

December 1997

DEFENSE ACQUISITION

Guidance Is Needed on Payments for Conditionally Accepted Items



**National Security and
International Affairs Division**

B-278211

December 12, 1997

The Honorable William S. Cohen
The Secretary of Defense

Dear Mr. Secretary:

During prior work on the C-17 program, we noted that the Air Force generally accepted aircraft with incomplete or deficient work, on the condition that the contractor complete the work after delivery.¹ Although the Air Force withheld payment for the work not done, the amounts withheld were less than the estimated cost and profit to complete this work. We conducted this review to determine if this situation occurred on other programs and if additional guidance was needed to avoid paying contractors for work not done at the time of delivery.

Background

When acquiring goods or services by contract, U.S. government policy is generally to pay only for completed work. The purpose of this policy is to reduce the government's risk of financial exposure in the event a contractor fails to perform. In the case of payments at the time of conditional acceptance, this would generally mean withholding sufficient funds to cover the estimated cost and profit associated with completing the work. This policy of only paying for completed work is grounded in the prohibition against advance payments contained in title 31, section 3324 of the United States Code, which states that "a payment under a contract to provide a service or deliver an article for the United States Government may not be more than the value of the service already provided or the article already delivered." This policy is also evident in the provisions governing progress payments,² which state that agencies "shall ensure that any payment for work in progress . . . is commensurate with the work accomplished. . . ."³ The statutory exceptions to this policy apply conditions or restrictions to the transaction. For example, a written determination is required from the head of an agency, or his or her designee, that the use of advance payments is in the public interest.

¹Conditional acceptance means that a contracting officer has determined that it is in the government's best interest to accept an item that does not conform to contract specifications or is otherwise incomplete with the expectation that the contractor will later correct nonconformances or complete other work.

²Progress payments are a method of interim contract financing in which the government and a contractor share the financial burden of contract performance.

³41 U.S.C. 255(e)(1) and 10 U.S.C. 2307(e)(1).

These policies are implemented in the Federal Acquisition Regulations System. This system consists of the Federal Acquisition Regulation (FAR), which is the primary authority, and agency acquisition regulations that implement and supplement the FAR. The Department of Defense's (DOD) implementing regulation is the Defense Federal Acquisition Regulation Supplement (DFARS). In addition, each of the military services' acquisition organizations has issued supplemental guidelines for use in implementing policies and procedures in the FAR and the DFARS.

According to the FAR, contracting officers normally should reject supplies and services that do not conform to contract specifications. However, FAR section 46.407 (Nonconforming Supplies or Services) provides exceptions for those circumstances (such as for reasons of economy or urgency) in which accepting such supplies or services may be in the government's best interest. This section addresses only situations when the government has decided to accept items with permanent nonconformances and not require a contractor to correct the deficiencies after delivery. In these situations, the FAR recommends that the contract be modified to reduce the price or provide other consideration to reflect that the items are less than were specified in the contract.

Results in Brief

Our review of four selected Air Force, Army, and Navy acquisition programs showed that each of the services accept items conditionally. However, federal and DOD regulations do not provide guidance to contracting officers for determining amounts to be withheld from payments in these cases. We also found that there is no consensus among Office of the Secretary of Defense and service officials as to what policy should govern payments at the time of conditional acceptance. Some officials agreed that the amount withheld should reflect the estimated cost and profit associated with the work to be done by a contractor after delivery while others indicated that contracting officers should have discretion to withhold whatever amount they determine appropriate.

The extent of service guidance ranged from the Army providing no guidance to standard Air Force and Navy contract clauses that leave determining the amount to be withheld to the contracting officer's discretion. Such guidance does not ensure that the amount withheld reflects the estimated cost and profit to correct known deficiencies and perform other incomplete work. As a result, it lacks the safeguards necessary to reduce the government's risk of financial exposure and is inconsistent with the policy of paying only for completed work.

Our review of the four selected acquisition programs showed that when items were conditionally accepted, each of the services paid contractors the billing price, assuming 100-percent completion, less some amount for nonconforming or unfinished work. In general, the amounts withheld were less than the costs to correct known deficiencies and complete unfinished work and resulted in contractors being paid for work that had not been performed at the time of conditional acceptance. For example, the estimated price to correct known deficiencies and complete unfinished work on two C-17 production contracts exceeded the amounts withheld by about \$61 million, based on the contractor's cost estimates, or \$127 million based on the cost estimates used by the Defense Contract Management Command (DCMC) in administering the contract. The Hunter Unmanned Aerial Vehicle program accepted five systems with six conditional waivers for which no money was withheld. Program officials told us that they believed the contractor would correct the deficiencies. The program office was not able to provide an estimate of the potential cost of this work.

The DFARS should be amended to provide departmental guidance on the amounts to be withheld in cases of conditional acceptance by the services. This amendment should require that the amount withheld when conditionally accepting nonconforming items reflect at least a reasonable estimate of the cost to correct known deficiencies and to do other incomplete work remaining at the time of delivery. If a contracting officer determines that withholding a lesser amount would be in the best interests of the government, the determination should be accompanied by safeguards adequate to protect the government's interests.

Guidance on Conditional Acceptance of Items Is Not Adequate

The FAR and the DFARS do not provide guidance for withholding payment for work to be performed after delivery in situations where the government conditionally accepts nonconforming or incomplete work. Moreover, within the military acquisition community, no consistent way has been developed for determining whether payments should be withheld or how to determine the amount to withhold.

The DOD Director of Defense Procurement told us that a contracting officer should withhold from payment the estimated cost and profit for work to be done by the contractor after delivery. However, Air Force and Army acquisition officials told us that while the cost and profit of the remaining work should be a consideration, the amount withheld, if any, should be left to the discretion of the contracting officer.

Air Force supplemental guidance includes a standard contract clause allowing contracting officers to use their discretion in determining the amount to be withheld. The Army provides no supplemental guidance to the FAR for use in conditionally accepting items and establishing a withhold amount. At the Naval Sea Systems Command and the Naval Air System Command (NAVAIR) procurement and contracting officials agreed that amounts withheld should directly relate to the anticipated cost of work to be performed by a contractor after delivery. However, contract clauses that the two commands use give a contracting officer authority to withhold a lesser amount.

From 1981 through 1992, the Air Force Materiel Command's (AFMC) Aeronautical Systems Division supplements provided for a standard contract clause entitled "Correction of Supplies Accepted With Deficiencies," which called for withholding 10 percent of the price when conditionally accepting items. The clause allowed a contracting officer to use a higher or lower percentage as conditions warranted.

In July 1997, AFMC revised this clause and left the determination of the amount withheld to the contracting officer's discretion. The revised clause provides a list of factors to consider when deciding on a withhold amount, including (1) the cost to correct the deficiencies; (2) any loss of value to the government due to reduced reliability, increased life-cycle costs, or reduced availability; and (3) any other factors that may affect government use or cost of ownership.

In ship construction and conversion contracts, the Naval Sea Systems Command uses a standard payment clause that requires a contracting officer to withhold a percentage of the contract price when a ship is conditionally accepted. The clause provides for withholding, as a performance reserve, the greater of either 1.5 percent of the contract price or \$100,000. This clause also provides that a contracting officer may withhold more than the 1.5 percent if he or she finds that the standard withhold amount is insufficient to cover the cost to correct deficiencies or complete unfinished work. The NAVAIR standard clause entitled "Acceptance Under Fixed-Price Contracts" allows a contracting officer, under certain conditions, to accept nonconforming items and to withhold an amount, as he or she determines appropriate.

A policy that would require the withholding of at least the estimated cost and profit in this circumstance or require written justification for an exception would protect the government's interests and be consistent with

the treatment accorded payments for work that has not been completed in other instances. For example, FAR, subpart 32.4, which implements the advanced payment statutes, requires that approval of a contracting officer's recommendation for an advance payment be based on a written determination by an approving official that such advance payment is in the public interest or facilitates the national defense.

Inadequate Withholds Result in Contractors Being Paid for Work Not Completed

Our review of four selected acquisition programs indicated that each of the services conditionally accepted nonconforming items, with the expectation that the contractors would correct known deficiencies and complete unfinished work. When conditionally accepting nonconforming items, each of the services paid contractors the billing prices, assuming 100-percent completion, less some amount that was withheld for nonconforming or unfinished work. The services differed in how they determined the withhold amounts, but in each case, the amounts were less than the estimated costs to correct known deficiencies and complete unfinished work. As a result, the contractors were paid for work not yet done.

Air Force's C-17 Program

To meet the need for additional long-range airlift, the Air Force contracted with the McDonnell Douglas Corporation, which later merged with the Boeing Company, to develop and produce 120 C-17 aircraft. As of October 1997, the contractor had delivered 34 production aircraft, all of which were conditionally accepted by the Air Force with a number of waivers and deviations that required corrective action by the contractor. We reviewed the adequacy of amounts withheld for eight aircraft conditionally accepted under two contracts for fiscal years 1990 and 1992, production lots III and IV, respectively. At the time of last aircraft delivery for each lot, the Air Force had withheld a net amount of about \$47 million for problems with such things as computer software and assembly workmanship and for certain components on which qualification testing had not been completed. However, the amount withheld was significantly less than the estimated cost to correct known deficiencies and finish other incomplete work.

Both contracts stipulated that the contracting officer should withhold a minimum of 10 percent of the contract price when conditionally accepting aircraft until the contractor completed the corrective actions. The lot IV contract, however, allowed the contracting officer to deviate from this requirement and withhold a lesser amount. C-17 program officials stated

that they did not believe 10 percent was reasonable given the aircraft's high price. Therefore, starting with lot III, instead of withholding 10 percent of an aircraft's billing price, the program office and the contractor agreed to categorize waivers and deviations and establish standard withhold amounts for each category. In addition, they agreed to negotiate specific amounts for unique nonconformances. However, the program office did not modify the C-17 contracts to incorporate this withhold policy.

Program officials told us that the withhold policy implemented in the C-17 program was not intended to cover the estimated cost and profit of the work remaining to be done by the contractor after conditional acceptance. They said that withholds were intended only to be an incentive to the contractor to correct deficiencies and finish other incomplete work.

Table 1.1 compares our estimate of what should have been withheld after the delivery of the last aircraft in each lot with the amounts actually withheld. Our review indicated that the cost and profit to correct deficiencies and complete unfinished work for production lots III and IV exceeded the \$47 million withheld by about \$61 million, based on the contractor's estimates of the cost of the aircraft at completion, or about \$127 million, based on DCMC's estimates of the cost of aircraft at completion.⁴ The final aircraft of lots III and IV were accepted in February and August 1994, respectively. At the time of our review, the contractor was correcting deficiencies and completing unfinished work.

⁴These cost estimates were in effect at or shortly after the delivery of the last aircraft in each lot.

Table 1.1: Estimates of Unearned Cost and Profit Paid at the Time of Last Aircraft Delivery for C-17 Production Lots III and IV

Dollars in millions						
	Based on:					
	Contractor's estimate at completion			DCMC's estimate at completion		
	Lot III	Lot IV	Total	Lot III	Lot IV	Total
Price paid at delivery ^a	\$1,202.9	\$1,131.6		\$1,202.9	\$1,131.6	
Less overpayment in price ^b		22.0			13.2	
Adjusted price		1,109.6			1,118.4	
Less earned cost and profit at delivery	1,136.7	1,067.2		1,082.5	1,064.1	
Unearned cost and profit	66.2	42.4		120.4	54.3	
Less amount withheld	29.0	18.3		29.0	18.3	
Unearned amount paid at delivery	\$37.2	\$24.1	\$61.3	\$91.4	\$36.0	\$127.4

^aIncludes only aircraft contract line items.

^bThe contractor was overpaid due to the government's failure to decrease the billing price to reflect a transfer of engineering costs from the lot IV contract to the development contract. The amount of overpayment also depends on whether the contractor's or government's cost estimate is used to compute an adjusted billing price.

Army's Tactical Vehicles Program

The Army established the Family of Medium Tactical Vehicles (FMTV) program to replace its aging fleet of 2.5-ton and 5-ton trucks and vans. The Army plans to purchase about 85,000 FMTV vehicles over a 30-year period. In October 1991, the program office awarded a \$1.2-billion contract to Stewart and Stevenson Services, Inc., for the initial production of 10,843 trucks and vans over 5 years. In August 1996, the program office revised the contract to procure these vehicles over a 7-year period. As of June 1997, the contract price to produce 11,197 trucks and vans was \$1.36 billion.

The contractor produced 3,040 vehicles during the program's low-rate initial production phase. Nearly all of these vehicles (2,936) required a retrofit after production to resolve problems. These problems had been

identified prior to acceptance during early testing.⁵ The government conditionally accepted 1,941 of these vehicles prior to retrofitting them. Many of these vehicles required an extensive retrofit effort, dismantling them down to the frame.

The program office applied three different payment withholds, related to retrofit requirements, against the 1,941 vehicles. One withhold was for parts that were missing when the trucks were conditionally accepted. A second was imposed on vehicles accepted before the completion of first article testing, and a third involved deficiencies in the contractor's quality control system. These withholds were released to the contractor after each vehicle had been retrofitted and accepted by the government.

The second withhold was required by the contract's conditional acceptance clause. This clause required that 10 percent of the billing price be withheld for those vehicles conditionally accepted prior to completion and approval of first article testing. The 10-percent figure was negotiated between the program office and the contractor. It did not bear any relationship to a projected cost estimate for retrofitting delivered trucks after testing was completed. A contracting officer with the U.S. Army Tank-Automotive and Armaments Command (TACOM) said that this clause was included in the FMTV contract based on experience with the previous M939A2 5-ton truck program.⁶

The third withhold was implemented later in the program because of government concerns that the vehicles did not conform to contract specifications because of inadequate contractor quality control. In July 1995, the program office modified the contract's conditional acceptance clause to require an additional withhold amount on program year 1 and 2 vehicles. It involved withholding \$2,000 for each vehicle built prior to April 11, 1994, and \$1,000 for each vehicle built on or after this date. FMTV program officials were unable to provide an analytical basis for the two withhold amounts. Contracting files indicated that this withhold was implemented as an incentive to the contractor to improve his quality control system, thereby reducing the government's risk in conditionally accepting vehicles.

⁵The remaining 104 vehicles were produced when the other vehicles were being retrofitted, and the modifications were incorporated during production.

⁶In that program, the contractor, which had been paid the full price, was required to retrofit about 2,500 trucks to correct nonconformances found during testing. The contractor was planning to do the retrofit work during breaks in new truck production or at the end of the program. TACOM officials convinced the contractor that leaving the retrofit work until the end would not be acceptable.

DCMC had estimated that the cost could be as high as \$24 million to retrofit vehicles but had not developed a detailed estimate that we could use to evaluate the reasonableness of the amounts withheld. However, on the basis of the actual costs to retrofit these vehicles, we estimated the cost to retrofit the 1,941 vehicles conditionally accepted and compared that estimate to the amounts withheld related to the retrofit. As shown in table 1.2, we estimated the cost to retrofit the 1,941 vehicles exceeded the amounts withheld by about \$2 million. At the time of our review, the retrofit required at the time of conditional acceptance had been accomplished.

Table 1.2: Estimate of Unearned Costs Paid for Vehicles Conditionally Accepted Prior to Retrofit

Dollars in millions				
	Number of vehicles ^a	Cost	Less withhold amount	Unearned amount paid at delivery
Retrofitted	2,917	\$32.0 ^a		
Accepted but not retrofitted	19	0.2		
Total requiring retrofit	2,936	32.2		
Less: vehicles not accepted prior to retrofit	995	9.6		
Conditionally accepted prior to retrofit	1,941	\$22.6	\$20.6 ^a	\$2.0

^aActual.

Navy's Conversion of Commercial Container Ships

To improve the Military Sealift Command's prepositioning and surge sealift programs, the Navy is converting commercial container ships into roll-on roll-off sealift ships. Three ships are being converted under a contract with the National Steel and Shipbuilding Company. We reviewed the adequacy of the payment withholds for one of these ships, the USNS Shughart, which the Navy conditionally accepted on May 7, 1996. The contract for these ships contained the standard Naval Sea Systems Command clause that provides for a 1.5-percent performance reserve at the time of conditional acceptance but allows for a greater withhold as determined necessary by the contracting officer.

At the time of the USNS Shughart's conditional acceptance, the Navy project officer recommended withholding about \$10.3 million for critical incomplete work and other deficiencies. However, there was only about \$9.5 million available to withhold from the ship's \$289.7 million billing price because the Naval Sea Systems Command, with appropriate higher

approval, had already released \$5 million in prior progress payment retentions to the contractor. Accordingly, the project officer recommended and the contracting officer withheld the \$9.5 million. At the time of our review, the contractor had generally completed work and corrected deficiencies identified at the time of conditional acceptance.

Joint Tactical Unmanned Aerial Vehicle Program - Hunter System

The Hunter Unmanned Aerial Vehicle (UAV) is a small, fixed-wing aircraft piloted remotely from a ground control station. The Hunter system, a part of the Joint Tactical UAV program, began in 1989 as a joint service effort to provide short-range UAVs for use by the Army, the Navy, and the Marine Corps. The Hunter system contract is administered by NAVAIR. In February 1993, this command exercised contract options with TRW, Incorporated, for the low-rate initial production of seven Hunter systems. In January 1996, DOD decided to end the Hunter Program at the end of the low-rate initial production contract.

Between April and August 1995, the government conditionally accepted five Hunter systems, and it has since accepted, on an incremental basis, the remaining two systems. The cumulative billing price for the five complete systems was about \$128.5 million. From this, the government withheld about \$1.6 million for missing parts, nonconforming items, and other incomplete work.

Although the contracting officer withheld payment for the above noted work, he did not withhold for other deficiencies. The contracting officer had issued 34 separate contractual waivers to prevent acceptance delays because the systems did not conform to contract specifications. Six of these waivers were temporary in nature and were approved on the condition that corrective action would be taken after delivery. These waivers involved hardware and software problems, subcontractor workmanship deficiencies, and incomplete work.

The contracting officer did not withhold from the billing price the estimated cost to correct these deficiencies because program officials believed that the contractor was committed to correcting the deficiencies. However, not withholding funds based on the belief that the contractor will perform requires the government to assume a major risk in the event of nonperformance and is not consistent with a policy that requires paying only for completed work. Because the system had been terminated, we were unable to readily determine the status of the unfinished work. In commenting on a draft of this report, DOD stated that the contractor has

since corrected the six deficiencies and the government has accepted, on a final basis, all of the systems.

Conclusion and Recommendations

When the government chooses to conditionally accept nonconforming items, the FAR, the DFARS, and supplementary service regulations do not require that an amount sufficient to cover the remaining work be withheld from the contract payment. As a result, the services' withholding practices are inconsistent and contractors are being paid for work not completed at the time of delivery.

We recommend that the Secretary of Defense amend the DFARS to require that, when conditionally accepting nonconforming items, amounts withheld be at least sufficient to cover the cost and related profit to correct deficiencies and complete other unfinished work. If the contracting officer determines that withholding a lesser amount is in the best interests of the government, such a determination should be properly documented and justified in the contract files.

Agency Comments and Our Evaluation

DOD generally concurred with the report's findings, however, it only partially concurred with our recommendation. DOD agreed that the DFARS should be changed to include a requirement that when conditionally accepting nonconforming items, amounts to be withheld should at least cover the cost and related profit to correct deficiencies and complete unfinished work. DOD did not agree that the contracting officer should be required to obtain higher level approval before deviating from this general policy. DOD's comments are reprinted in appendix I. Technical comments have been addressed in the report as appropriate.

While we continue to believe that certain safeguards would help ensure adherence to the policy of only paying for work that is completed, revising the DFARS to specifically include the requirement is a good first step toward achieving this goal. DOD assumes that departure from the prescribed standard would be rare. We do not have information on a sufficient number of programs to address DOD's assumption. Accordingly, we have modified our recommendation to delete the requirement for higher level approval of decisions to depart from the prescribed standard. We continue to believe, however, that requiring such departures to be justified and documented in the contract file will facilitate further oversight of this issue as needed.

Scope and Methodology

We reviewed the FAR, the DFARS, and supplementary service regulations regarding conditional acceptance of nonconforming items. We also spoke with the DOD Director of Defense Procurement and with acquisition and contracting officials from the Departments of the Air Force, the Army, and the Navy and the Defense Logistics Agency located in Washington, D.C., to determine their policies and procedures for accepting temporarily nonconforming items.

We selected four acquisition programs that had entered low- or full-rate production to obtain coverage of Air Force, Army, Navy, and joint service programs. In addition, our selections were based on the size of the programs and the availability of documentation on the acceptance process. We reviewed contract files, billing and delivery documentation, and cost data. To gain an understanding of how conditional acceptance was implemented in each of the services, we interviewed contracting and procuring officials with the (1) C-17 program office in Dayton, Ohio; (2) FMTV program office located at the Army's Tank-Automotive and Armaments Command in Warren Michigan; (3) Supervisor of Shipbuilding and Conversion in San Diego, California; and (4) Joint Tactical UAV project office at Redstone Arsenal, Alabama. We also discussed management of the various contracts with contracting personnel at the DCMC offices located at the Boeing Company in Long Beach, California; TRW Avionics and Surveillance Group in San Diego, California; and Stewart and Stevenson Services, Inc., in Sealy, Texas.

Because we confined our review to defense programs, we have limited our recommendation to the DFARS. However, we will provide copies of this report to the FAR Council, the group responsible for approving changes to the FAR, for their consideration.

Please contact me at (202) 512-4841 if you or your staff have any questions concerning this report. Major contributors to this report are listed in appendix II.

Sincerely yours,

A handwritten signature in black ink, reading "Louis J. Rodrigues". The signature is written in a cursive style with a large, looping initial "L".

Louis J. Rodrigues
Director, Defense Acquisitions Issues

Comments From the Department of Defense



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NOV 20, 1997

DP/DSPS

Mr. Louis J. Rodrigues
Director, Defense Acquisition Issues
National Security and International
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U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Rodrigues:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report, "DEFENSE ACQUISITION: Guidance is Needed on Payments for Conditionally Accepted Items," dated October 21, 1997 (GAO Code 707227/OSD Case 1479). The DoD generally concurs with the report's findings.

The DoD partially concurs with the GAO recommendation. The Department concurs that the DoD Federal Acquisition Regulation Supplement (DFARS) should include a requirement that, when conditionally accepting nonconforming items, amounts withheld should generally be at least sufficient to cover the cost and related profit to correct deficiencies and complete other unfinished work, and that the basis for withholds should be appropriately documented in the contract file. However, we prefer to implement this requirement with the assumption that contracting officers will make sound business decisions, departing from this general policy rarely and only for good reasons. Therefore, we do not consider it necessary to make contracting officers obtain higher-level approval before deviating from the general policy. The nature of the decision involved here is comparable to the decision to reduce or suspend progress payments in accordance with FAR 32.503-6, which the contracting officer is empowered to make without obtaining higher level approval.

Technical corrections were provided separately. The Department appreciates the opportunity to comment on the draft report.

Sincerely,

A handwritten signature in cursive script, reading "Eleanor R. Spector".

Eleanor R. Spector
Director, Defense Procurement



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