June 25, 2003

Acquisition

Administration of Performance-Based Payments Made to Defense Contractors
(D-2003-106)

Department of Defense
Office of the Inspector General

Quality *Integrity* *Accountability*

Report Documentation Page

Form Approved
OMB No. 0704-0188

Public reporting burden for the collection of information is estimated to average 1 hour per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Washington Headquarters Services, Directorate for Information Operations and Reports, 1215 Jefferson Davis Highway, Suite 1204, Arlington VA 22202-4302. Respondents should be aware that notwithstanding any other provision of law, no person shall be subject to a penalty for failing to comply with a collection of information if it does not display a currently valid OMB control number.

1. REPORT DATE **25 JUN 2003**	2. REPORT TYPE **N/A**	3. DATES COVERED **-**
4. TITLE AND SUBTITLE **Acquisition: Administration of Performance-Based Payments Made to Defense Contractors (D-2003-106)**		5a. CONTRACT NUMBER 5b. GRANT NUMBER 5c. PROGRAM ELEMENT NUMBER
6. AUTHOR(S)		5d. PROJECT NUMBER 5e. TASK NUMBER 5f. WORK UNIT NUMBER
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) **DoD-IG ODIG-AUD (AFTS) Secondary Reports Distribution 400 Army Navy Drive (801) Arlington, VA 22202-4704**		8. PERFORMING ORGANIZATION REPORT NUMBER **D-2003-106**
9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)		10. SPONSOR/MONITOR'S ACRONYM(S) 11. SPONSOR/MONITOR'S REPORT NUMBER(S)

12. DISTRIBUTION/AVAILABILITY STATEMENT
Approved for public release, distribution unlimited

13. SUPPLEMENTARY NOTES

14. ABSTRACT
Acquisition policy makers and staff that ensure that performance-based payments are used effectively should read this report. These personnel include program managers, procuring contracting officers, contracting officer representatives, administrative contracting officers, technical specialists, and Defense Contract Audit Agency auditors. This report assesses the challenges DoD personnel faced in implementing the use of performance-based payments to acquire supplies and services on fixed-price contracts.

15. SUBJECT TERMS

16. SECURITY CLASSIFICATION OF:			17. LIMITATION OF ABSTRACT	18. NUMBER OF PAGES	19a. NAME OF RESPONSIBLE PERSON
a. REPORT **unclassified**	b. ABSTRACT **unclassified**	c. THIS PAGE **unclassified**	**UU**	**40**	

Standard Form 298 (Rev. 8-98)
Prescribed by ANSI Std Z39-18

Additional Copies

To obtain additional copies of this report, visit the Web site of the Inspector General of the Department of Defense at www.dodig.osd.mil/audit/reports or contact the Secondary Reports Distribution Unit of the Audit Followup and Technical Support Directorate at (703) 604-8937 (DSN 664-8937) or fax (703) 604-8932.

Suggestions for Future Audits

To suggest ideas for or to request future audits, contact the Audit Followup and Technical Support Directorate at (703) 604-8940 (DSN 664-8940) or fax (703) 604-8932. Ideas and requests can also be mailed to:

ODIG-AUD (ATTN: AFTS Audit Suggestions)
Inspector General of the Department of Defense
400 Army Navy Drive (Room 801)
Arlington, VA 22202-4704

Defense Hotline

To report fraud, waste, or abuse, contact the Defense Hotline by calling (800) 424-9098; by sending an electronic message to Hotline@dodig.osd.mil; or by writing to the Defense Hotline, The Pentagon, Washington, DC 20301-1900. The identity of each writer and caller is fully protected.

Acronyms

ACO	Administrative Contracting Officer
DCAA	Defense Contract Audit Agency
DCMA	Defense Contract Management Agency
DLA	Defense Logistics Agency
FAR	Federal Acquisition Regulation
MOCAS	Mechanization of Contract Administration Services
PBPs	Performance-Based Payments
PCO	Procuring Contracting Officer
USD(AT&L)	Under Secretary of Defense for Acquisition, Technology, and Logistics

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202–4704

June 25, 2003

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR ACQUISITION, TECHNOLOGY, AND LOGISTICS

SUBJECT: Report on Administration of Performance-Based Payments Made to Defense Contractors (Report No. D-2003-106)

We are providing this report for review and comment. We considered management comments on a draft of this report when preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Under Secretary of Defense for Acquisition, Technology, and Logistics comments were partially responsive. We request that the Under Secretary of Defense for Acquisition, Technology, and Logistics provide by July 25, 2003, additional comments on Recommendation 1.

We appreciate the courtesies extended to the staff. Questions should be directed to Mr. Joseph P. Doyle at (703) 604-9349 (DSN 664-9349) or Mr. Eric L. Lewis at (703) 604-9314 (DSN 664-9314). See Appendix E for the report distribution. The team members are listed inside the back cover.

David K. Steensma

David K. Steensma
Deputy Assistant Inspector General
for Auditing

Office of the Inspector General of the Department of Defense

Report No. D-2003-106 **June 25, 2003**
(Project No. D2001CK-0061)

Administration of Performance-Based Payments Made to Defense Contractors

Executive Summary

Who Should Read This Report and Why? Acquisition policy makers and staff that ensure that performance-based payments are used effectively should read this report. These personnel include program managers, procuring contracting officers, contracting officer representatives, administrative contracting officers, technical specialists, and Defense Contract Audit Agency auditors. This report assesses the challenges DoD personnel faced in implementing the use of performance-based payments to acquire supplies and services on fixed-price contracts.

Background. The Federal Acquisition Streamlining Act of 1994 authorized the expanded use of performance-based payments. Performance-based payments allow DoD to pay the contractor based upon demonstrated performance rather than incurred costs. The performance-based payments include profit and can significantly increase the contractor's cash flow; however, poor performance can significantly reduce the contractor's cash flow. The Government prefers to use performance-based payments for contract financing on definitized fixed-price contracts for noncommercial purchases. However, the contracting officer and the contractor must agree to use the financing method. Federal Acquisition Regulation Subpart 32.10, "Performance-Based Payments," prescribes performance-based payments policies and procedures. The Under Secretary of Defense for Acquisition, Technology, and Logistics stated that performance-based payments should become the prevalent form of fixed-price contract financing by FY 2005. In November 2000, the Under Secretary issued guidance requiring 25 percent of fixed-price contracts valued at $2 million or more to use performance-based payments financing by FY 2002. Using the Defense Finance and Accounting Service Mechanization of Contract Administration Services system, we identified a universe of 201 contracts, valued at about $54.9 billion, on which performance-based payments were made as of January 2001.

Results. DoD did not adequately administer contracts with approximately $5.5 billion of performance-based payments. Specifically, 43 of 67 contracts reviewed with performance-based payments had poorly defined event schedules, which allowed for payments for contract award and advance payment; lacked performance criteria; or did not document event dependence. Event dependence requires a determination of whether events are dependent upon the completion of other events before receiving payment. As a result of inadequate performance-based payments administration, $4.1 billion (including a possible $900 million in accelerated payments) of the $5.5 billion in performance-based payments lacked adequate documentation to ensure the payments

were for demonstrated performance. The Under Secretary of Defense for Acquisition, Technology, and Logistics needs to: establish performance measures to assess the benefits of using performance-based payments; issue mandatory guidance to ensure that DoD goals for performance-based payments are attained; and require procuring contracting officers to obtain, document, and use input from Defense Contract Management Agency and Defense Contract Audit Agency personnel to ensure payments are commensurate with performance. (See the Finding section for the detailed recommendations.) Implementing the corrective actions will improve the management controls over performance-based payments and compliance with related contract financing policies.

Management Comments. The Director, Defense Procurement and Acquisition Policy stated many of the contracts in the report were negotiated prior to revised guidance, a user's guide, and an on-line training course for performance-based payments. The Director concurred in principle with the recommendations. The Director proposed to conduct an assessment of the benefits of expanded performance-based payments implementation. The assessment will address contracting officer compliance with performance-based payment policies and determine whether any changes are needed to those policies, the Performance-Based Payment User's Guide, or training resources based upon input obtained from the Defense Contract Management Agency, the Defense Contract Audit Agency, contractors, and other interested parties. The Director did not believe the User's Guide should be mandatory and made an alternative proposal to amend the User's Guide to remind contracting officers of their responsibility under the Federal Acquisition Regulation to document their evaluation of performance-based payments. The Director stated this documentation would also evaluate whether contracting officers used field input from the Defense Contract Management Agency or the Defense Contract Audit Agency. The Director's office subsequently provided that the assessment will begin in September 2003 with an anticipated completion date of April 2004. See the Finding section of the report for a discussion of management comments and the Management Comments section of the report for the complete text of the comments.

Audit Response. The Director, Defense Procurement and Acquisition Policy comments were generally responsive. However, the comments did not address the establishment of performance measures. We request that the Under Secretary of Defense for Acquisition, Technology, and Logistics provide by July 25, 2003, additional comments on the recommendation relating to the establishment of performance measures.

Table of Contents

Executive Summary i

Background 1

Objectives 2

Finding

Adequacy of the DoD Administration of Performance-Based Payments 3

Appendixes

A. Scope and Methodology 13
Management Control Program Review 14
Prior Coverage 14
B. Contracts Reviewed 15
C. Questionable Performance-Based Payments Administration 20
D. Value of Questionable Performance-Based Payments Events 22
E. Report Distribution 24

Management Comments

Under Secretary of Defense for Acquisition, Technology, and Logistics 27

Background

Significance of Performance-Based Payments. Performance-based payments (PBPs) are a contract financing method that allows the Government to make payments to a contractor on fixed-price type contracts[1] for noncommercial purchases. PBPs financing requires agreement between the Government and the contractor. PBPs differ from progress payments. Measurable events and performance criteria define PBPs, whereas incurred contractor costs define progress payments. The Under Secretary of Defense for Acquisition, Technology, and Logistics (USD[AT&L]) stated that using PBPs as the principal method of contract financing under fixed-price contracts for noncommercial purchases has potential benefits for both the Government and contractors. Further, under PBPs financing, contractors do not have to create or maintain a Government compliant cost accounting system and the Government does not have to monitor the contractor's system. Also, the benefits include enhancing technical and schedule focus, broadening contractor participation, reducing the cost of administration and streamlining oversight, enhancing and reinforcing the roles of program managers and integrated teams, increasing contractor cash flow, and linking payment to performance.

Requirement for Performance-Based Payments. The Federal Acquisition Streamlining Act of 1994, codified in section 2307, title 10, United States Code, "Contract Financing," authorized the expanded use of PBPs financing when associating performance with quantifiable measurements. The Federal Acquisition Regulation (FAR) Part 32, "Contract Financing," provides criteria for implementing contract financing payment methods.

Establishing DoD Policy. On November 13, 2000, USD(AT&L) issued a memorandum, "Use of Performance-Based Payments (PBP)," that stated in FY 1999 DoD identified 195 PBPs contract actions valued at $5.6 billion. The USD(AT&L) memorandum established goals requiring 25 percent of fixed-price contracts valued at $2 million or more to use PBPs financing by FY 2002, and that PBPs financing become the prevalent form of fixed-price contract financing by FY 2005.

Estimating the Increase in Cash Flow. USD(AT&L) stated that PBPs increase contractor cash flow by 29 percent because payments can be up to 90 percent of the contract price. In the USD(AT&L) example, a fixed-price contract for $10 million that has a potential profit of 15 percent can be financed as much as $9 million. The USD(AT&L) example further illustrates that by using the progress payment rate of 80 percent, traditional cost-based progress payments could amount to about $7 million (contract price [$10 million] divided by the

[1]Fixed-priced type contracts have a firm price. A firm-fixed-price contract places maximum risk on the contractor with responsibility for all costs and resulting profit or loss. The contract type provides maximum incentive for the contractor to control costs and perform effectively and imposes a minimum administrative burden on the contracting parties. Contracting officers use a firm-fixed-price contract for supplies or services when functional specifications are definite and prices are fair and reasonable.

profit percentage [1.15] multiplied by the progress payment percentage [.80]). The difference in cash flow over the life of the contract is $2 million or a 29 percent improvement with PBPs over traditional progress payments.

Planning for the Use of Performance-Based Payments. USD(AT&L) stated that effective planning is key to success. Decisions and agreements on PBPs must be reached in the contract formation phase. DoD and the contractor must identify and agree on events or accomplishments used as a basis for contract financing payments, methods for measuring or confirming completion, and values for the events. Setting valuations for selected events, a unique requirement under a PBPs approach, has a beneficial impact in clearly setting technical and schedule success as the key to contract goals.

Responsibility for Defense Contracting. The procuring contracting officer (PCO) negotiates the PBPs terms with the contractor and may delegate administrative responsibilities, such as PBPs verification, to the administrative contracting officer (ACO). The ACO is generally an employee of the Defense Contract Management Agency (DCMA). The USD(AT&L) guidance document, the "User's Guide to Performance-Based Payments" (the User's Guide) Revision 1, November 30, 2001, states that the Government team has access to the valuable experience of DCMA and Defense Contract Audit Agency (DCAA) personnel. The experience of DCMA and DCAA personnel can help the PCO and the program manager select and define appropriate PBP events. The Government team that is responsible for awarding the contract consists of the PCO, the program manager, and technical and logistics advisors. The User's Guide encourages contracting officers to seek DCMA and DCAA input and to keep them involved when negotiating and structuring contract financing.

Use of PBPs Contracts. Through the Defense Finance and Accounting Service Mechanization of Contract Administration Services (MOCAS), we identified a universe of 201 contracts with PBPs,[2] valued at about $54.9 billion as of January 2001.

Objectives

The overall audit objective was to determine whether DoD procedures were adequate for administering PBPs to Defense contractors. We reviewed how DoD negotiated, verified, and paid PBPs. We also reviewed the management control program as it related to the overall objective. See Appendix A for a discussion of the audit scope and methodology, our review of the management control program, and a summary of prior audit coverage.

[2]The total contract value may overstate the actual value of the PBPs because PBPs only represent contract line items in some contracts.

Adequacy of the DoD Administration of Performance-Based Payments

DoD did not adequately administer contracts with about $5.5 billion in PBPs. Specifically, 67 contracts with PBPs were reviewed and 43 had poorly defined event schedules, which allowed for payments with no performance; lacked performance criteria; or did not document event dependence. The administration of PBPs was not adequate because USD(AT&L) did not:

- establish performance measures for PBPs implementation and effectiveness,
- issue mandatory guidance to ensure that PBPs financing is properly and uniformly implemented,
- require the PCOs to consult with DCMA or DCAA personnel before finalizing PBPs events and criteria, and
- develop a comprehensive training program for contracting officers on use of PBPs contract financing.

As a result of inadequate PBPs administration, DoD assumed a greater share of the financial risk than anticipated. Specifically, contracting officers scheduled $4.1 billion in PBPs that did not specifically relate to demonstrated performance. Additionally, this could allow contracting officers to accelerate payments by an estimated $900 million.

DoD Administration of Performance-Based Payments

DoD did not adequately administer contracts with about $5.5 billion in PBPs. Specifically, 67 contracts with PBPs were reviewed (Appendix B) and 43 had poorly defined event schedules, which:

- allowed payments for contract award,
- allowed an advance payment without appropriate approval,
- lacked performance criteria, and
- did not document event dependence, or
- contained a combination of these conditions.

Table 1 summarizes the results of contracts reviewed from the Army, the Navy, the Air Force, and the Defense Logistics Agency (DLA) with PBPs.

Table 1. Results for PBPs Contracts Reviewed
($ millions)

	Contracts Reviewed[1]		Contracts With Inadequate Administration[2]	
	Number	**Value**	**Number**	**Value**
Army	11	$ 4,741.0	8	$2,951.2
Navy	34	14,539.0	24	1,920.8
Air Force	18	19,033.4	7	584.9
DLA	4	3.9	4	3.9
Total	**67**	**$38,317.3**	**43**	**$5,460.8**

[1]See Appendix B for specific contracts reviewed.
[2]See Appendix C for details on contracts with deficiencies.

Contracting officers contributed to PBP administration weaknesses on 43 contracts by not adhering to FAR Subpart 32.10, "Performance-Based Payments" provisions on contract award, advance payments, event completion, and event dependence. Event dependence requires a determination of whether events are dependent upon the completion of other events before receiving payment. The 43 contracts had about $4.1 billion in questionable PBPs events for contract award, advance payments, event completion, event dependence, or a combination of conditions (see Appendix D).

Contract Award. On eight contracts with questionable PBPs events, DoD paid prime contractors $34.4 million in PBPs, as presented in Table 2, based on the award of the contract. FAR Subpart 32.10 states that the signing of contracts or modifications, the exercise of options, or other such actions must not be PBPs events or criteria, and that PBPs shall not be used in contracts that provide for other methods of contract financing, except advance payments in accordance with FAR Subpart 32.4[3] or guaranteed loans in accordance with FAR Subpart 32.3.

The following are examples of contracts with event schedules that allowed the contractor to receive payment for contract award.

- On contract DAAH23-98-C-0008, which was to acquire 207 fire control radar systems for aircraft with maintenance from the Longbow Limited Liability Company for $565.8 million, the PCO scheduled the first event as the contract award in December 1997 and the contractor was paid $11.3 million.

- On contract N00019-97-C-0046, which was to obtain services from the McDonnell Douglas Corporation to remanufacture 45 AV-8 aircraft for $566.7 million, the PCO scheduled the first PBPs event in each

[3]FAR Subpart 32.4 states that the agency shall authorize advance payments sparingly. Advance payments are the least preferred method of contract financing and generally should not be authorized if other types of financing are reasonably available to the contractor.

year of the multiyear contract as a contract award. The payments totaling $6.7 million were made in December 1999, January 2000, January 2001, and July 2001.

Table 2. Contract Awards

Contract	Payment ($ millions)	Contract Action
DAAH23-98-C-0008	$11.3	Contract Award
DAAB07-00-C-L995	2.6	Contract Award
N00019-97-C-0027	5.1	Contract Award
N00019-97-C-0046	6.7	Contract Award
N65236-97-C-5603	0.2	Contract Award
N00383-98-G-001A*	7.0	Contract Award
N00164-99-C-0079	0.2	Contract Award
N00024-00-C-5399	1.3	Contract Award
Total	**$34.4**	

*PBPs were on specific delivery orders on the basic contract.

Advance Payment. On contract F34601-95-C-0538 for services costing $10.7 million from Sabreliner Corporation to repair one C-20G aircraft, the PCO paid the prime contractor a $2.2 million advance payment over ACO objections. The subcontractor required the payment before the repair work could begin. FAR Subpart 32.4 states that contracting officers must obtain agency permission to make advance payments. However, we could not find evidence that the PCO had obtained the proper permission to make the advance payment.

Event Completion. On the 43 contracts with questionable PBPs events, contracting officers did not follow event completion guidance on 24 contracts (see Appendix C). Specifically, the contracting officers did not document event descriptions or event completion requirements. FAR Subpart 32.10 states that each event or performance criterion that will trigger a finance payment must be identified in the contract along with a description of what constitutes successful performance of the event or attainment of the performance criterion. The requirement provides a means to measure contractor performance and to justify PBPs. The following examples provided no means to measure contractor performance and to justify PBPs.

- On contract N00019-97-C-0027 to acquire 172 missiles for $86.2 million from the Raytheon Company, PBPs events included delivering the plan, establishing baselines, contract awards, testing equipment, and delivering missiles. However, the contract did not include a description of what constituted successful performance of each event.

- On contract N00019-99-D-1016 for services costing $419.1 million from the Raytheon Company to remanufacture 817 missiles, PBPs

events included issuing the plan for missiles remanufacture, inducting missiles, submitting requirements, placing letter subcontracts, leasing a building, expanding and occupying a building, subcontracting critical supplies, and delivering missiles. However, the contract did not include a description of what constituted successful performance of each event.

- On delivery order 0001 under contract N00039-00-F-3153 for 14 data management systems costing $4.9 million from Sherikon Inc., PBPs events include issuing purchase orders for materials, receiving vendor hardware, and delivering cabinets. However, the PBPs event schedule did not describe the contractor performance necessary to complete the events.

Event Dependence. The contracting officers did not follow event dependence guidance on 35 contracts with questionable PBPs events (see Appendix C). Specifically, the contracting officers did not document whether events were dependent upon the completion of other events before contractors received payment. FAR Subpart 32.10 states that event schedules must document whether the event is cumulative (dependent on other events). The FAR requirement allows the Government and the contractor to identify an event dependent on other events so that the contractor does not receive payment before completing a dependent event. A severable (independent) event stands alone and the contractor can receive payment after completing the event.

- On contract N00024-00-C-5482, which acquired 13 guided missile launching systems from Raytheon Company for $124.8 million, the event schedule did not identify dependent and independent events. Events listed in the schedule included loading requirements and placing purchase orders. The event schedule did not identify dependent events in performance milestones.

- Contract F04606-98-D-0045, which acquired two aircraft transmitters and manuals through three delivery orders from the Harris Corporation for $3.3 million in PBPs, also included event schedules that did not identify dependent and independent events. The transmitter and manuals events, as listed in the schedules, included preparing the proposal, ordering the tube, ordering material, assembling the transmitter, testing the transmitter, integrating the transmitter, and final testing. However, the transmitter and manuals event schedules did not identify dependent events in performance milestones.

Performance-Based Payment Controls

PBPs administration was not adequate because USD(AT&L) did not:

- establish performance measures for PBPs implementation and effectiveness,

- issue mandatory guidance to ensure that PBPs financing is properly and uniformly implemented,

- require the PCOs to consult with DCMA or DCAA personnel before finalizing PBPs events and criteria, and

- develop a comprehensive training program for contracting officers on use of PBPs contract financing.

PBPs Oversight. On November 13, 2000, USD(AT&L) issued guidance that established goals for PBPs implementation.[4] However, the guidance did not establish performance measures to track how PBPs implementation would:

- enhance technical and schedule focus,

- broaden contractor participation,

- reduce administration costs and streamline oversight,

- enhance and reinforce the roles of program managers and integrated teams,

- improve contractor cash flow, and

- link payment to performance.

Use of PBPs in fixed-price contracts appears to be increasing. In FY 1999, USD(AT&L) identified 195 contract actions with PBPs totaling $5.6 billion. Using the Defense Finance and Accounting Service MOCAS system, we identified a universe of 201 contracts, valued at about $54.9 billion, on which PBPs of $23.8 billion were made as of January 2001. However, as of January 2003, USD(AT&L) and DCMA had not assessed the benefits of PBPs implementation. USD(AT&L) should establish a mechanism to monitor the effectiveness of PBPs implementation through 2005. Specifically, the mechanism should monitor adherence to policy, recommend policy changes, and assess the benefits of using PBPs.

Mandatory PBPs Guidance. In FY 2000, the FAR expanded the use of PBPs to competitive fixed-price type contracts for noncommercial purchases. Previously, DoD had the authority to use PBPs under sole-source fixed-price contracts. In January 2001, USD(AT&L) issued the User's Guide to encourage contracting officers to use PBPs as the preferred fixed-price contract financing method for DoD. However, USD(AT&L) did not mandate that the User's Guide be followed to administer PBPs. Consequently, the distribution of the User's Guide did not ensure that PBPs implementation would meet DoD goals. Because DoD intends to make PBPs financing the primary means to pay contractors on fixed-price contracts for noncommercial purchases, USD(AT&L) should incorporate required guidance on PBPs into one manual, and solicit comments from a sample of PCOs and ACOs, who would implement the requirements, prior to its issuance.

ACO and DCAA Assistance. PCOs did not effectively use DCMA or DCAA personnel before finalizing PBPs events and criteria. However, in the User's

[4]The USD(AT&L) memorandum states that PBPs financing should account for 25 percent of fixed-price contracts valued at $2 million or more by FY 2002 and become the prevalent form of fixed-price contract financing by FY 2005.

Guide, USD(AT&L) states that the ACOs and DCAA personnel should have special familiarity with the program and the contractor's operation and organization. The User's Guide provides the following rationale for the PCOs using the ACOs and DCAA.

- ACO and DCAA experience will provide the PCO with useful information for selecting and defining PBPs events.
- ACO and DCAA personnel can assist the PCO in developing the PBPs financing template.
- On-site ACOs provide the best resource for verifying performance.

Table 3 summarizes the frequency that PCOs did not request DCMA and DCAA assistance on the 43 contracts with administration problems.

Table 3. DCMA and DCAA Assistance Not Requested on Contracts With PBPs Administration Problems

	Contracts	DCMA Not Requested	DCAA Not Requested
Army	8	1	6
Navy	24	15	21
Air Force	7	2	5
DLA	4	4	0
Total	**43**	**22**	**32**

Using Administrative Contracting Officers. PCOs did not seek or use advice from ACOs in establishing PBPs in 22 contracts with questionable PBPs events. PCOs are not required to obtain ACO input when selecting and defining PBP events. However, the ACOs administer the contracts and must certify that the contractors have demonstrated the required performance. As a result, the ACOs may certify payments without knowing whether the PBPs were in the Government's best interest. Therefore, PCOs should obtain ACO written input before selecting and defining events and document any reasons for not using ACO input. For example, on delivery order EF03 under contract N00383-98-G-001A, which acquired 71 radars and 47 radar kits from Raytheon Company for $210.7 million, the PBPs event schedule allowed the contractor 45 percent of the contract value for production expenses and liquidated the remaining 55 percent through a series of deliveries. As a result, the contractor received payments worth about one-half of the contract value after completing 36 of 154 PBP events (23 percent). The ACO challenged the payment schedule; however, the PCO approved it.

Using the Defense Contract Audit Agency. DCAA personnel were not requested to provide input for 32 contracts with questionable PBPs events. The User's Guide encourages PCOs to seek the input of DCAA representatives and to continue using DCAA representatives when negotiating and structuring the contract finance template. In July 2001, DCAA issued internal guidance to help DoD achieve its goal of using PBPs as the predominant form of contract financing

on fixed-priced contracts by 2005. The guidance stated that DCAA auditors could identify events, value events, conduct post payment verifications, and assess the contractor's financial strength. We believe USD(AT&L) should issue guidance that reinforces the use of DCAA expertise.

Training Contracting Officers. Contracting officers (PCOs and ACOs) on 50 of the contracts reviewed (Table 4) stated more PBPs training was needed. On the 50 contracts requiring more training, 34 had inadequate PBPs administration. Guidance and focused training on the selection and valuation of meaningful payment events is critical for effective use of PBPs.

Table 4. Contracting Officers Needing Training

	Contracts	Training Needed	Inadequate Administration and Training Needed
Army	11	11	8
Navy	34	25	18
Air Force	18	10	4
DLA	4	4	4
Total	**67**	**50**	**34**

The following examples on earned value management, commercial item purchase, and payments commensurate with performance indicate a need for more training for contracting officers.

Earned Value Management. In three contracts with PBPs totaling $74.5 million,[5] the PCOs inappropriately used the earned value management system rather than establishing PBPs event schedules. FAR Subpart 32.10 states that PBPs must be specifically described events or some measurable performance criteria. The earned value management system requires the contracting officer to approve a baseline for the amount of effort and time required to complete a task, such as labor hours consumed. Also, the earned value management system allows for variation in payments, whereas PBPs require a fixed price for performance. Therefore, the contracts using the earned value management system did not establish appropriate events and prices to measure performance.

Commercial Item Purchase. The PCO inappropriately mixed PBPs and commercial item clauses in contract N00039-99-C-2212 to acquire 10 radar surveillance systems from CEA Technologies for $2.7 million in PBPs. FAR Subpart 32.10 states that PBPs contract financing is for noncommercial purchases and no other form of contract financing can be used with PBPs financing, except that advance payments in accordance with FAR Subpart 32.4 or guaranteed loans in accordance with FAR Subpart 32.3 may be used.

Payments Commensurate With Performance. On contract DAAH01-98-C-0013 for the acquisition of 2,720 Tube-launched Optically-tracked Wire-guided missiles from Raytheon Missiles Systems for $51.4 million, PBPs events did not show measurable performance. FAR Subpart 32.10 states

[5]Contract DAAH01-99-C-0085 for $37.5 million, delivery order 0001 for $23.4 million under contract DAAB07-00-D-H002, and contract N00024-99-C-5108 for $13.6 million used earned value management.

that PBPs must be commensurate with contractor performance. The event schedule stated that the contractor may invoice for 50 percent of the contract price, less progress payments made, upon the placement of 9 of 10 purchase orders. The contractor may then liquidate the remaining balance upon missile delivery. As a result, PBPs were not commensurate with performance as the contractor received 50 percent of the contract value while the Army received no missiles.

Using Performance-Based Payments

As a result of inadequate PBPs administration, DoD assumed a greater share of the financial risk than anticipated. Specifically, contracting officers authorized $4.1 billion in PBPs without adequate documentation to prove the payments were for demonstrated performance. Further, of the 67 PBPs contracts reviewed, 43 did not adequately focus attention on linking payments to contractor performance. The 43 contracts also did not reinforce the importance of technical and schedule accomplishment. Rather, PBPs schedules reflected payments for:

- contract awards,
- an advance payment without proper approval**,**
- events with no measurable performance criteria, and
- events that may have been paid too soon.

Additionally, inadequate PBPs administration could allow contracting officers to accelerate $900 million in payments to contractors. The PBPs financing on $4.1 billion is $3.7 billion ($4.1 billion multiplied by 90 percent) using USD(AT&L) guidance. Assuming progress payments at a 15 percent profit, the contractor would be entitled to 80 percent of incurred costs or $2.8 billion ($4.1 billion divided by 1.15 equals $3.5 billion, $3.5 billion multiplied by 80 percent equals $2.8 billion). Therefore, the event schedules could provide the contractors with accelerated payments of approximately $900 million ($3.7 billion less $2.8 billion). FAR Subpart 32.10 states that accelerated payments represent a cost to the Government because the funds must be borrowed to make the payments. The costs cannot be calculated because the dates those payments would be made using progress payments is not known.

Actions Taken by Management

Management Assessment. The Director, Defense Procurement and Acquisition Policy stated that many of the contracts in the report were negotiated prior to revised guidance, a user's guide, and an on-line training course for performance-based payments. Many of the contracts were awarded before the March 2000 FAR revisions to Part 32.10. Indeed, our selection of the 67 contracts for review was based on a judgment sample of available PBPs contracts as of January 2001. Consequently, USD(AT&L) personnel believe that within a few years a subsequent review of PBPs contracts issued after 2001 may not have the problems found in this report.

PBPs Training Initiatives. Prior to the issuance of this report, USD(AT&L), DCMA, and Air Force personnel informed us they had taken steps to improve PBPs training. Specifically, USD(AT&L) personnel stated that an online PBPs course with the Defense Acquisition University had been developed in January 2002. DCMA personnel stated that a training course that included PBPs was developed for its personnel. Also, Air Force personnel stated they have training initiatives underway to supplement PBPs guidance. As a result, we believe that the management initiatives on training are sufficient to address the problems we found.

Conclusion

This report provides the acquisition workforce with an assessment of PBPs. There is usually a learning curve involved when implementing a new procedure and mistakes are made. However, lessons are learned and guidance becomes more focused. PBPs have the potential to improve the acquisition process on fixed-price contracts for noncommercial purchases**.** The use of PBPs allows the Government to base payments on measurable contractor performance that is documented in the event schedules. The contractor can receive accelerated payments that are higher than progress payments. Also, the contractor does not need a Government approved cost accounting system and the Government is not required to review the cost accounting system. However, DoD administration of PBPs was not sufficient to ensure that $4.1 billion in PBPs (including a possible $900 million in accelerated payments) were for demonstrated performance.

Recommendations, Management Comments, and Audit Response

We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics:

1. Establish a working group to monitor the effectiveness of expanded performance-based payments implementation through 2005. The team should monitor adherence to policy, recommend policy changes, establish performance measures, and assess the benefits of using performance-based payments.

Under Secretary of Defense for Acquisition, Technology, and Logistics Comment. The Director, Defense Procurement and Acquisition Policy concurred in principle and will conduct an assessment of the benefits of expanded performance-based payments implementation. The assessment will address contracting officer compliance with Part 32.10 of the Federal Acquisition Regulation on performance-based payments policies and whether any changes are needed to those policies, the Performance-Based Payments User's Guide, or training resources. The assessment would be based upon input obtained from procuring contracting officers, the Defense Contract Management Agency, the Defense Contract Audit Agency, contractors, and other interested parties. The Director's office subsequently provided that the assessment will begin in September 2003 with an anticipated completion date of April 2004.

2. Obtain and incorporate comments from procuring contracting officers, the Defense Contract Audit Agency, and the Defense Contract Management Agency on the User's Guide to performance-based payments and implement as mandatory guidance.

Under Secretary of Defense for Acquisition, Technology, and Logistics Comment. The Director, Defense Procurement and Acquisition Policy concurred in part. The comments on the User's Guide would be obtained as part of the assessment discussed in response to Recommendation 1. However, the Director, Defense Procurement and Acquisition Policy does not believe the User's Guide should be mandatory, but proposed to amend the User's Guide to remind contracting officers of their responsibility contained in Part 15.406-3 of the Federal Acquisition Regulation. The Federal Acquisition Regulation requires contracting officers to fully document their evaluation of performance-based payments, including how they complied with the Federal Acquisition Regulation policies, and how they did or did not use the guidance available to them in the User's Guide.

3. Establish procedures requiring the procuring contracting officer to obtain Defense Contract Management Agency and Defense Contract Audit Agency input before finalizing the event description, event prices, and event measurement criteria or to document the justification for not obtaining the input. The procuring contracting officers should also document the justification for not using Defense Contract Management Agency and Defense Contract Audit Agency input.

Under Secretary of Defense for Acquisition, Technology, and Logistics Comment. The Director, Defense Procurement and Acquisition Policy concurred in principle and as part of the assessment would solicit input on whether current guidance needs additional emphasis regarding the use of Defense Contract Management Agency and/or Defense Contract Audit Agency input. In addition, the Director, Defense Procurement and Acquisition Policy would amend the User's Guide to remind contracting officers of their responsibilities as stated in their response to Recommendation 2. Also, the comments stated that the User's Guide currently includes guidance for obtaining Defense Contract Management Agency and Defense Contract Audit Agency input.

Audit Response. We consider the comments from the Director, Defense Procurement and Acquisition Policy to be responsive and meet the intent of the recommendations, except the comments did not address the establishment of performance measures. We request that the Under Secretary of Defense for Acquisition, Technology, and Logistics provide additional comments on Recommendation 1 relating to the establishment of performance measures.

Appendix A. Scope and Methodology

We reviewed negotiation, verification, and payment procedures for contracts identified as receiving PBPs financing. We assessed DCMA procedures for administering contracts and reviewed contract files maintained at DCMA field offices. We compared contract performance events, performance criteria for event completion, and payment schedules to the FAR for compliance with regulations. We interviewed DCAA representatives and obtained DCAA guidance on providing assistance in administering PBPs. We contacted ACOs for the 70 contracts and 40 PCOs that negotiated 50 contracts.

We performed this audit from January 2001 through March 2003 in accordance with generally accepted government auditing standards.

We utilized a questionnaire to obtain negotiation, verification, and payment information on the contracts reviewed as well as information on negotiation teams, contracting officer training, and payment procedures.

Use of Computer-Processed Data. We used MOCAS computer-processed data to determine the number of contracts and the dollar values of the contracts that received PBPs. Selection criteria specified contracts identified as PBPs in MOCAS that received payments in FY 1999 and FY 2000. We received three MOCAS lists (June 2000, August 2000, and January 2001) and matched contract data on the lists. About 50 percent of the contracts matched among the lists. We did not determine the reliability of the computer-processed data because we only used that data to select the PBPs contracts for review. We believe that the reliability of the data would not affect the audit results. We obtained the contract data used in this report from the actual contracts and associated contract files.

From the 3 MOCAS lists mentioned above, we developed a universe of 201 contracts valued at $54.9 billion. We grouped contracts by the ACO office responsible for administering the contracts, then clustered the contracts by state and ranked the states by the dollar value of the contracts. We judgmentally selected a sample of 70 contracts; however, during the audit 3 were found not to have PBPs. The remaining 67 contracts (11 Army, 34 Navy, 18 Air Force, and 4 DLA) reviewed had an approximate MOCAS value of $39.4 billion (72 percent of the $54.9 billion universe). In 50 contracts, PBPs were for supplies and in 17 contracts PBPs were for services.

Use of Technical Assistance. We relied on assistance from members of the Quantitative Methods Division of the Office of the Deputy Inspector General for Audit to determine the method for selecting the sample.

General Accounting Office High-Risk Area. The General Accounting Office has identified several high-risk areas in DoD. The DoD high-risk area covered in this report is improve processes and controls to reduce contract risk.

Management Control Program Review

DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, and DoD Instruction 5010.40, "Management Control (MC) Program Procedures," August 28, 1996, require DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of the Review of the Management Control Program. We reviewed the adequacy of DoD management control activities over negotiation, verification, and payment of PBPs. Specifically, we reviewed policies, procedures, techniques, and mechanisms that enforce management's directives.

Adequacy of Management Controls. We identified material management control weaknesses for PBPs as defined by DoD Instruction 5010.40. DoD management control activities for negotiating and administering PBPs were not adequate to ensure that contract payment plans were fair and reasonable and based upon demonstrated performance. Recommendations, if implemented, will improve the PBPs process. We will provide a copy of the report to the office of USD(AT&L), through its senior management control official.

Adequacy of Management's Self Evaluation. DoD officials did not identify PBPs as an assessable unit, and, therefore, did not identify or report the material management control activities weaknesses identified by the audit.

Prior Coverage

General Accounting Office

General Accounting Office Report No. GAO-01-515R, "Internal Controls: C-17 Payment Procedures Can Be Improved," May 30, 2001

Appendix B. Contracts Reviewed

Army Contracts Reviewed

As shown in Table 1, we reviewed 11 Army contracts, with PBPs valued at $4.7 billion, for compliance with DoD procedures for negotiating and administering PBPs. Of the 11 contracts, 10 were for supplies and 1 was for services.

Table B-1. Total Army Contracts

Contract	Function	Product	Contractor	PBP (millions)
DAAA09-95-C-0036[1, 3, 4]	Supplies	Ammunition	General Dynamics	$ 243.4
DAAE30-95-C-0086[3, 4]	Supplies	Ammunition	General Dynamics	330.1
DAAJ09-95-C-A001[1, 2, 3, 4]	Services	Aircraft	McDonnell Douglas	1,909.8
DAAH01-97-C-0209[2, 3]	Supplies	Missiles	Raytheon	762.2
DAAH01-98-C-0013[1, 2, 3, 4]	Supplies	Missiles	Raytheon	51.4
DAAH23-98-C-0008[1, 2, 3]	Supplies	Radar	Longbow	565.8
DAAH01-99-C-0085[1, 2, 3, 4]	Supplies	Radar	Raytheon	37.5
DAAB07-00-C-L995[1, 3]	Supplies	Terminals	Cubic	31.4
DAAB07-00-D-E501[1, 2, 3]	Supplies	Computers	TRW	88.5
DAAB07-00-D-H002[1, 2, 3, 4]	Supplies	Radar	Raytheon	23.4
DAAH01-00-C-0108[2, 3]	Supplies	Missiles	Raytheon	697.5
Total				$ 4,741.0

[1]Inadequate administration.
[2]PCOs did not consult with DCMA and/or DCAA before establishing and valuing events.
[3]Adequate PBPs training not provided.
[4]Contract had progress payments before converting to PBPs.

Navy Contracts Reviewed

As shown in Table 1, we reviewed 34 Navy contracts, with PBPs valued at $14.5 billion, for compliance with DoD procedures for negotiating and administering PBPs. Of the 34 contracts, 26 were for supplies and 8 were for services.

Table B-2. Total Navy Contracts

Contract	Function	Product	Contractor	PBP (millions)
N00019-94-C-0033[1, 2, 3]	Services	Missiles	Raytheon	$ 1.6
N00019-94-C-0034[4]	Supplies	Aircraft	McDonnell Douglas	94.0
N61339-94-C-0050[1, 2, 3]	Supplies	Simulator	Martin Marietta	25.8
N68520-94-D-0021[1, 2, 3]	Supplies	Aircraft	Avtel	0.4
N00019-95-C-0031[4]	Supplies	Aircraft	McDonnell Douglas	723.0
N00383-95-G-M120[1, 3]	Services	Power Unit	Honeywell	0.5
N00019-97-C-0027[1, 2]	Supplies	Container	Raytheon	86.2
N00019-97-C-0046[1, 3, 4]	Services	Aircraft	McDonnell Douglas	566.7
N00019-97-C-0059[2]	Supplies	Aircraft	McDonnell Douglas	225.9
N00019-97-C-0136[3, 4]	Supplies	Aircraft	McDonnell Douglas	2,109.1
N65236-97-C-5603[1, 2, 3]	Supplies	Switches	Palomar	2.4
N00019-98-C-0114[2]	Supplies	Aircraft	McDonnell Douglas	474.6
N00024-98-C-5409[1, 2, 3, 4]	Supplies	Radar System	Raytheon	9.9
N00024-98-C-5435[2]	Supplies	Missiles	Raytheon	19.8
N00383-98-G-001A[1, 2, 3]	Supplies	Radar	Raytheon	210.7
N66604-98-C-0166[1, 2, 3]	Supplies	Radar	R&F Products	0.1
N68335-98-C-0042[1, 2, 3]	Services	Aircraft	Palomar	0.7
N00019-99-C-1226[3, 4]	Supplies	Aircraft	McDonnell Douglas	8,963.4
N00019-99-D-1016[1, 2, 3, 4]	Services	Missiles	Raytheon	419.1
N00024-99-C-5108[1, 2, 3]	Supplies	Radar	Raytheon	13.6
N00039-99-C-2212[1, 2, 3]	Supplies	Radar	CEA Tech.	2.7

[1]Inadequate administration.
[2]PCOs did not consult with DCMA and/or DCAA before establishing and valuing events.
[3]Adequate PBPs training not provided.
[4]Contract had progress payments before converting to PBPs.

Table B-2. Total Navy Contracts (cont'd)

Contract	Function	Product	Contractor	PBP (millions)
N00164-99-C-0079[1, 2, 3]	Supplies	Display Unit	Palomar	0.6
N00189-99-P-1512[3, 5]	Supplies	Lockers	York	0.0
N00383-99-D-020G[1, 3]	Services	Radar	Raytheon	19.4
N00019-00-C-0117[3]	Supplies	Computer	Litton	8.4
N00019-00-C-0289[1, 2, 3]	Supplies	Computer	Lockheed Martin	59.1
N00024-00-C-5399[1, 2, 4]	Supplies	Missiles	Raytheon	231.4
N00024-00-C-5401[1, 2]	Services	Phalanx	Raytheon	57.9
N00024-00-C-5482[1, 2]	Supplies	Missiles	Raytheon	124.8
N00024-00-C-5487[1, 2]	Supplies	Missiles	Raytheon	77.4
N00039-00-F-3153[1, 2, 3]	Supplies	Computer	Sherikon	4.9
N61339-00-G-0001[1, 2]	Supplies	Simulator	Research Triangle	2.6
N66001-00-C-0008[2, 3, 6]	Services	Software	Rantec	0.0
N66001-00-D-5031[1, 2, 3]	Supplies	Radar	CEA Tech.	2.3
Total				$ 14,539.0

[1]Inadequate administration.
[2]PCOs did not consult with DCMA and/or DCAA before establishing and valuing events.
[3]Adequate PBPs training not provided.
[4]Contract had progress payments before converting to PBPs.
[5]PBPs value was $58,629.
[6]PBPs value was $46,592.

Air Force Contracts Reviewed

As shown in Table 1, we reviewed 18 Air Force contracts, with PBPs valued at $19.0 billion, for compliance with DoD procedures for negotiating and administering PBPs. Of the 18 contracts, 12 were for supplies and 6 were for services.

Table B-3. Total Air Force Contracts

Contract	Function	Product	Contractor	PBP (millions)
F04701-89-C-0036[3, 4]	Supplies	Imager	Aerojet	$ 40.1
F33657-94-C-2251[4]	Supplies	Aircraft	McDonnell Douglas	1,618.5
F08626-95-C-0106	Supplies	Tail Kits	Martin Marietta	14.8
F19628-95-C-0169[4]	Services	Aircraft	Northrop Grumman	348.0
F34601-95-C-0538[1, 3]	Services	Aircraft	Sabreliner	10.7
F19628-96-C-0021[4]	Services	Aircraft	Northrop Grumman	304.6
F33657-96-C-2059[3]	Supplies	Aircraft	McDonnell Douglas	13,590.7
F33657-97-C-0030[3]	Supplies	Aircraft	Lockheed Martin	1,962.5
F33657-97-C-0031[3]	Services	Technical	Lockheed Martin	285.1
F41608-97-C-0764[1]	Supplies	Seats	McDonnell Douglas	1.7
F04606-98-D-0045[1, 2]	Supplies	Transmitters	Harris	3.3
F08626-98-C-0018[1, 2, 4]	Supplies	Missiles	Raytheon	472.5
F08626-98-C-0027[1, 2]	Services	Technical	Raytheon	37.3
F19628-98-C-0003[4]	Services	Aircraft	Northrop Grumman	201.4
F33657-98-D-2030[1, 2, 3]	Supplies	Simulator	McDonnell Douglas	39.7
F04701-99-F-0204[1, 2]	Supplies	Imager	Spectro Astro	38.3
F04701-00-C-0500[3, 4]	Supplies	Satellites	TRW	45.5
F08635-00-C-0029[1, 2, 3]	Supplies	Missiles	McDonnell Douglas	18.7
Total				$ 19,033.4

[1]Inadequate administration.
[2]PCOs did not consult with DCMA and/or DCAA before establishing and valuing events.
[3]Adequate PBPs training not provided.
[4]Contract had progress payments before converting to PBPs.

Defense Logistics Agency Contracts Reviewed

As shown in Table 1, we reviewed four Defense Logistics Agency contracts, with PBPs valued at $3.9 million, for compliance with DoD procedures for negotiating and administering PBPs. Of the four contracts, all were for supplies.

Table B-4. Total Defense Logistics Agency Contracts

Contract	Function	Product	Contractor	PBP (millions)
SP0920-98-C-0033[1, 2, 3]	Supplies	Valve Assembly	ATI Tools	$ 1.7
SP0430-99-C-5093[1, 2, 3]	Supplies	Cable Terminal	ATI Tools	0.9
SP0430-99-C-5181[1, 2, 3]	Supplies	Cable Terminal	ATI Tools	0.7
SP0430-99-C-5191[1, 2, 3]	Supplies	Cable Terminal	ATI Tools	0.6
Total				$ 3.9

[1]Inadequate administration.
[2]PCOs did not consult with DCMA and/or DCAA before establishing and valuing events.
[3]Adequate PBPs training not provided.

Appendix C. Questionable Performance-Based Payments Administration

Questionable Performance-Based Payments Administration				
Contract No.	**PBPs Value**	**Contract Award**	**Event Completion**	**Event Dependence**
DAAH23-98-C-0008	$ 565.8	X		
N00019-97-C-0046	566.7	X		
N00024-00-C-5399	231.4	X		
N00024-00-C-5401	57.9		X	
N61339-00-G-0001	2.6		X	
F41608-97-C-0764	1.7		X	
DAAA09-95-C-0036	243.4			X
DAAJ09-95-C-A001	1,909.8			X
DAAH01-98-C-0013	51.4			X
DAAB07-00-D-E501	88.5			X
N61339-94-C-0050	25.8			X
N00383-95-G-M120	0.5			X
N00383-99-D-020G	19.4			X
N00019-00-C-0289	59.1			X
F08626-98-C-0018	472.5			X
F33657-98-D-2030	39.7			X
F04701-99-F-0204	38.3			X
F08635-00-C-0029	18.7			X
DAAB07-00-C-L995	31.4	X		X
N00383-98-G-001A	210.7	X		X
DAAH01-99-C-0085	37.5		X	X
DAAB07-00-D-H002	23.4		X	X
N00019-94-C-0033	1.6		X	X
N68335-98-C-0042	0.7		X	X
N68520-94-D-0021	0.4		X	X

Questionable Performance-Based Payments Administration (cont'd)				
Contract No.	**PBPs Value**	**Contract Award**	**Event Completion**	**Event Dependence**
N00024-98-C-5409	9.9		X	X
N66604-98-C-0166	0.1		X	X
N00019-99-D-1016	419.1		X	X
N00024-99-C-5108	13.6		X	X
N00024-00-C-5482	124.8		X	X
N00024-00-C-5487	77.4		X	X
N00039-00-F-3153	4.9		X	X
N66001-00-D-5031	2.3		X	X
F04606-98-D-0045	3.3		X	X
SP0920-98-C-0033	1.7		X	X
SP0430-99-C-5093	1.0		X	X
SP0430-99-C-5181	0.7		X	X
SP0430-99-C-5191	0.6		X	X
N00019-97-C-0027	86.2	X	X	X
N65236-97-C-5603	2.4	X	X	X
N00164-99-C-0079	0.6	X	X	X
F34601-95-C-0538	10.7	Advance Payment		
N00039-99-C-2212	2.7	Commercial Item		
Totals	**$5,460.9**	**8**	**24**	**35**

Appendix D. Value of Questionable Performance-Based Payments Events

Value of Questionable Performance-Based Payments Events

($ millions)

Contract No.	PBPs Value	Questionable Events	Total Events
DAAH23-98-C-0008	$ 565.8	$ 11.3	
N00019-97-C-0046	566.7	6.7	
N00024-00-C-5399	231.4	1.3	
Total for Condition 1	**1,363.9**	**19.3**	**3**
(Condition 1 contained contract award as events.)			
N00024-00-C-5401	57.9	57.9	
N61339-00-G-0001	2.6	2.6	
F41608-97-C-0764	1.7	1.7	
Total for Condition 2	**62.2**	**62.2**	**3**
(Condition 2 had no event completion criteria.)			
DAAA09-95-C-0036	243.4	243.4	
DAAJ09-95-C-A001	1,909.8	1,909.8	
DAAH01-98-C-0013	51.4	51.4	
DAAB07-00-D-E501	88.5	88.5	
N61339-94-C-0050	25.8	25.8	
N00383-95-G-M120	0.5	0.5	
N00383-99-D-020G	19.4	19.4	
N00019-00-C-0289	59.1	59.1	
F08626-98-C-0018	472.5	472.5	
F33657-98-D-2030	39.7	39.7	
F04701-99-F-0204	38.3	38.3	
F08635-00-C-0029	18.7	18.7	
Total for Condition 3	**2,967.1**	**2,967.1**	**12**
(Condition 3 had no evidence of event dependence.)			
DAAB07-00-C-L995	31.4	31.4	
N00383-98-G-001A	210.7	210.7	
Total for Condition 4	**242.1**	**242.1**	**2**
(Condition 4 was a combination of conditions 1 and 3.)			
DAAH01-99-C-0085	37.5	37.5	
DAAB07-00-D-H002	23.4	23.4	
N00019-94-C-0033	1.6	1.6	
N68335-98-C-0042	0.7	0.7	
N68520-94-D-0021	0.4	0.4	

Value of Questionable Performance-Based Payments Events (cont'd) ($ millions)			
Contract No.	**PBPs Value**	**Questionable Events**	**Total Events**
N00024-98-C-5409	9.9	9.9	
N66604-98-C-0166	0.1	0.1	
N00019-99-D-1016	419.1	419.1	
N00024-99-C-5108	13.6	13.6	
N00024-00-C-5482	124.8	124.8	
N00024-00-C-5487	77.4	77.4	
N00039-00-F-3153	4.9	4.9	
N66001-00-D-5031	2.3	2.3	
F04606-98-D-0045	3.3	3.3	
SP0920-98-C-0033	1.7	1.7	
SP0430-99-C-5093	1.0	1.0	
SP0430-99-C-5181	0.7	0.7	
SP0430-99-C-5191	0.6	0.6	
Total for Condition 5 (Condition 5 was a combination of conditions 2 and 3.)	**723.0**	**723.0**	**18**
N00019-97-C-0027	86.2	86.2	
N65236-97-C-5603	2.4	2.4	
N00164-99-C-0079	0.6	0.6	
Total for Condition 6 (Condition 6 contained all conditions.)	**89.2**	**89.2**	**3**
F34601-95-C-0538	10.7	2.2	
N00039-99-C-2212	2.7	2.7	
Total-Other (The last two contracts included an advance payment and a commercial item, respectively.)	**13.4**	**4.9**	**2**
Total	**$ 5,460.9**	**$4,107.8**	**43**

Appendix E. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Acquisition, Technology, and Logistics
  Director, Defense Procurement and Acquisition Policy
Under Secretary of Defense (Comptroller)/Chief Financial Officer
  Deputy Chief Financial Officer
  Deputy Comptroller (Program/Budget)

Department of the Army

Assistant Secretary of the Army (Financial Management and Comptroller)
Auditor General, Department of the Army

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Logistics Agency
Director, Defense Contract Audit Agency
Director, Defense Contract Management Agency
Director, Defense Finance and Accounting Service

Non-Defense Federal Organizations and Individuals

Office of Management and Budget

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member (cont'd)

House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Efficiency and Financial Management, Committee on Government Reform
House Subcommittee on National Security, Emerging Threats, and International Relations, Committee on Government Reform
House Subcommittee on Technology, Information Policy, Intergovernmental Relations, and the Census, Committee on Government Reform

Under Secretary of Defense for Acquisition, Technology, and Logistics Comments

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON, DC 20301-3000

ACQUISITION, TECHNOLOGY AND LOGISTICS

May 27, 2003

DPAP/P

MEMORANDUM FOR DEPUTY DIRECTOR, CONTRACT MANAGEMENT DIRECTORATE, DODIG

THROUGH: DIRECTOR, ACQUISITION RESOURCES AND ANALYSIS 6/9/03

SUBJECT: Response to DoDIG Draft Report D2001CK-0061, "Administration of Performance-Based Payments Made to Defense Contractors"

As requested, I am providing responses to the general content and recommendations contained in the subject report.

General Content:

It should be emphasized that the findings contained in this report address contract actions that were negotiated prior to: 1) the issuance of FAR guidance on performance-based payments (Federal Register dated March 27, 2000, 65 FR 16282), 2) the AT&L User Guide for Performance Based Payments, and 3) the on-line training course. It is important that the users of this reports understand that OUSD(AT&L) took these significant pro-active actions to address many of the concerns noted in the report. The FAR rule revised the Regulations to emphasize that each performance-based payment should represent what the contractor could reasonably be expected to incur to achieve the payment event rather than resemble an advance payment.

Recommendations:

DoDIG Recommendation #1: Establish a working group to monitor the effectiveness of expanded performance-based payments implementation through 2005. This team should monitor adherence to policy, recommend policy changes, establish performance measures, and assess the benefits of using performance-based payments.

DPAP Response: Concur in Principle. As a follow-up to the attached USD(AT&L) letter of November 13, 2000, DPAP will conduct an assessment of the benefits of expanded performance-based payments implementation. The assessment will address contracting officer compliance with FAR 32.10 performance-based payment policies.

The assessment will also address whether any changes are needed to those policies, to the Performance-Based Payment Users Guide, or to training resources, based upon input obtained from procuring contracting officers, the Defense Contract Management Agency (DCMA), the Defense Contract Audit Agency (DCAA), contractors, and other interested parties.

DoDIG Recommendation #2: Obtain and incorporate comments from procuring contracting officers, the Defense Contract Audit Agency, and the Defense Contract Management Agency on the User's Guide to performance-based payments and implement as mandatory guidance.

DPAP Response: Concur in Part. Comments from procuring contracting officers, the Defense Contract Audit Agency and the Defense Contract Management Agency on the User's Guide will be obtained as part of the assessment discussed in our response to Recommendation #1. However, we do not believe the user's guide should be mandatory. Contracting officers should be provided the necessary tools to perform their responsibilities, coupled with the flexibility to make decisions based on the particular facts and circumstances of each business situation. As an alternative, we propose to amend the User's Guide to remind contracting officers of their responsibility at FAR 15.406-3 to fully document their evaluation of performance based payments, including how they complied with the FAR policies and how they did or did not use the guidance available to them in the User's Guide (including whether they used field input provided by DCMA and/or DCAA).

DoDIG Recommendation #3: Establish procedures requiring the procuring contracting officer to obtain Defense Contract Management Agency and Defense Contract Audit Agency input before finalizing the event description, event prices, and event measurement criteria or to document the justification for not obtaining the input. The procuring contracting officers should also document the justification for not using Defense Contract Management Agency and Defense Contract Audit Agency input.

DPAP Response: Concur in Principle. As part of the assessment discussed in our response to Recommendation #1, DPAP will solicit input as to whether current guidance needs additional emphasis regarding the use of DCMA and/or DCAA input. In addition, as noted in the DPAP response to Recommendation #2, DPAP will amend the User's Guide to remind contracting officers of their responsibility at FAR 15.406-3 to fully document their evaluation of the performance based payments (PBP), including whether they used field input provided by DCMA and/or DCAA.

It is important to note that the User's Guide currently includes guidance for obtaining DCMA and DCAA input. In particular, the use of DCMA and DCAA is

emphasized on Page 13 of the guide, "Utilizing the Government Team":

> "In many cases, representatives of DCMA and the Defense Contract Audit Agency (DCAA) will have special familiarity with the program as well as with the contractor's operations and organization. This experience and familiarity can be a valuable asset for the contracting officer and the program office when selecting and defining appropriate PBP events. Also, DCMA on-site representatives are frequently the best resource for verifying event accomplishment during contract performance. **Contracting officers are encouraged to seek the input of DCMA and DCAA representatives and to build in their continuing involvement when negotiating and structuring the contract finance template."**

If you have any questions regarding this memorandum, please contact my point of contact Mr. David J. Capitano, at 703-847-7486 or at david.capitano@osd.mil.

Deidre A. Lee
Director, Defense Procurement
and Acquisition Policy

Attachment:
As stated

THE UNDER SECRETARY OF D FENSE

3010 DEFENSE PENTAGON
WASHINGTON, DC 20301-3010

ACQUISITION AND TECHNOLOGY

NOV 1 3 2000

MEMORANDUM FOR SECRETARIES OF THE MILITARY DEPARTMENTS
COMPONENT ACQUISITION EXECUTIVES
DIRECTORS, DEFENSE AGENCIES

SUBJECT: Use of Performance-Based Payments (PBP)

The Department has had the authority to make performance-based payments to contractors under sole source fixed-price contracts for several years, but with the exception of their significant use with "other transactions," this financing technique has not been used widely. Recently, the Federal Acquisition Regulation was changed to remove the prohibition on using PBPs on research and development and competitively negotiated acquisitions, and to permit prime contractors with cost type contracts to use PBPs on fixed-price subcontracts (FAC 97-16).

There are many significant advantages to be gained from the use of PBPs instead of cost-based progress payments. The Department must take maximum advantage of the benefits of performance-based payments as the preferred means of providing contract financing under fixed-price contracts by making this form of payment the primary and most commonly used form of contract financing. For fiscal year 2002, we must ensure PBP is the primary form of contract financing in at least 25% of contracts valued at $2 million or more. By fiscal year 2005, this method of financing should be the most prevalent form used in fixed-price contracts, such as those for complex services or for production efforts.

In fiscal year 1999, there were 195 contract actions valued at $5.6B that used this form of contract financing. By fiscal year 2005, this method of financing should be used in most contracts that provide financing. Exceptions to the use of this contract financing technique should only be agreed to by the contracting officer when supported by a sound business case justification. The attached summarizes PBP policy and lessons learned.

As with many of the acquisition reforms that we are pursuing, changing the predominant way we provide financing payments under fixed price contracts will require all of us to become more sophisticated customers. To that end, I have directed the Deputy Under Secretary of Defense for Acquisition Reform to lead the development and distribution of a guidance document that will assist contracting officers and program managers in the selection and valuation of meaningful technical progress indicators to use in conjunction with performance-based financing payments. I look forward to your enthusiastic and effective implementation of the actions necessary to successfully transition our contract financing practices to this new paradigm.

J. S. Gansler

Attachment:
As stated

ATTACHMENT

The Case for Performance-Based Payments (PBP)

Policy - Statute and Regulation

The authority to make performance-based payments to contractors resides in 10 U.S.C. 2307(b), which states: "Whenever practicable, payments under subsection (a) shall be made on any of the following bases:

(1) Performance measured by objective, quantifiable methods such as delivery of acceptable items, work measurement, or statistical process controls.
(2) Accomplishment of events defined in the program management plan.
(3) Other quantifiable measures of results."

This statutory authority implemented in FAR Part 32.10 states: "Performance-based payments are ***the preferred Government financing method*** when the contracting officer finds them practical, and the contractor agrees to their use."

Advantages of Using PBP

Using PBP as the principle method of furnishing contract financing under fixed price contracts has many potential benefits for both the Government and contractors. Among them, are the following:

Enhanced Technical and Schedule Focus.

PBP focuses attention on the accomplishment of meaningful and measurable technical progress and on meeting program schedule commitments. By contrast, cost-based progress payments reward incurring cost with only a tangential relationship between those costs and actual, demonstrable progress and schedule results. By linking a contractor's financing payment to critical aspects of technical and schedule performance prior to contract award, PBP reinforces the primacy of technical and schedule connectivity for successful performance. To be successful, parties need to negotiate, at the time of contract formation, the events or accomplishments to be measured, how those measurements will be made, and what value these events or accomplishments will have for financing payment purposes. Thus, both parties will have, in effect, converted appropriate portions of the program plan and schedule into meaningful criteria that will be used throughout the life of the contract to make financing payments. Financing payments will occur only when meaningful, objectively determinable performance accomplishments are achieved.

Broadened Contractor Participation.

Traditional cost-based progress payments can only be used with those contractors who have approved accounting systems. This practice may unintentionally reduce the array of potential contractors with whom the Department can do business. When PBPs are used, however, the contractor's accounting system is no longer a pre-condition of the financial relationship between the parties. Many of today's leading technology firms do not regularly perform under Government contracts and, therefore, have no need for government compliant accounting systems. Use of PBP allows the Department to eliminate one potential barrier to wider supplier participation in the Defense marketplace.

Reduced Cost of Administration and Streamlined Oversight.

Reductions in the oversight and compliance costs of both the Government and contractors are feasible when using PBP. Because the accounting system is not an integral part of the contract financing process, the Government does not require auditors to review payment requests for accounting consistency and compliance with oversight systems, such as cost principles and material management accounting systems. Similarly, contractors' financing requests are event or accomplishment driven and contain no financial information that must be prepared according to financial regulations and practices dictated by the Government. Both parties should be able to reduce non-value added cost-based oversight.

Enhanced and Reinforced Roles of Program Managers and IPTs.

PBP is a management tool that allows the program manager to link financing to performance in fixed price contracts because the contractor is entitled to agreed-upon payments only when specific measurable events have been accomplished. The IPT comprised of government program management, contracting officer, technical and logistic managers, Defense Contract Management Agency (DCMA) and the respective contractor team members jointly develop the PBP plan.

The program manager, supported by IPT members, gives the "thumbs up or down" regarding the assessment of the contractor's technical and schedule results. "Thumbs-up," the program manager verifies to the contracting officer that the contractor is meeting the event requirement and is entitled to payment in accordance with the jointly agreed to performance schedule. "Thumbs-down," the contractor does not receive payment for that event. The Government's business and technical managers are directly involved in all aspects of the process.

PBP is in effect, "self policing" because the contractor is entitled to the agreed-upon payments ***only when*** he accomplishes the paying event and the program manager confirms it before the disbursement is made.

Competition Considerations.

In a competition where the solicitation invites offers to propose PBPs, the contracting officer should ensure that each offeror's PBPs comply with FAR 32.1004 and are reasonable and consistent with other technical and cost information in the offeror's proposal. If the contracting officer anticipates that the cost of providing PBPs will have a significant impact on the selection of the best value offer, the solicitation should provide for the adjustment of proposed prices to reflect the estimated cost to the Government of providing each offeror's proposed PBPs.

Cash Flow Advantages.

Structuring effective performance-based events or accomplishments can provide significant cash flow advantages to a successfully performing contractor. PBP can, under current FAR provisions, be made for up to 90 percent of the contract or line item's **price** whereas cost-based progress payments are currently limited to a fixed percentage of **incurred costs** (currently 75 percent). This can be advantageous from a cash flow perspective. For instance, assume a fixed price contract for $10.0 million that has a potential profit of 15 percent as negotiated and one deliverable item. Under PBP, the total amount financed could be as much as $9.0 million. Using the current progress payment limit of 75 percent, traditional cost-based progress payments could amount to slightly more than $6.5 million. The difference in cash flow over the life of the contract is $2.5 million or a 38 percent improvement with PBP over traditional progress payments. Conversely, if significant technical or schedule accomplishments are not being achieved as originally contemplated, the contractor's cash flow picture can be markedly disadvantaged under PBP versus traditional progress payments. However, this is another reason why the Government should prefer to use PBP as another means to motivate good performance by its contractors and realistic technical and schedule plans by both parties.

Importance of Realistic Performance Milestones.

While it is important to ensure that performance-based payment "triggering" events be carefully chosen to reflect meaningful contract progress, it is important to keep in mind that the events are being selected to make financing payments. To this end, acquisition personnel should consider that, during the early stages of a project, the contractor's rate of expenditure might be high. Therefore, selection of meaningful payment milestones and values during the early phases of a contract is necessary to ensure that the contractor's cash flow needs are adequately addressed. Experience has shown that early performance based payments are important to motivate contractor effort and assist in meeting the cash flow needs that typically arise during the early stages of performance. However, contracting officers should also ensure that PBPs not be structured to result in payments that are in excess of the expected value of performance events, and that they not be designed to result in an unreasonably low level of contractor investment in the contract.

Are there any drawbacks?

Effective planning is key to success and decisions and agreements must be reached during the contract formation phase. The parties have to identify and agree upon which events or accomplishments will be used as a basis for contract financing payments, how they will be measured or confirmed, and the values of the events. In reality, however, all programs have projected technical plans and schedules when the contract is being negotiated so the parties could agree upon milestones that will become the basis for PBP. Setting valuations for the events selected is a unique requirement under a PBP approach. However, even this added activity has a beneficial impact in clearly setting technical and schedule success as the key contract goals. It is important to remember that PBP is a financing tool that is only available for use under fixed-price contracts, so the degree of uncertainty for price and schedule commitments should be low. In order to use PBP effectively, guidance and focused training on the selection and valuation of meaningful payment events is critical. A PBP guide will be available for the acquisition workforce by November 2000 on the acquisition reform web page (www.acq.osd.mil). A distance learning module is also under development and will be reviewed with the Services prior to release to the workforce.

Team Members

The Contract Management Directorate, Office of the Deputy Inspector General for Auditing, DoD, prepared this report. Personnel of the Office of the Inspector General of the Department of Defense who contributed to the report are listed below.

Robert K. West
Joseph P. Doyle
Eric L. Lewis
Michael Baker
Marcia L. Kilby
Galfrid S. Orr
Suk Webb
Nephateria N. Moore
Monelle K. Riviere
Edward M. Vogt
Brian R. McNamara
Jeff Brown
Lisa Rose-Pressley