisions, determines how the cost risk associated with contract performance is shared between the parties. Therefore, it is essential the appropriate contract type be selected consistent with the degree of risk of successful performance of the required work effort. Also, one must be aware of funding implications associated with the various types of contracts in order to make smart and proper budget decisions relative to the different contract types.

In addition to understanding the relationship between the contract management and financial management disciplines, it is important that financial management professionals in the Defense Acquisition community be aware of recent increased emphasis on both awarding contracts for acquisition programs and providing oversight of those contracts once awarded. The emphasis on awarding contracts concerns achieving greater competition before contract award, while the emphasis on oversight deals with actions with contractors after contract award. Closely associated with these two aspects of contracting is recognition of the need for more accurate cost estimating for acquisition programs. As a result of negative findings from a GAO study of 95 major defense acquisition programs conducted in 2008 and follow-on supporting comments by both the President and the Secretary of Defense, Congress passed the "Weapon Systems Acquisition Reform Act (WSARA) of 2009" (Public Law 111-23), which President Obama signed into law 22 May 2009.

Where applicable, this teaching note has incorporated provisions of the WSARA. As of the date this teaching note was sent to the printer, USD (AT&L) had not yet formally revised DoDI 5000.02 to reflect the requirements of that public law; however, that office had issued a Directive-Type Memorandum (DTM – 09-027) to institutionalize selected requirements of that law. The edition of this teaching note published after the required change to DoDI 5000.02 will reflect implementing guidance set forth in revised DoD directives.

The WSARA established a number of requirements directly impacting operation of the Defense Acquisition System and duties of key officials that support it. Provisions in that law pertinent to contract management (and, therefore, indirectly to financial management) include the following:

a. Acquisition strategies for Major Defense Acquisition Programs (MDAPs) shall describe measures taken to ensure competition or the option of competition, at both the prime and subcontract level throughout the program life cycle. Examples of such measures include competitive prototyping; dual-sourcing; unbundling of contract; funding of next-generation prototypes or subsystems; periodic competition for subsystem upgrades; and periodic system/program reviews to address long-term competitive effects of program decisions.
b. Acquisition strategies for MDAPs and most other acquisition programs shall identify the potential for competition in selecting the source of repair, maintenance and sustainment of the acquisition system.
c. The technology development strategy for MDAPs shall provide for prototypes of the system (or critical subsystems, if necessary because it is not feasible to have a prototype of the major system) before Milestone B approval. While the MDA may waive this statutory requirement under certain conditions, written notification to the congressional defense committees and Comptroller General is required if a waiver is granted.

There are several primary regulations of interest pertaining to topics covered by this teaching note. The reader is encouraged to use these resources to see more details on this topic.

a. For Federal government contracting issues: The Federal Acquisition Regulation (FAR), which can be viewed online at http://www.arnet.gov/far/.
b. For Federal government financial issues: Title 31, United States Code, which can be viewed online at http://www.access.gpo.gov/uscode/title31/title31.html.
c. For interpretation of Federal government fiscal laws: GAO *Principles of Federal Appropriations Law* (i.e., GAO "Red Book") at http://www.gao.gov/legal/redbook.html.
d. For DoD contracting issues: The Defense Federal Acquisition Regulations Supplement, (DFARS), which can be viewed online at http://www.acq.osd.mil/dpap/dars/dfars/index.htm.
e. For DoD budgeting issues: The DoD Financial Management Regulation (FMR), DoD 7000.14-R, which can be viewed online at http://www.dod.mil/comptroller/fmr/.

f. For requirements for acquisition-related contract competition: Public Law 111-23, "Weapon Systems Acquisition Reform Act of 2009," 22 May 2009. This law may be viewed online at www.acq.osd.mil/sse/docs/Public-Law-111-23-22May2009.pdf .

This teaching note addresses the following topics relative to contract management: (1) contracts crossing fiscal years; (2) contract types; (2) budgetary implications of contracting; and, finally, (4) aspects of budget execution that are routinely associated with executing contracts previously awarded.

CONTRACTS CROSSING FISCAL YEARS

A contract that is funded by annual appropriations may not cross fiscal years, except in accordance with statutory authorization (e.g., 41 U.S.C. 11a; 31 U.S.C. 1308; 42 U.S.C. 2459a; 42 U.S.C. 3515; and the provisions cited in the next paragraph), or when the contract calls for an end product that cannot feasibly be subdivided for separate performance in each fiscal year (e.g., contracts for expert or consultant services).

The head of an executive department agency (except NASA) may enter into a contract, exercise an option, or place an order under a contract for severable services for a period that begins in one fiscal year and ends in the next fiscal year if the period of the contract awarded, option exercised, or order placed does not exceed one year (10 U.S.C. 2410a and 41 U.S.C. 2531). Funds made available for a fiscal year may be obligated for the total amount of an action entered into under this authority.

The above two paragraphs of this section of the teaching note are quoted from the Federal Acquisition Regulation (FAR 48 C.F.R. Subpart 32.7; paragraph 32.703-3). Because the second quoted paragraph is permissive (i.e., as stated, "the agency may") rather than prescriptive (if it had said "the agency shall"), the agency involved may choose to not avail itself of the flexibility provided by the two cited sections of the U.S. Code and the quoted provision in the FAR.

CATEGORIES OF CONTRACTS

Contract types are grouped into two broad categories (also called families): ***fixed-price*** (where the government pays a pre-determined price, subject to some fixed maximum "ceiling" amount if a sharing incentive is used) and ***cost-reimbursement*** (where the government reimburses the contractor for allowable costs incurred to do the contracted effort, subject to some specific limitations, as well as normally some type fee). Each category consists of several different types of contracts, which will be discussed in greater detail in following pages.

THE CONTRACTUAL PROMISE

In fixed-price contracting, the contractor promises to deliver specific goods or services – at a specific time – that meet contract specifications. Fixed-price contracting is serious business especially for the contractor. If a contractor does not deliver on time or if the product delivered does not meet specifications for acceptance, the government may terminate the contract for default and not pay the contractor. In some circumstances, the government will reprocure the items from another source and, if more expensive, will charge the first contractor the difference in the two prices. Clearly, in fixed-price contracting, the contractor bears a tremendous risk. The higher the contractor perceives the cost risk to be, the higher the contractor will normally set the price to protect the company.

In cost-reimbursement contracts, the government promises to reimburse the contractor for all ***"allowable"*** costs incurred on the contract. ***Allowable*** costs are defined as those that are reasonable, allocable, in compliance with required accounting principles, not excluded by terms of the contract and not prohibited by law. The contractor promises to exert its best efforts to perform the desired work. If the desired work effort requires more funding than originally estimated, the contractor notifies the government and the contractor may stop work when the money runs out (or perhaps earlier if so directed or authorized).

INCENTIVE CONTRACTS (FAR 16.401)

Incentive contracts as described in this subpart are appropriate when a firm-fixed-price contract is not appropriate and the required supplies or services can be acquired at lower costs and, in certain instances, with improved delivery or technical performance, by relating the amount of profit or fee payable under the contract to the contractor's performance. Incentive contracts are designed to obtain specific acquisition objectives by--

(1) Establishing reasonable and attainable targets that are clearly communicated to the contractor; and

(2) Including appropriate incentive arrangements designed to --

(i) motivate contractor efforts that might not otherwise be emphasized and

(ii) discourage contractor inefficiency and waste.

When predetermined, formula-type incentives on technical performance or delivery are included, increases in profit or fee are provided only for achievement that surpasses the targets, and decreases are provided for to the extent that such targets are not met. The incentive increases or decreases are applied to performance targets rather than minimum performance requirements.

The two basic categories of incentive contracts are fixed-price incentive contracts (see FAR 16.403 and 16.404) and cost-reimbursement incentive contracts (see FAR 16.405). Since it is usually to the Government's advantage for the contractor to assume substantial cost responsibility and an appropriate share of the cost risk, fixed-price incentive contracts are preferred when contract costs and performance requirements are reasonably certain. Cost-reimbursement incentive contracts are subject to the overall limitations stated in FAR 16.301 that apply to all cost-reimbursement contracts.

A determination and finding, signed by the head of the contracting activity, shall be completed for all incentive- and award-fee contracts justifying that the use of this type of contract is in the best interest of the Government. This determination shall be documented in the contract file and, for award-fee contracts, shall address all of the suitability items in FAR 16.401(e)(1).

It should also be noted that award-fee contracts are a type of incentive contract.

INCENTIVE SHARING

In either fixed-price or cost-reimbursement contracts, the parties may agree to sharing costs that are over or under pre-set targets. This concept of cost incentive means that the contractor's profit (if a fixed-price contract) or fee (if a cost-reimbursement contract) is increased or decreased by a pre-determined share of the cost overrun or under run. This ***fee adjustment formula*** or ***share ratio*** is usually expressed as a simple percentage ratio with the government's share listed first. Thus, an “80/20” share ratio means that for every dollar of cost overrun, the government will pay only 80 cents; the contractor must absorb the remaining 20 cents of the overrun. In the event of a cost under run, the same share ratio and accompanying computation would apply. No incentive contract may provide for other incentives without also providing a cost incentive (or constraint).

SPECIFIC CONTRACT TYPES

Contract type determines how cost risk is passed to the contractor. The most common types of contracts used in acquisition programs are described below. This listing is in descending order of how cost risk has been passed to the contractor (i.e., the first has the greatest cost risk and the last has the least cost risk for the contractor). Generally, the cost risk maintained by the government is in an inverse relationship to the cost risk passed to the contractor.

Firm Fixed Price (FFP)

A firm fixed price contract is exactly that: a fixed price is negotiated in the contract and that is the price the government will pay, regardless of what it costs the contractor to produce the good or service. When the contractor determines the bid/offer price he will charge the government for the good or service (assuming the government accepts that bid/offer price), the contractor includes his profit in that price. As noted previously, from the contractor’s perspective, this type of contract has the greatest cost risk. FFP contracts are commonly used for commercial items or services where there are multiple vendors and there is little risk that the contractor will incur significant increases/decreases in his estimated cost to provide the good or service (e.g., office supplies, janitorial services, etc.)

Fixed Price - Economic Price Adjustment (FP-EPA)

This type of contract is very similar to the FFP except that the price is negotiated based on certain assumptions regarding economic prices of materials or labor that go into producing the goods or services. If these assumptions turn out to be significantly incorrect, then the economic price adjustment (EPA) clause will become active, and the price will be adjusted upward or downward as called for in the clause specifications. FP-EPA contracts are appropriate for goods or services where there may be significant cost risks for certain inputs due to supply or demand fluctuations (e.g., items containing rare metals such as platinum, certain labor categories). Again, as in FFP contracts, the contractor's profit is built into the negotiated price, but the profit amount is protected to some extent by the EPA clause.

Fixed Price Incentive (FPI)

Under a FPI contract, the price is not truly fixed. Instead, there is a negotiated ***target price, which*** consists of a ***target cost*** and a ***target profit***. If the final actual cost of the contract is above or below the target cost, then the contractor's profit will be adjusted downward or upward using a fee adjustment formula. The final price consists of the final negotiated cost plus the profit computed at that final cost using the share ratio. However, at no time will the amount paid exceed the ***ceiling price*** set for the contract. If the contractor's cost exceeds the ceiling price, the contractor takes a loss on the contract.

The most common type of FPI contract is one in which targets (cost and profit) are firm; this is known as a ***fixed-price incentive (firm target)*** contract, abbreviated as ***FPIF***. A more sophisticated and infrequently used ***FPIS*** contract means targets are successive (firmed up later). FPIS type contracts are beyond the scope of this teaching note and will not be discussed further.

FPI contracts may be appropriate when other fixed-price type contracts cannot be supported because they place undue risk on the contractor, but where a cost-reimbursement type contract does not provide sufficient incentive for the contractor to control costs. Under an FPI contract, profit is inversely related to cost, so this contract type provides a positive, calculable incentive to the contractor to control costs. The necessary elements for a FPI contract are as follows:

Target Cost:	best estimate of expected cost
Target Profit:	fair profit at the Target Cost
Fee Adjustment Formula:	a formula used to adjust profit after actual costs are documented
Ceiling Price:	the maximum amount the government may pay

Fixed Price Award Fee

Award fee provisions may be used in conjunction with fixed-price contracts when the Government has a need to motivate the contractor and other incentives cannot be used because contractor performance cannot be measured objectively. In the decision to use fixed-price award fee as a contract type, the contracting officer must ensure the administrative costs associated with conducting award fee evaluations do not exceed the benefits gained from use of award fees.

Cost Sharing

A cost-reimbursement contract in which the contractor does not receive a fee and receives reimbursement only to the extent of an agreed upon portion of allowable costs.

Cost Plus Incentive Fee (CPIF)

Under a CPIF contract, the contractor is permitted to recover all allowable costs incurred, regardless of the cost over/under run, as appropriate for a cost-reimbursement contract. Like the FPI contract, the CPIF contract adjusts the ***fee*** earned by the contractor based on its cost performance on the contract relative to the pre-determined ***target cost***. However, unlike the FPI contract, there is **not** a ceiling price associated with a CPIF contract. As long as the government allows (or directs) the contractor to continue performing work on the contract, the government is agreeing to reimburse the contractor all allowable cost plus pay a negotiated fee as specified in the contract terms. Each CPIF contract has a target fee, a maximum fee and usually a minimum fee that the contractor can earn in addition to being reimbursed all allowable costs. The necessary elements for a CPIF contract are as follows:

Maximum Fee:	most fee the contractor is entitled to receive
Minimum Fee:	least fee the contractor is entitled to receive
Target Cost:	best estimate of expected cost to be incurred
Target Fee:	negotiated fair fee at the Target Cost
Fee Adjustment Formula:	a formula used to determine amount of fee owed the contractor

Although cost is normally the performance factor that is incentivized on a CPIF contract, either technical or schedule performance could be incentivized. However, because shortening the schedule usually results in an increased cost, both schedule and cost are typically not incentivized on the same contract.

Cost Plus Award Fee (CPAF)

A cost plus award fee contract is a cost reimbursement contract that provides for a fee that consists of two portions: (1) a base amount fixed at inception of the contract, if applicable and at the discretion of the contracting officer, and (2) an award amount the contractor may earn in whole or in part during contract performance, which is sufficient to provide motivation for excellence in the areas of cost, schedule, and technical performance. Although dependent on the contracting officer's discretion, the base amount is normally in the range of 0% to 3% of the agreed-to estimated total cost of the contract. This base fee amount, prorated over the planned period of performance, is basically the contractor's "profit" for performing the contract requirements. The amount earned from the award fee pool is based on specific criteria laid out in the contract.

These criteria generally relate to the contractor's cost, technical, schedule and/or quality performance. Determination of the award fee to be paid the contractor is made unilaterally by the government and is not normally subject to appeal by the contractor under the Disputes clause. CPAF contracts are suitable for contracts where the government wishes to incentivize contractor performance in areas other than just cost (quality, timeliness, technical ingenuity) and where it is difficult to determine in advance specific objective targets for cost, technical performance or schedule.

All contracts that provide for an award fee shall be supported by an award-fee plan that establishes procedures for evaluating the award fee and an Award-Fee Board that conducts the award fee evaluation. The Award-fee plan shall be approved by the Fee Determination Official (FDO). The Award Fee Pool portion is typically divided among specific periods based on either time (e.g., 6, 9 or 12 month increments), specific events (e.g., milestones or other significant events), or a combination of time and events. After the period has passed, the government determines the percentage of the Award Fee pool (plus an equitable share of the base fee) that the contractor has earned based on the subjective criteria identified with that period.

Paragraph 16.401 (e)(3) of the FAR states that information contained in Table 16-1 of the FAR will be used to determine the percentage of the award-fee pool the contractor may earn for the target evaluation period as set forth in the award-fee plan; the percentage earned will be based on the specific adjectival rating given. If the contractor has failed to meet overall cost, schedule, and technical performance requirements of the contract as defined and measured against the criteria in the award-fee plan for the award-fee evaluation period, the rating is "unsatisfactory" and the percentage of the award fee pool the contractor may earn is zero.

Until a 14 October 2009 change to the FAR, if a Service or Defense Agency permitted it, any unearned portion of the award fee pool could be rolled over to the next evaluation period. "Rollover" is a practice in which unearned award fee is moved from one evaluation period to a subsequent evaluation period or periods, thus providing the contractor an additional opportunity to earn previously unearned fee. However, with the 14 October 2009 change to the FAR, rollover of unearned award fee is now prohibited (reference paragraph 16.401 (e)(4) of the FAR). The prohibition on rollover came about primarily as a result of Congressional concern starting in the 2006 timeframe that federal agencies were paying out large sums of award fees even though the contractors involved had not satisfactorily met overall cost, schedule, and technical performance requirements of the contract as defined and measured against the criteria in the award fee plan for the award fee evaluation period. In the Duncan Hunter National Defense Authorization Act for FY 2009, Congress directed that the FAR be amended by the middle of October 2009 to provide additional guidance on the use of award fees. The stated prohibition was one result of that directed action.

The interim rule (FAR Case 2008-008), which implemented Section 814 of the John Warner National Defense Authorization Act for FY2007, Section 867 of the Duncan Hunter National Defense Authorization Act for FY2009 and OFPP guidance memo dated 4 December 2007, was made final and published in the Federal Register on 29 September 2010. As of the date of this teaching note, the two below listed related DFARS cases are pending:

- DFARS Case 2010-P010, Award and Incentive Fees, will provide Procedures, Guidance and Information (PGI) on Award and Incentive Fee Contracts. On 8 December 2010, the DAR Council agreed to draft such language.
- DFARS Case 2006-D021, Award Fee Contracts, supplements FAR Case 2008-008. On 13 December 2010, the draft DFARS rule was sent to the DAR editor for review.

Cost Plus Fixed Fee (CPFF)

A CPFF contract is a cost-reimbursement contract that contains no incentives. The contractor is reimbursed for all allowable costs and is paid a pre-determined ***fixed fee*** regardless of how well or poorly it performs. This is clearly the most risky type of contract for the government and the least risky for the contractor. Statutory and regulatory limits dictate that the fee portion of the cost-plus-fixed-fee (CPFF) contract may not exceed 15 percent of the contract's estimated cost, excluding fee, for experimental, developmental, or research work and may not exceed 10 percent of the contract's estimated cost, excluding fee, for other CPFF contracts. CPFF contract may not exceed 6 percent of the contract's estimated cost, excluding fee, for architect-engineer services or for public works or utilities.

FACTORS IN SELECTING THE TYPE CONTRACT TO USE

The contract type determines how cost risk is passed to the contractor. With the movement from cost-reimbursement type contracts to fixed-price contracts, the contractor assumes more and more of the cost risk.

Matching cost risk to the appropriate contract type is the basic key to narrowing in on the complex subject of selecting contract type. Expected costs of performance are uncertain but our approach should say "how uncertain." If the work is easy to price with high confidence that the price will be within a few percentages of the estimate, the contract should probably be FFP. If the work is very hard to estimate and the probability of the price being close to the estimate is risky, then a CPFF or CPAF may be appropriate. Early in the developmental life cycle, the expectation is to see more cost reimbursement type contracts; once the program moves into production, the expectation is to move toward CPIF, FPIF, and FFP type contracts.

There are many factors the contracting officer should consider in selecting and negotiating the contract type. These factors are explained in detail in FAR paragraph 16.104 but are listed here for convenience:

(1) Price competition
(2) Price and cost analysis
(3) Type and complexity of the requirement
(4) Urgency of the requirement
(5) Period of performance (or length of production run)

(6) Potential contractor's technical capability and financial responsibility
(7) Adequacy of the potential contractor's accounting system
(8) Concurrent contracts (with potential contractor)
(9) Extent and nature of proposed subcontracting
(10) Acquisition history with the potential contractor

BUDGETARY IMPLICATIONS

Although a program manager (PM) and possibly the supporting Procuring Contracting officer (PCO) might like to budget for (and ultimately obligate) as much as possible for an acquisition-related contract to cover every potential contingency, the realities of limited defense budgets and governing policies do not allow this. Instead, PMs are expected to budget to the ***most likely price*** of a contract (i.e., the most likely amount the government will pay for the contracted effort).

The requirement to budget on the basis of "most likely price" is tied directly to the funding policies for the various appropriations; those policies are addressed in the DoD Financial Management Regulation, 7000.14-R (FMR). For example, according to Volume 2A, Chapter 1, paragraph 010214, funding resource requirements for RDT&E funds are to be budgeted on an "incremental" basis, which states that only those funds required for work to be done in a given fiscal year shall be included in the RDT&E budget request for that year. As stated later in that paragraph, "work to be done" translates to "cost expected to be incurred during the fiscal year" to do that work. Hence, for RDT&E, the concept is to budget for the best estimate of the cost to be incurred during the fiscal year. Paragraph 010202 of the same reference applies to the full funding policy associated with acquiring defense systems (i.e., use of a procurement appropriations); that paragraph states the budget estimate should reflect the most likely cost to the government of a procurement action.

The specifics for budgeting to "most likely price" differ depending on the type contract. The below listing addresses those specifics:

FFP - Budget to the anticipated final negotiated price. Since the price is fixed, this is the best estimate of the amount the government will ultimately pay.

FP-EPA - Budget to the anticipated final negotiated price, which does not include any economic price adjustments. The EPA clause represents a contingency which should not occur under the most likely scenario if the contract has been appropriately negotiated.

FPI - Budget to the anticipated target price of the contract. If an organization planning to award this type contract were to budget to the ceiling price, it would indicate the organization does not believe the incentives provided in the contract would actually incentivize contractor performance. Budgeting to ceiling would also provide the organization with a budgetary reserve if the contractor performed to the negotiated target price.

CPIF - Budget to the expected cost to be incurred plus the fee earned at that expected cost. Before contract execution begins, the expected cost to be incurred is the target cost and the fee earned at that cost is the target fee, the sum of which is the target price of the contract. Again, if the contract has been properly negotiated and risk appropriately placed, the most likely outcome should be the contractor achieving target cost and, therefore, target fee.

CPAF - Budget to an amount that is the sum of the expected cost to be incurred plus the base fee plus the entire award fee which can be earned (or paid) during the budget period. The award fee criteria must be structured in such a way that the contractor can actually earn the award fee. If the PM budgets for less than this amount, it is tantamount to saying that the contractor cannot earn the entire award fee for that period, and may taint the evaluation process.

CPFF - Budget to the sum of the expected cost to be incurred plus the fixed fee.

The guidelines described above for specific contract types govern the initial budgeting for a contract, which is done well in advance of the PCO completing all administrative actions and actually awarding (i.e., signing) the contract. While the original budget estimate for planned contract work would be a specific dollar amount, final decisions (e.g., negotiations with potential contractors) may result in changes to that amount. Circumstances may change the most likely price, which may have implications on the amount obligated on the contract as well as follow-on budget amounts. A discussion on actually obligating funds for contracted efforts – to include pertinent laws, regulations, and policies – is provided later in this Teaching Note in the "Budget Execution" section.

TERMINATION LIABILITY

Termination liability refers to the amount the government is liable to pay the contractor in the event the contract is terminated before completion. Generally speaking, DoD regulations do not permit acquisition programs to include in their budget request an additional amount to cover potential termination liability on a contract (i.e., the budget request should be only for the most likely price for the contracted work effort). Legal requirements of the Anti-Deficiency Act and the policy of not committing a successor Congress to a course of action make it necessary that the unliquidated obligation on a contract normally be sufficient to cover the cost of terminating that contract for the convenience of the government. This policy is stated in Volume 2A, Chapter 1, of the DoD Financial Management Regulation (FMR). For research and development contracts, see paragraph 010214 C.2.; for procurement contracts for advance procurement of long lead-time items, see paragraph 010202 B.3.; and for procurement contracts for economic order quantity (EOQ) items, see paragraph 010202 B.4; and for multiyear procurement contracts, see paragraph 010203 B. 2. Instead of adding budgeted funds for a potential termination liability, a clause should normally be included in the contract that permits the government to cover the termination liability with funds already obligated on the contract.

According to FAR paragraph 32.704 (for cost reimbursement type contracts) and DFARS paragraph 232.704-70 (for incrementally funded fixed price contracts), when a contract contains one of the following specific clauses, the government contracting officer, upon learning the contractor is approaching the estimated cost of the contract or the limit of funds allotted against that contract, shall promptly obtain funding and programming information pertinent to the contract's continuation and notify the contractor in writing that ---

(1) Additional funds have been allotted, or the estimated cost has been increased in a specified amount; or
(2) The contract is not to be further funded and the contractor should submit a proposal for an adjustment of fee, if any, based on the percentage of work completed in relation to the total work called for under the contract; or
(3) The contract is to be terminated; or

(4) The government is considering whether to allot additional funds or increase the estimated cost and the contractor is entitled by the contract terms to stop work when the funding or cost limit is reached and any work done by the contractor beyond the funding or cost limit will be at the contractor's risk.

The three common contractual clauses used for the purpose of notifying the contractor that the government intends to cover the termination liability with funds already on the contract and stating contractor responsibilities to achieve this purpose are the following:

(1) Limitation of Cost (LOC) clause. This clause (found at FAR paragraph 52.232-20) applies to fully funded (i.e., the entire estimated cost of the contract is obligated upon signing) cost type contracts that are generally less than 12 months in duration or the last increment of an incrementally funded contract. Basically, this clause requires the contractor to provide notice to the government 60 days before the contractor expects to have incurred costs equal to 75% of funds obligated on the contract. The 60 day period may be varied from 30 – 90 days and the 75 percent may range from 75 – 85 percent. Under the LOC clause, the government is not required to reimburse the contractor for costs incurred that exceed the amount obligated on the contract, and the contractor is not required to continue performance when it would exceed the amount obligated in the contract unless informed in writing that the estimated cost has been increased.

(2) Limitation of Funds (LOF) clause. This clause (found at FAR paragraph 52.232-22) applies to incrementally funded cost type contracts. An incrementally funded contract is one where the entire amount is not obligated upon contract signing, but where funds are obligated in increments according to an ***allotment*** schedule in the contract. Basically, this clause requires the contractor to provide notice to the government 60 days before the contractor expects to have incurred costs equal to 75% of the funds allotted to date on the contract. The 60 day period may be varied from 30 – 90 days and the 75 percent may range from 75 – 85 percent. With this notice, the government can decide whether to continue obligating funds on the allotment schedule, obligate additional funds, or terminate the contract and cover termination costs with the funds remaining. The government is not obligated to reimburse the contractor for costs incurred that exceed the total allotment to date on the contract and the contractor is not required to continue performance when it would exceed the amount allotted to date on the contract.

(3) Limitation of Government's Obligation (LOGO) clause. This clause (found at DFARS paragraph 252.232-7007) applies to incrementally funded fixed price contracts. Basically, this clause requires the contractor to provide notice to the government 90 days before the contractor expects to reach a point where the total amount payable by the government, including any costs for termination, will approximate 85% of the funds allotted to date on the contract. The 60 day requirement may be revised to 30 or 90 days as appropriate. The contractor must also provide the government with an estimate of any additional funding needed to continue performance up to the next scheduled allotment date. The contractor agrees to perform up to the point where the total amount payable by the government, including any costs for termination, approximates the total amount currently allotted to the contract. The government is not obligated to reimburse the contractor in excess of the allotted amount.

TIME - PHASING OF BUDGETING FOR CONTRACT AWARDS

The PM faces a number of challenges in the development of budget requests associated with contracting for work efforts. The first major challenge is that of accurately predicting in which fiscal year specific work efforts will be required. Consider the fact that the acquisition program office must, in laying out the acquisition strategy for the system being developed and procured, determine a schedule of events to occur over multiple fiscal years in the future (some of which are contracts for specific work to be done by a contractor) several years prior to the first of those events actually occurring and that schedule must be determined very early in the life of that system. As previously stated, DoD regulations require the budget for contractual work effort to be prepared on the basis of “most likely price” of that work. When the program office prepares a budget request for a future year, that preparation is done a minimum of two years before the target fiscal year begins (e.g., once submitted to higher headquarters, that budget request is evaluated within the DoD PPBE process for a year before becoming part of the President’s Budget request to Congress and, thereafter, another eight or nine months being evaluated within the Congressional Enactment process before becoming part of the Defense Appropriations Act).

The second major challenge is that of the contract negotiation process before the contract is actually awarded for the work effort that was projected to be required when the budget was developed. Many things can happen between the time the program office prepared the initial budget request and when final contract negotiations resulted in a contract award.

If funds for projected contractual work effort are requested in a given fiscal year and, due to technical problems, the work contracted to be completed in a prior year is not completed, the entire schedule could potentially slip. Such schedule slippage puts the budgeted funds requested for the given fiscal year at risk to either being eliminated or reduced during the PPBE process. On the other hand, if the original budget request is not based on the acquisition strategy laid out by the program manager, there could be the perception that the program is not adequately funded.

If funds for projected contractual work effort are requested and appropriated in a fiscal year earlier than the technical aspects of the development and procurement of the acquisition system allow for the follow-on contract effort, the funds might not be obligated in a timely manner and make the program's budget execution appear inefficient. This puts those funds at risk of being withdrawn by higher headquarters during the year of budget execution. If not withdrawn, the funds could expire before the contract can be awarded. If the funds are requested too late, the program schedule could be delayed. Some of the most important factors that PMs should consider in factoring contract awards into their budget formulation include the following:

- Appropriation type ("color of money" - RDT&E, Procurement, MILCON, O&M) to be used for the contract and the period of obligation availability of that appropriation
- How long does it take to get a Procurement Request through the "chop chain"?
- Is a milestone decision required before the award of the contract?

After considering these issues and others, the program office must develop a time line of events and come up with a reasonable estimate by fiscal year as to when funds must be budgeted for the program's various contract awards.

A rule of thumb in planning for contract awards and developing corresponding budgets for the awards is to avoid planning to award major contracts in either first or fourth quarter of a fiscal year. With regard to the first quarter, because Congress frequently does not pass the Defense Appropriations

Act prior to the start of a new fiscal year, the total amount of funds requested for contracted actions is not normally available. Because Congress routinely provides the temporary stop-gap funding measure known as the Continuing Resolution Authority (CRA), only a limited amount of funds might be available for the program office. While specific guidance from USD (Comptroller) or higher authority (e.g., Office of Management and Budget) might state otherwise, language usually associated with a CRA is that obligations may be incurred "at a rate not exceeding the current rate of operations". That “current rate” is normally based on the lesser of the following levels depending on circumstances specified in the Continuing Resolution: (1) the amount the activity was appropriated in the prior year or (2) the lowest Congressional mark of the President’s Budget currently being enacted. However, if the activity (e.g., program office) has a normal pattern for obligations whereby a large portion of its annual budget is obligated during the early part of the fiscal year (i.e., for on-going contractual actions), the activity may continue that obligation pattern under the CRA. Obviously, there must be coordination between the program office and its higher headquarters to ensure that required amount is actually allotted to the activity during the CRA period; otherwise, an ADA violation could occur.

With regard to planning to award major contracts in the fourth quarter, there are three factors that make this a risky plan. First, in the past several years, Congress has put language in the Defense Appropriations Acts that has stated that, at the appropriation account level, obligations in the fourth quarter of the fiscal year can be no greater than the average of the first three quarters of the year. Second, some contracting offices often impose a “moratorium” on creating obligations in the final weeks of the fiscal year because contract award schedules are full; therefore, a planned significant obligation at the end of the fiscal year might not be executable because of the workload involved in the action. Third, the OSD Comptroller budget analysts who review the Services’ Budget Estimate Submission (BES) in the PPBE process will typically question why proposed fourth quarter contract awards can not be slipped to the following year. That question frequently results in a Resource Management Decision (RMD) that shifts the requested funds from the targeted budget year to the next fiscal year; in effect, this becomes an OSD-imposed reduction in the component’s budget request for the targeted budget year. The “justification” used in the RMD is that slippages in on-going current year contract work effort will have a ripple effect that will result in the follow-on contracts (planned for award with the requested budget) being delayed. Hence, the requested amount of funds in the targeted budget year is considered “excessive” and that budget request is reduced accordingly.

BUDGET EXECUTION FOR CONTRACTUAL ACTIONS

Although the primary focus of this teaching note is on the relationship between types of contracts and budgeting for those contracts, a few words about the actual use (i.e., execution) of those funds on contracts seems appropriate to prevent misunderstanding between the actions of budgeting for contracted work and awarding the actual contract for that work.

As with any action involving federal appropriated funds, there are specific actions that government officials must take to be in compliance with legal and regulatory requirements. More details pertaining to the budget execution process can be found in the DAU teaching note titled “Budget Execution”. The basic process, however, is as follows: Upon receipt of some form of request (e.g., Procurement Request, Purchase Order, etc.) for a spending action requiring the use of RDT&E, procurement, or MILCON appropriated funds, the comptroller will execute a ***commitment*** (i.e., administrative reservation of funds) for the purpose requested. [Although there is no requirement that commitment accounting be done for the MILPER and O&M appropriations, the agency may do so if the potential benefits outweigh the costs.] Upon reviewing the request of funds for commitment, the comptroller (resource manager) will

certify that the funds requested are of the correct appropriation for the work to be done (i.e., proper ***purpose***); of the correct fiscal year (i.e., ***time***); and that the amount requested is available (i.e., ***amount)***. After certification, another government official (e.g., contracting officer) may then legally ***obligate*** up to that committed amount. An ***obligation*** is the "legal reservation" of funds tying the government to a liability (e.g., a contract for goods or services). An ***expenditure*** is payment of some or all of an obligation and is generally considered to have occurred when the paying finance office issues a check or releases an electronic funds transfer (EFT), which is the preferred method of payment. DoD policy and procedures relative to payment of contracts is found in Volume 10 of the DoD FMR. An ***outlay*** occurs when actual money is withdrawn from the U.S. Treasury and transferred to the recipient's bank account (i.e., "cashing" the check). Allocations, commitments, obligations, and expenditures are carefully controlled to avoid over-spending and to track actual fiscal progress against plan.

During the execution phase of PPBE (which normally occurs at least one year after the buying activity developed its budget requirements for the proposed contracted work effort), the process is governed by another set of laws, regulations, and policy for purposes of actually using the budget authority provided by one of the appropriation acts. Standards for proper recording of obligations are found in 31 U.S.C. § 1501(a); the primary purpose of that statute is to ensure that all federal agencies record only those transactions which meet specified standards for legitimate obligations. In addition to that statute, during the past years the U.S. Comptroller General [Government Accountability Office (GAO)] has made and published numerous decisions that help interpret fiscal laws. That publication, the GAO ***Principles of Federal Appropriation Law*** (better known as the "Red Book"), serves as a detailed fiscal law guide covering those areas of law in which the Comptroller General renders decisions. The Red Book describes existing legal authorities to illustrate the principles discussed, their application, and exceptions. This portion of the Teaching Note relies heavily on information contained in the Red Book, which may be viewed on line at www.gao.gov/legal/redbook.html. Volume I addresses Comptroller General decisions and questions related to the proper ***purpose*** for which appropriated funds have been obligated; Volume II addresses questions related the proper ***timing*** and ***amount*** of obligation of appropriated funds; and Volume III covers those areas closely associated with contract issues (i.e., claims against the United States; debt collection; and payment of judgments).

Basically, the expected amount of the government's liability should be recorded as an obligation when that amount is known. Generally, that is translated to what is considered the "most likely price" the government will pay for the contracted work effort. However, because of the passage of time and other factors, this amount is not necessarily the same amount estimated to be "most likely" one or more years earlier when the original budget was developed. DoD policy is to obligate at contract award for target or base price (reference FAR 48 C.F.R. Subpart 32.703-1). This means that the amount obligated upon contract award is whatever is then considered to be most likely; obviously, the maximum amount that can be obligated is the funding available to the program office via their funding authorization document (FAD). Upon contract award when the obligation is incurred, the precise amount may not be known; however, an obligation amount must still be recorded on a preliminary basis. As more precise data on the liability becomes available, the obligation must be periodically adjusted; that is, the agency must increase the amount obligated or decrease the obligation by deobligating funds as later information becomes available (or as the scope of work on the contract is either increased or decreased). These adjustments will be made in the form of contract modifications or "mods". Perhaps some examples will help illustrate:

- If the contract in question were a simple firm fixed-price contract, the amount to be obligated initially is the fixed price stated in the contract; that is the obligation amount that should be entered in the accounting records. The possibility the government might ask the contractor at a later date to do additional work scope on that contract does not provide a basis for recording an obligation amount greater than the fixed-price contract price. If the work scope is increased (or decreased) at a later date, the contract would be modified and funds associated with that additional work effort would be obligated on the contract (or deobligated if work scope were decreased).

- If the contract in question were a fixed-price contract with escalation, price re-determination, or one with incentive provisions, the amount to be obligated initially is the fixed price stated in the contract <u>or</u> the target price in the case, for example, of a contract with an incentive clause. Several Comptroller Decisions have been rendered pertaining to these type contracts. [B-255831, July 7, 1995; 34 Comp. Gen. 418 (1955); B-133170, Jan. 29, 1975; B-206283-O.M., Feb. 17, 1983].

- If the contract in question were an incentive contract with a target price of $85 million and a ceiling price of $100 million, the proper amount to record initially as an obligation is the target price of $85 million. [55 Comp. Gen. 812, 824 (1976)]. [Target price is the combination of target cost plus target fee.] The agency must increase or decrease the amount recorded (i.e., the target price) to reflect price revisions at the time such revisions are made or determined pursuant to the provisions of the contract. [34 Comp. Gen. at 420–21].

- When obligations are recorded based on a target price, the agency should establish appropriate safeguards to guard against violations of the Antideficiency Act. This usually means the organization should commit up to the ceiling price (i.e., an administrative reservation of funds) to ensure sufficient funds are available to cover potential liability. [B-255831, July 7, 1995; 34 Comp. Gen. at 420–21; B-206283-O.M., Feb. 17, 1983]. The difference between the obligated amount ($85 million in the above example) and the committed amount ($100 million) would be considered a ***contingent liability***; that contingency would ripen into a recordable obligation for purposes of 31 U.S.C. § 1501(a) only if and when that contingency materializes. [62 Comp. Gen. 143, 145–46 (1983)] and [37 Comp. Gen. 691– 92 (1958)]. At that time, previously committed funds would be obligated up to the greater of the known liability or the amount committed. If it is anticipated the government's liability will become greater than what has already been committed, the necessary additional amount should be committed and then obligated up to the government's total liability. Once it is known that there is a firm decrease in the committed contingency amount, that decrease can be de-committed and those funds made available for other purposes.

As previously stated, there is a normal administrative process that most organizations follow to avoid over-spending and to track actual fiscal progress against that organization's spend plan; that process includes the careful control of allocations, commitments, obligations, and expenditures. Specifically for contractual actions (to include a new award, modification, change order, letter contract, a task or delivery order, or before the start of an award period on a CPAF type contract), the estimated price of that action is included in the formal commitment made by the resource manager (e.g., comptroller) as part of the certification as to the "proper purpose, proper fiscal year and available amount" (usually shortened to "purpose, time and amount"). When the contractual action document is signed by the authorized contracting officer, the formal obligation is incurred. With regard to the award fee determined to be paid the contractor under a CPAF type contract, the obligation occurs after the award period has passed and the government decision made as to the specific amount the contractor is to be paid.

After contract award and during the period of contract execution (when the contractor is performing the required work and submitting invoices for payment – and the government is reviewing, analyzing and paying for the invoiced work in an appropriate manner) government oversight is required. There is a direct relationship between contract type and degree of oversight; less oversight is required for fixed price types contracts and more for cost reimbursement contracts or those with some type incentive. For example, if earned value information on an on-going CPIF contract indicates a potential cost overrun, the PM should adjust the expected "cost to be incurred" upward (and the fee adjusted downward) in order to calculate a new most likely price. If the new estimated price for the original scope of work is greater than had been originally budgeted, the government has basically two alternatives: (1) increase funds to meet the adjusted most likely price for the original scope of work, which was intended to satisfy the Key Performance Parameter (KPP) objectives laid out in the Acquisition Program Baseline (APB) or (2) reduce contract work scope to meet current and projected funding available for the effort. If additional funds are requested and obtained, at the appropriate time they should then be obligated against the contract.

In the latter situation wherein reduction of contract work scope is considered, the program office should make appropriate trade-offs using the philosophy of "Cost as an Independent Variable" (CAIV). Under the CAIV philosophy, the program manager may treat the difference between the APB objective and its associated threshold as a "trade space," subject to agreement by the user. As discussed in the Defense Acquisition Guide (Chapter 2, paragraph 2.1.2.), cost, schedule, and performance may be traded within the "trade space" between the KPP objective and the threshold without obtaining Milestone Decision Authority (MDA) approval.[1] Trade-offs outside the trade space (i.e., decisions that result in acquisition program parameter changes) require approval of both the MDA and the capability needs approval authority. Validated KPPs may not be traded-off without approval by the validation authority. The program manager and the user representative should work together on all trade-off decisions.

SUMMARY

Financial management personnel typically budget for the amount of appropriated funds required for the acquisition program and manage those funds that are allotted for those purposes. Contract management personnel typically determine the appropriate type of contract for a specific type of work effort; negotiate price and cost amounts for that work effort; and obligate the government to a future outlay of those appropriated funds upon signing the official contract document. The two disciplines need to work together to ensure all laws, regulations and policies are followed in the most effective and efficient manner.

Passage of the "Weapon Systems Acquisition Reform Act of 2009" in May 2009 established a number of requirements directly impacting the Defense Acquisition System and duties of key officials involved in the acquisition process. Several provisions of that law are of specific interest to the relationship between contract management and financial management. Two provisions that will have a potential impact on the requirement for additional funding early in the system's life is the increased

[1] Following publication of the revised DoDI 5000.02 in December 2008, the Defense Acquisition Guidebook (DAG) was taken off-line for updating and revision. The updated and fully interactive DAG was officially activated 17 December 2009.

emphasis on competition and the requirement for prototypes of the system (or of critical subsystems of the primary system). While this may necessitate the need for more resources early in the acquisition process, there should be both a net savings over the life cycle of the system as well as the potential for faster fielding of the capability provided by that system.

There are two basic categories or families of contracts (i.e., cost reimbursement and fixed price) and several contract types (e.g., FFP, FP-EPA, FPI, CPIF, CPAF and CPFF) within those two families. The government contracting officer determines the appropriate type contract to be used for a specific work effort based on, among other factors, the degree of cost risk associated with performance of the proposed contractual work effort and the need to incentivize the contractor for one or more of the performance factors (such as cost, schedule or technical performance).

In developing the budget for proposed contractual work effort, financial management personnel should budget on the basis on the most likely price to be paid on the contract; that varies depending on the contract type chosen for the particular contract action. In awarding the contract and obligating the appropriated funds, contract management personnel should obligate the amount considered most likely for the government to pay for that contracted effort (i.e., do not obligate an amount for contingency liability unless the contingency becomes actual). Execution (i.e., use) of appropriated funds on contracts requires some level of government oversight – depending on the type contract awarded – to track fiscal progress against the plan and to avoid violations of fiscal laws and regulations.

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