

Contract Financing Failure

Written by Nick Sanders
Monday, 17 March 2014 00:00



The mission of the Department of Defense Office of the Inspector General (DOD IG) is "to provide independent, relevant, and timely oversight of the Department of Defense that supports the warfighter, promotes accountability, integrity and efficiency, advises the secretary of defense and Congress, and informs the public." Audit reports and testimony issued from the DOD IG generally fall in line with its mission. However, every once in a while we scratch our head(s) in puzzlement and wonder what in the name of accountability the DOD IG was thinking.

This is one of those times.

Recently the DOD IG issued [an audit report](#) criticizing financial management of the Army's Ground Combat Vehicle (GCV) program. We think it missed the mark and failed to promote accountability, integrity and efficiency. We think it failed to advise the Secretary of Defense and Congress regarding significant issues. We think it failed to inform the public regarding significant procurement policy shortfalls.

As you may be able to ascertain, we don't think very highly of that particular DOD IG audit report.

First, let's remind readers that we have [expressed concerns](#) with the management of the GCV program before. We've gone on record as expressing skepticism that any contractor could meet the Army's expressed requirements in the timeframe it wanted them met, for the

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budget it said it had to spend. Despite our concerns, in August, 2011, the Army awarded two early GCV technology development contracts. BAE Systems Land & Armaments division received \$450 Million and General Dynamics Land Systems received \$440 Million. The contracts called for each contractor to deliver a design for consideration by August, 2013. A prototype development contract was expected to follow. The GCV prototype was to be delivered by 2014.

In January, 2013, the technology development contract performance period was extended by six months. The Army decided it would award an Engineering & Manufacturing Development (EMD) contract to only one of the two competing contractor teams, though it is not clear if the downselect decision would be made solely on the design or whether the two teams would each produce a prototype to give the Army something tangible to evaluate.

Now, nearly three years after initial contract award, the program is [essentially dead](#). The Secretary of Defense publicly announced termination of the program in February, 2014; but the truth is that the program continues today, though it has been "downgraded to a study project."

What happened? The Defense News reported-

BAE Systems and General Dynamics have been given hundreds of millions of dollars by the Army since 2011 to develop technologies for the GCV program, even though the Congressional Budget Office has argued against building the platform due to its ballooning weight, armor and projected sustainment requirements. In an April report, the agency estimated that the Army would have to spend \$29 billion between 2014 and 2030 to purchase 1,748 GCVs.

Obviously, sequestration and other budget constraints were going to negatively impact the Army's ability to fork over a couple of billion dollars per fiscal year. (Actually, it would be more than that if you make a reasonable estimate of probable cost growth.) Plus, if you do the math you get a fairly high cost per vehicle (something in the neighborhood of \$16.6 million per). That seems rather pricey when you consider that the world's most effective anti-armor missile (the Javelin) can be had for a \$125,000 command and control unit plus \$40,000 per missile. All other factors being ignored, putting \$16 Million at risk from a \$165K missile would not seem to be on the right side of the economic equation.

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Thus, the GCV program was essentially doomed before it got started.

With the foregoing as background we can put the DOD IG audit report in its proper context. In the proper context, the audit report becomes a stellar example of the maxim that *an auditor is one who enters the battlefield after the battle has already been fought and proceeds to efficiently bayonet the wounded*.

The DOD IG showed up at end of the program's life to audit the Army's financial management of the program. If the IG's input was really going to affect the program's financial management of the program, wouldn't we (as taxpayers) have wanted the IG auditors to show up *at the program's inception*? At this point, the audit report is essentially moot and simply criticizes those who are probably searching for new jobs at this point in time.

But the timing of the report is not our real concern. It's not like government audit reports spit out from an assembly line in a week or two. The timing of this report is nothing more than a cavil. No. Our real concerns (and criticisms) of this particular IG audit report lie elsewhere.

Let's start here. Readers should be clear that when the DOD IG says it audited the Army's financial management of the program, it *did not*, in fact, audit the Army's financial management of the program. The DOD IG did not audit whether the Army's program requirements were reasonably achievable, or whether the required technology was sufficiently mature, or whether the program schedule was achievable for the appropriated budgets. Nope. The DOD IG didn't look at any of those attributes, though we believe most people would agree with us that those aspects might reasonably be considered to be important signposts of the financial health (or lack thereof) of a Major Defense Acquisition Program.

When the DOD IG says it audited the Army's financial management of the GCV program, what it means is that it audited the administration of progress payments by DOD officials, so as to determine whether those officials "authorized and administered progress payments in accordance with selected Federal Acquisition Regulation (FAR) [requirements] and [the requirements of] DOD policies."

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Yep, that's it. *That was the entire audit objective.*

You've got a billion taxpayer dollars being spent, and your *entire audit focus* is on whether or not the program's progress payments were being "appropriately authorized and administered"? *Seri*
ously?

No, this was not a joke. The DOD IG was completely serious.

In fairness, we have to report that the DOD IG audit objective actually grew during performance (much like we suspect the GCV program requirements grew during design and development). As the DOD IG audit report stated-

Our initial announced objective was to determine whether DoD officials authorized and administered progress payments in DoD contracts in accordance with selected Federal Acquisition Regulation (FAR) and DoD policies. During the course of the audit, we found significant issues related to the authorization of contract financing for the Ground Combat Vehicle (GCV) development contracts. As a result, we modified the audit objective to determine whether DoD officials complied with selected FAR and Defense Federal Acquisition Regulation Supplement Subpart (DFARS) clauses for progress payments awarded for the GCV Technology Development Phase.

So the DOD IG added compliance with DFARS clauses to the audit scope, based on findings during audit procedures.

Now readers can see the vastness and pertinence of the DOD IG audit scope. It not only encompassed compliance with FAR requirements and DOD policy requirements, but it also included compliance with DFARS requirements as well! (Note: You must read the foregoing sentence in a biting, sarcastic, tone of voice.)

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Seriously. That was the scope of the DOD IG audit.

Now before we get into the "meat" of the audit report, we should remind readers that administration of contracting financing payments is not the DOD's strong suit. Those pesky Performance Based Payments (PBPs) always seem to trip up Contracting Officers. As we [told our readers](#) during the last go-round (in April, 2013)-

DOD has been using PBPs for contractor financing since 2000. DOD IG has been criticizing DOD's administration of PBPs for just about that same length of time. While some of the details have changed, in a larger sense none of the 2013 criticisms are new; they are essentially the same criticisms asserted in 2001 and 2003. Pentagon policy-makers continue to largely concur with the IG's audit findings, and continue to commit to enhanced/revised policy guidance and enhanced/revised detailed user's guidance, and to enhanced/revised training for DCMA personnel involved in the administration of PBPs. Not too much has changed over the past decade.

So let us offer this prediction.

Sometime in the next decade, the DOD IG will conduct an 'audit' of DOD's administration of PBPs on its fixed-priced contracts. That audit will find many failures. It will recommend enhanced policy guidance. It will recommend more detailed direction. It will recommend enhanced training. And the Pentagon policy-makers will concur, and agree to implement the recommendations.

And that cycle will continue. *Forever.*

Well, it took *less than a year* for the DOD IG to issue another report finding fault with DOD's administration of contract financing payments on fixed-priced contracts. You may be as unsurprised as we were to see that additional internal guidance and additional training were found among the IG's recommended corrective actions. You may be as unsurprised as we were to see that DOD policy makers concurred with the findings and agreed to implement the recommended corrective actions.

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But if that was all to tell you, we wouldn't have bothered.

What makes this audit report more interesting than the usual run-of-the-mill criticisms of those who do by those who do not, was (1) the IG was auditing the use of "customary" progress payments based on contractor costs incurred, and (2) the IG found that US Army Procurement Contracting Officers (PCOs) were inappropriately mixed "customary" and "unusual" contract financing methods on the GCV contracts.

That's kind of new.

By way of background, contract financing payments are permitted in certain circumstances and are intended to assist contractors with cash flow needs when their contract delivery dates are far in the future. Customary progress payments mean that a contractor can submit payment requests equal to a percentage of costs it incurs—generally, large contractors can receive reimbursement equal to 80 percent of their costs. On the other hand, PBPs are not tied to incurred costs; instead, they are tied to significant program events that measure technical progress. If a contract uses PBPs, the contractor can (in theory) receive financing of up to 90 percent of contract price (assuming program milestones are achieved).

So which is better?

Well, to those who remember the [A-12 fiasco](#), PBPs are significantly better than cost-based progress payments. The A-12 nightmare taught us that progress payments do not pay contractors for making progress; instead, they pay contractors for spending (taxpayer) money. A contractor can be dead in the water (in terms of program execution) and still get 80% or so of the cost it incurs on the program. In contrast, a contractor needs to complete its program event milestones in order to be able to submit PBP requests. So if you want to tie payments to execution, you go with PBPs every single time.

But if you are a government bureaucrat you don't really care for PBPs. Use of PBPs does not require an "approved" accounting system. PBPs are not subject to the kind of GAGAS-compliant audit that certain government auditors like to perform. Use of PBPs is not

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well understood by the government contracting officers who have to administer them. Proper use of PBPs requires an investment of time and effort by those who have little of either, in return for downstream cost savings by other functions. PBP event milestones are "yes/no" questions that can only be answered by technical folks, which leaves certain government auditors with idle time on their hands. Plus, it's undeniable that contractors have used the government's wide-spread ignorance of PBPs to their advantage by "gaming" event milestone values so as to accelerate their cash flow.

Consequently (and despite the official FAR policy that PBPs are the "preferred" contract financing method), the [DOD announced](#) in 2011 that it was going to go back to the tried-and-true customary contract financing method of cost-based progress payments. As we reported at the time, the Honorable Shay Assad, who was at that time Director of Defense Procurement and Acquisition Policy (DPAP) wrote a memo that reinstituted the old policy, based primarily on the assertion that contractors had accelerated their cash flow by use of PBPs without providing the Pentagon with adequate consideration for having done so. (We have to admit he was probably correct in his assertion, even though we thought (and still think) he was engaging in a bit of overreaction.)

We wrote at the time-

So nice job, Mr. Assad. You managed to reverse one of the more important innovations of Clinton-era acquisition reform. You've opened the door for contractors to increase their offer prices at a time when the DOD (and indeed the entire Federal government) is focused on lowering those very prices. And you've managed to recreate the environment that led to one of the worst DOD weapon system 'train wrecks' in history.

(Reading that quote two years later, we suspect we were engaging in a fair bit of overreaction ourselves.)

Which brings us back to the GCV program and the DOD IG audit of its use of cost-based "customary" progress payments.

According to the IG audit report, the two contractors quickly found that submitting progress payment requests based on 80 percent of costs incurred (as adjusted in accordance with the

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progress payments contract clause) led to a negative cash-flow situation. Which is exactly what one should expect, right? If you are only getting reimbursed for about 80 percent of the costs you're incurring, that obviously means you have a negative cash flow of at least 20 cents on the dollar. Nobody should have been surprised about that situation, especially the two GCV contractors. That didn't stop the contractors from complaining to the PCO, however. The IG noted with approval that the assigned PCOs rejected the contractors' requests to modify their contract financing arrangements so as to augment their cash flows.

But just a few months later, one PCO executed a bilateral modification to one of the contractors (GDLS)

... that authorized the current customary progress payments be supplemented with additional financing payments for the successful completion of the Systems Functional Review, the Preliminary Design Review, and the end of the period of performance. The Systems Functional Review and Preliminary Design Review were included in the original GDLS contract under the Contract Data Requirements List, which was a 'not separately priced' contract line item. The modification stated that its purpose was to establish 'a change to the current contract financing arrangement' and also included a payment plan for event completion to incorporate the terms and conditions of the additional financing payments.

Thus, by mixing use of cost-based progress payments with use of PBPs on the same contract, the PCO was in violation of FAR requirements. Just as importantly (as the IG pointed out), the modification was "not in line with ... the April 5, 2012, memorandum [from the PCO] that stated [those particular] performance events did not represent value or benefit to the Government." Finally, the IG noted that the PCO failed to obtain "adequate consideration" from the implementation of PBPs, as directed by the 2011 Shay Assad Memo we discussed above.

The DOD IG audit report devotes some verbiage to the discussion of the PCO's failure to document why GDLS needed the contract financing and how consideration should have been calculated. We were interested to note that the IG stated that DPAP guidance required the PCO to calculate consideration "at no less than a 2 percent interest rate," and criticized the PCO for using the current Treasury Rate instead. The PCO's argument that "the Government received additional work concurrent with the change in financing, and the additional work approximated the value of the consideration that he calculated," was received with some skepticism by the IG auditors.

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A similar situation was reported with respect to the BAE contract. The second GCV program PCO followed the GDLS PCO in issuing contract modifications that enabled use of PBPs while concurrently continuing use of cost-based progress payments.

Had the "proper" interest rate been used by the two PCOs, then (according to the IG) the government would have received \$1.3 million in consideration from the two contractors.

The DOD IG audit report described the ignorance of the DOD personnel involved in the foregoing decisions in some detail. Let's quote a bit-

The PCOs either did not understand the proper use and approval of contract financing, or disregarded key FAR contract financing guidance. Specifically, both PCOs stated they did not consider the additional financing payments to be unusual contract financing payments. Instead, all internal ACC-Warren documents called the extra events PBPs and the modifications referred to the revisions as additional financing, the PCOs stated that they never intended the events to be additional financing. The PCOs stated the events were actually contract deliverables with a discrete price. The PCOs believed they only erred by using the financing and PBP wording choices. Therefore, the PCOs stated they did not obtain the approval for unusual financing required by FAR 32.114 and DFARS PGI 232.501-2 because they did not believe they were providing unusual financing. They could not explain why they used the financing and PBP wording originally, and then later determined it was in error. However, based on the evidence the ACC-Warren PCOs provided, including comparison of the original contract terms to the modification, the modifications on the two contracts most closely exhibited payments for specific performance events, as opposed to distinct deliverables; and therefore, the payments represented PBPs.

The DOD IG audit report contained several recommendations for fixing the various problems it noted. However, the current Director of DPAP pointed the finger for implementing some of those recommendations at Mr. Assad (currently Director of DOD Pricing), because it is Mr. Assad (and not Mr. Ginman) who "is responsible for overseeing the complete renovation of DoD's pricing capability." In other words, the office of Defense Procurement and Acquisition Policy declines to take responsibility for at least some aspects of defense procurement and acquisition policy.

We are reminded of that bit in the classic movie, "Office Space," where the two external efficiency consultants ask that one poor employee "so what would you say you do here?"

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That being said, we have no doubts *whatsoever* that the assignments and workload are clearly delineated between Mr. Ginman's and Mr. Assad's organizations.

But if the DOD IG audit report in question is simply a bit more of the same-albeit with a twist involving cost-based progress payments instead of the traditional PBP target-then why did we devote so much typing time to this particular article? Why do we criticize the DOD OIG so harshly for taking time and attention to a mooted matter than really did little more than point to widespread training problems within the DOD acquisition team?

Well, here's the thing.

We think the DOD IG audit report was so focused on slapping these two PCOs (and their management) on the wrists for helping the contractor that they missed the root cause of the problem. What's the root cause?

Fixed-priced development contracting.

Four-and-a-half years ago, [we warned](#) our readers about the perils of fixed-priced development contracting. We had lots to say, including quoting from FAR Part 35 regarding the official regulatory preference for cost-reimbursement development contracting.

In that same article we discussed the four elements that one policy wonk asserted would need to be aligned in order for fixed-priced development contracting to work. Those four elements were:

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Stable, detailed, and technically sophisticated customer requirements definition

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Clear understanding of those requirements by the contractor(s)

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Savvy and skilled contract negotiating by the Government

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A willingness to adjust requirements to meet the fixed price, if necessary

We wonder how the GCV technology program addressed those four elements. We wonder whether the decision to give the two contractors additional cash flow was driven by a tacit acknowledgement that the contracting parties never should have been involved in fixed-priced development contracting in the first place.

We wonder, but we'll never know the answers. We'll never know the answers to those questions because the DOD IG chose to focus on minutiae instead of things that would actually lead to better outcomes for future DOD programs. The DOD OIG missed its opportunity to create an audit report that tackled fundamental issues, and to make value-added recommendations. Instead the DOD OIG settled for more of the same: more contract financing violations, more recommendations about policy guidance and training. And so the DOD leadership that decided a fixed-priced was the right way to go for the GCV development program was let off the hook, and no doubt they were happy to agree to the same type of recommendations the DOD OIG has been making for more than a decade (without a noticeable improvement in results).

And speaking of DOD leadership, it seems funny how the same bureaucrats who ignored FAR Part 32's official regulatory preference for the use of PBPs instead of cost-based progress payments are seemingly the same ones who also ignored FAR Part 35's official regulatory preference for cost-reimbursement development contracting. Are they in fact the same individuals? We don't know because, once again, the DOD IG auditors chose to ignore (or at least not pursue) that particular issue.

Choosing to focus on the administration of contract financing payments instead of whether the parties should have been in a fixed-priced development contract was clearly the easier path, the one with fewer political pitfalls for all involved. But by making the choice it made, we believe the IG auditors missed a significant opportunity to promote accountability, integrity, and

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efficiency. We believe the IG auditors missed a significant opportunity to inform the Secretary of Defense and Congress, and to inform the public about the perils of fixed-priced development contracting.

Not the DOD OIG's best choice, in our view.