

May 10, 2005



Financial Management

Report on Recording and Accounting for DoD Contract Financing Payments (D-2005-062)

Department of Defense
Office of the Inspector General

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Article I, Section 9

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Acronyms

ACO	Administrative Contracting Office
DCMA	Defense Contract Management Agency
DFARS	Defense Federal Acquisition Regulation Supplement
DFAS	Defense Finance and Accounting Service
DLA	Defense Logistics Agency
EDA	Electronic Data Access
FAR	Federal Acquisition Regulation
FMR	Financial Management Regulation
DoD IG	Department of Defense Inspector General
MOCAS	Mechanization of Contract Administration Service
OMB	Office of Management and Budget
PP&E	Property, Plant, and Equipment
SFFAS	Statement of Federal Financial Accounting Standard
USD(C/CFO)	Under Secretary of Defense (Comptroller)/Chief Financial Officer
WIP	Work-in-Process



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May 10, 2005

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE
(COMPTROLLER)/CHIEF FINANCIAL OFFICER
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MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL
MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE AIR FORCE
(FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE

SUBJECT: Report on Recording and Accounting for DoD Contract Financing Payments
(Report No. D-2005-062)

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

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer comments were not responsive. We request additional comments on Recommendations 1 and 2. We request that the Deputy Chief Financial Officer provide comments on Recommendations 1 and 2 by June 10, 2005

If possible, please send management comments in electronic format (Adobe Acrobat file only) to Audcolu@dodig.osd.mil. Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the / Signed / symbol in place of the actual signature. If you arrange to send classified comments electronically, they must be sent over the SECRET Internet Protocol Router Network (SIPRNET).

We appreciate the courtesies extended to the staff. Questions should be directed to Mr. James L. Kornides at (614) 751-1400 ext. 211 or Mr. Mark Starinsky at (614) 751-1400 ext. 231. The team members are listed inside the back cover. See Appendix C for the report distribution.

By direction of the Deputy Inspector General for Auditing:

A handwritten signature in black ink, appearing to read "Paul J. Granetto", with a horizontal line extending to the right.

Paul J. Granetto, CPA
Assistant Inspector General
Defense Financial Auditing
Service

Department of Defense Office of the Inspector General

Report No. D-2005-062

(Project No. D2004FJ-0126)

May 10, 2005

Recording and Accounting for DoD Contract Financing Payments

Executive Summary

Who Should Read This Report and Why? DoD civilian and military personnel who are responsible for compiling and presenting contract financing payments on DoD financial statements. The report discusses the current recording and accounting for contract financing payments.

Background. Contract financing is an authorized Government payment to a contractor prior to delivery of supplies or services to the Government. DoD reported \$18.9 billion of outstanding contract financing payments in the Other Assets section and \$27.9 billion of Accounts Payable on the FY 2003 Balance Sheet.

Results. DoD reported \$18.9 billion of contract financing payments in the DoD Financial Statements, but did not properly record the payments in the Balance Sheet. DoD recorded the contract financing payments as Outstanding Contract Financing Amounts in the Other Assets account on the Balance Sheet. However, Federal accounting standards require that the contract financing payments be recorded in an asset in process account such as Construction Work in Process or Inventory Work in Process. Additionally, DoD did not report an estimated \$3.6 billion of costs incurred by the contractors, which were not yet paid by the Government and will not be until the completed asset is delivered. Overall, the Other Assets account was overstated by \$18.9 billion and in-process assets (such as Construction Work in Process and Inventory Work in Process) were understated by about \$22.5 billion on the FY 2003 Consolidated Balance Sheet. Additionally, the liabilities on the Balance Sheet were understated by about \$3.6 billion. The Under Secretary of Defense (Comptroller)/Chief Financial Officer needs to issue procedures that would ensure that the presentation of contract financing payments on the Balance Sheet is in accordance with Federal accounting standards. (See the Finding section of the report for the detailed recommendations.)

We also reviewed the management control program as it related to presentation of contract financing payments.

Management Comments and Audit Response. The Deputy Chief Financial Officer, Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer nonconcurred with the recommendations. She stated that DoD accounting practices and the DoD Financial Management Regulation policies for recording and accounting for contract financing payments are compliant with Federal Accounting Standards, and accurately reflect the legal and financial status of DoD.

She stated that the audit erroneously equates the accounting policies and the DoD Financial Management Regulation related to progress payments under fixed-price

construction contracts with contract financing payments. She added that the Federal Acquisition Regulation states that payments made under fixed-price construction contracts are not financing payments and the failure of the DoD OIG to recognize the legal distinction results in a misinterpretation and misapplication of Federal acquisition regulations, Federal accounting standards, and DoD financial management regulations. She stated that classifying contract financing payments under Other Assets, with full disclosure in the footnotes as to their nature, provides relevant and reliable information to decision makers and financial statement users and is fully compliant with Federal Accounting Standards.

The Deputy General Counsel (Acquisition and Logistics) stated that the title to the property paid for by the Progress Payment passes to the Government at the time of the payment. He also stated that the audit erroneously appears to equate progress payments with partial acceptance of the contracted end item. He added that whether progress payment inventory is booked as Work-In-Process or as Other assets is a matter of accounting policy. He stated that booking unpaid progress payments as a liability before final delivery and acceptance does not accurately reflect either the legal status of the Government's contractual obligation or the Department's financial status, and there is no liability to pay until delivery and acceptance is made.

We disagree with the comments from the Deputy Chief Financial Officer. We did not focus on the accounting for fixed-price construction contracts or equate them with contract financing payments. When we examined the types of assets purchased with contract financing payments, the associated documentation showed that the items more appropriately fit the category of Construction Work-in-Process (for Property, Plant, and Equipment being manufactured) or Inventory Work-in-Process (for inventory being acquired). It remains our opinion that because the title passes to the Department when the contract financing payments are made, DoD should present the Property, Plant, and Equipment and Inventory-related items as such in the financial statements. We also disagree with the Deputy General Counsel's comment that there is no liability to pay the amount retained by the contracting officer at the time of the progress payment until delivery and acceptance. Statement of Federal Accounting Standard No. 5, "Accounting for the Liabilities of the Federal Government," provides three criteria needed to account for a liability on the financial statements: that an accounting event has occurred, that the event results in a future payment, and that the payment is measurable and probable. In our opinion, the payment of the progress payment is an accounting event that creates a future outflow that is measurable and probable.

The Deputy Chief Financial Officer (Comptroller) stated, in her comments on the report that the issues identified in the report have remained unresolved for some time. We agree. We request that the Deputy Chief Financial Officer (Comptroller) reconsider her position and provide additional comments by June 10, 2005. In the interim, we plan to concurrently elevate this issue to the Federal Accounting Standards Advisory Board. See the Finding section for a summary of the management comments and the Management Comments section for the complete text of those comments.

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Background

Contract financing is an authorized Government disbursement of monies to a contractor prior to delivery of supplies or services to the Government. Federal Acquisition Regulation (FAR) 32.503-5, “Administration of Progress Payments,” requires that contract financing be supported by the fair value of the work accomplished by the contractor.

According to the Defense Financial Acquisition Regulation Supplement (DFARS) Part 32.001, “Definitions,” contract financing payments are authorized Government disbursements of monies to a contractor prior to acceptance of supplies or services by the Government. In its financial statements, DoD reported three types of contract financing payments: performance-based payments, progress-based payments, and commercial financing interim payments.

Performance-based payments. Performance-based payments are contract financing payments made on the basis of performance measured by objective, quantifiable methods; accomplishment of defined events; or other quantifiable measures of results.

Progress-based payments. Progress-based payments are contract financing payments made on the basis of the contractor cost or percentage of completion accomplished. DFARS 232.501-1, “Customary Progress Payment Rates,” designates a customary DoD progress payment rate of 80 percent of a contractor’s cumulative allowable costs. Contractors provide cost data through progress payment invoices that summarize the total allowable costs incurred on a contract as of a specified date. The FAR states that progress payments may include reasonable and applicable costs consistent with generally accepted accounting principles and payments that have been made to subcontractors or suppliers or both by some form of payment. Progress payments may not include incurred costs by subcontractors or suppliers or costs that would otherwise be capitalized. As goods and services are provided, progress payments are liquidated, or recouped, based on the progress payment rate established in the contract. When progress payments are recouped, DoD pays the remaining amount owed minus the prior progress payments.

Commercial financing interim payments. Commercial financing interim payments are contract financing payments made under the following circumstances: the contract item financed is a commercial supply or service; the contract price exceeds the simplified acquisition threshold; and the contracting officer determines that it is appropriate or customary in the commercial marketplace to make financing payments for the item.

FY 2003 DoD Balance Sheet. As of September 30, 2003, DoD reported \$18.9 billion in outstanding contract financing payments in the Other Assets section of the Balance Sheet. In addition, DoD reported \$27.9 billion of Accounts Payable.

Amount of Contract Financing in FY 2004. The Defense Contract Management Agency (DCMA) was primarily responsible for administering and approving contract financing payments on DoD contracts, and the Defense Finance and Accounting Service (DFAS) was responsible for payment. In the first 6 months of FY 2004, the DFAS Columbus Center disbursed about \$12.6 billion in progress payments, performance-based payments, and commercial financing interim payments to Defense contractors, \$11.4 billion of which was for non-foreign military sales.

Objectives

The primary objective of our audit was to determine whether policy and procedures were in place to properly record and account for contract financing payments. See Appendix A for a discussion of the scope and methodology, our review of the management control program, and prior coverage related to the objectives.

Presentation of Contract Financing on the DoD Consolidated Balance Sheet

DoD was not following Federal accounting standards when recording transactions related to contract financing payments on the Consolidated Balance Sheet of the DoD Financial Statements. Specifically,

- DoD inappropriately recorded contract finance payments as Outstanding Contract Financing Amounts in the Other Assets account. DoD should have recorded the contract financing payments as an in-process account such as Construction Work-in-Process (WIP) and Inventory WIP; and
- DoD understated its Accrued Accounts Payable liability and the corresponding asset in process account. They were understated because DoD did not report an estimated amount of costs incurred by the contractor but not paid by the Government until the completed asset was delivered.

The misclassification of assets occurred because DoD policy to report contract financing did not comply with Federal accounting standards. The understatement of accounts payable and the related asset in process existed at least since 1998 because DoD did not implement policy to comply with Federal accounting standards. As a result, the Other Assets account was overstated by about \$18.9 billion and in-process assets (such as Construction WIP and Inventory WIP) were understated by about \$22.5 billion on the FY 2003 Consolidated Balance Sheet. Additionally, the liabilities on the Balance Sheet were understated by about \$3.6 billion. Unless corrected, future DoD Consolidated Balance Sheets will include the same misclassification of assets and understatement of assets and liabilities.

Prior DoD Coverage and DoD Position

Department of Defense Inspector General (DoD IG), DoD Report No. 98-139, "Financial Statement Presentation of DoD Progress Payments," May 27, 1998, and Report No. 98-022, "Reporting of Contract Holdbacks on the DoD Financial Statements," November 17, 1997, addressed presentation of contract financing payments on the DoD financial statements. Specifically, Report No. 98-139 concluded that the Military Departments and Defense Logistics Agency (DLA) materially misstated the \$29.6 billion of progress payments reported on the FY 1996 DoD financial statements. Report No. 98-002 reported that the Military Departments and DLA financial statements did not accurately report payment withheld from contractors in FY 1996 and the work associated with the payments. As a result, assets were understated by \$7.2 billion and liabilities were understated by \$4.9 billion on the FY 1996 financial statements of the Military Department General Fund and the DLA Defense Business Operations Fund.

At the time of those audits, the Under Secretary of Defense (Comptroller)/Chief Financial Officer (USD[C/CFO]) disagreed that contract finance payments represented assets in process and asserted that DoD does not incur a liability for contractor costs until the contractor delivers the item or service. The Office of the DoD Comptroller also stated that DoD should not recognize a liability for contractor costs because title does not pass to the Government until the final product is delivered. DoD also asserted that if the contractor does not deliver the product, the contractor would be liable to repay the Government for the progress payments made.

In lieu of the normal audit mediation process, the USD(C/CFO) and the Office of the DoD IG agreed to resolution by the Office of Federal Financial Management within the Office of Management and Budget (OMB). On October 2, 1998, the Deputy Controller within that office concluded that DoD should report progress payments for in-process accounts as assets in accordance with the position advocated by the DoD IG. See Appendix B for a copy of the OMB decision.

The USD(C/CFO) continued to disagree with the OMB Deputy Comptroller's decision and has not changed its accounting policy for presenting all of the necessary contracting financing transactions. Additionally, in the note to the FY 2003 Financial Statements, the Navy discloses that it believes that Statement of Federal Financial Accounting Standard (SFFAS) No. 1, "Accounting for Selected Assets and Liabilities," March 30, 1993, does not adequately address contract financing payments. We disagree that SFFAS No. 1 is not adequate guidance for DoD to record and present contract financing transactions.

SFFAS No. 1 states that Accounts Payable are set up to record an entity's liability for goods and services received or work in process made by a contractor for which payment has not been made.

Accounting for Contract Financing Payments

Presentation of Contract Financing Payments. At the end of FY 2003, DoD reported \$18.9 billion of contract financing payments in the Other Assets section of the Consolidated Balance Sheet. Table 1 shows contract financing amounts reported by Military Departments in FY 2003.

Military Departments	Amount (millions)	Reported Asset Account
Army General Fund	\$3,163.7	Other Assets
Army Working Capital Fund	\$250.1	Other Assets
Navy General Fund	\$5,809.6	Other Assets
Air Force General Fund	<u>\$9,645.3</u>	Other Assets
Total	\$18,868.7	

To determine whether the amounts shown were correct and were properly recorded and accounted for as other assets, we judgmentally sampled 39 contract financing payments totaling \$1.4 billion made from October 1, 2003, through March 31, 2004.

Information in the contract files showed that 36 of the 39 contract financing payments funded assets that meet the definition of Property, Plant, and Equipment (PP&E) or Inventory and should have been recorded in the Construction WIP or Inventory WIP account.

The definition of PP&E is set forth in SFFAS No. 6, "Accounting for Property, Plant, and Equipment," June 1996. The standard defines PP&E as tangible assets that have an estimated useful life of 2 or more years, are not intended for sale in the ordinary course of business, and are intended to be used or available for use by the entity. SFFAS No. 6 states that in the case of constructed PP&E, the PP&E shall be recorded as Construction WIP until it is placed in service.

SFFAS No. 3, "Accounting for Inventory and Related Property," October 27, 1993, defines inventory as tangible personal property that is held for sale, in the process of production for sale, or to be consumed in the production of goods for sale or in the provision of services for a fee.

Although not specifically stated in SFFAS No. 3, inventory in the process of production for sale is considered WIP by the U.S. Standard General Ledger.

The majority of the contract financing payments we sampled were used for items that met the above definitions of PP&E or inventory. These financing payments were used for the construction of military items such as the F-18 Hornet attack aircraft, the F-22 Raptor fighter, the C-17 Globemaster III cargo aircraft, and the AV-8B Harrier attack aircraft. Other items such as smart bomb dispensers, antennas, missiles, aircraft engines, and a Doppler Navigation set were also procured using DoD financing payments.

Table 2 shows the types of items being purchased and the proper category of those purchases according to Federal accounting standards. The 39 sample items disbursed from October 1, 2003, to March 31, 2004, included both working capital funds and general funds. The portions of the sample items paid out of working capital funds would most likely be classified as Inventory WIP and those paid out of the general funds would most likely be classified as Construction WIP. For three sample items, sufficient information was not available to determine whether the purchase was for PP&E or inventory. All of the contract documentation was not readily available at DFAS Columbus or through on-line scanned copies of the contracts. The contract data that were readily available for two of the three sample items indicated that the contract deliverables were Launching Canisters, Active Optical Target Detector, guide-frame spares, and an avionics test set. The available scanned contract documents lacked the detail needed to determine the asset account in which these items should be reported.

Table 2. Classification of Contract Financing Sample Items

Sample No.	Contract No.	Final Purchase	Probable Categorization
1	N0001999C1226	Aircraft	Construction WIP
2	N0002402C5410	Insufficient Information Available	Insufficient Information Available
3	N0002402C5103	Antenna and Airborne System	Construction WIP
4	N0002402C5410	Insufficient Information Available	Insufficient Information Available
5	N0002402C5312	Missiles	Construction WIP
6	N6893601D0008004	Antenna System	Construction WIP
7	N6833599C0167	Ammunition Loader	Construction WIP
8	N6833598C0216	Test and Support System	Construction WIP
9	N6833503C0074	Aircraft	Construction/Inventory WIP *
10	N6833502G31170001	Kit Development	Insufficient Information Available
11	F3365702C0010	Aircraft	Construction WIP
12	F0863501C0027	Missiles	Construction WIP
13	F1962803C0045	Replace ADP Systems	Construction WIP
14	F3365797D00120016	Missiles	Construction WIP
15	F3365702G40110003	Cheyenne Sensor Upgrade	Construction WIP
16	F3365796C2059	Aircraft	Construction WIP
17	F3365701C2095	Aircraft	Construction WIP
18	F3365702C2001	Aircraft	Construction WIP
19	F0863503C0022	Aircraft	Construction WIP
20	F3365701C1240	Engines	Construction WIP
21	F0470198D00010034	Missiles	Construction WIP
22	F3365703C2014	Aircraft	Construction WIP
23	F3365701C0022	JPATS T-6A	Construction WIP
24	F3365700D00230024	Aircraft	Construction WIP
25	F3365702C0006	Engines	Construction WIP
26	DAAH2300C0001	Aircrafts	Construction WIP
27	DAAH2303C0164	Aircrafts	Construction WIP
28	DAAB0702CB213	Helicopter Warning System	Construction WIP
29	DAAH0101C0034	TAIS Hardware	Construction WIP
30	DAAH2303C0164	Night Vision Sensors	Construction WIP
31	DAAH0101C0006	Helicopter	Construction WIP
32	DAAH2302D03140001	Aircraft Supplies	Inventory WIP
33	DAAH2301C0280	Supplies and Transmissions	Inventory WIP
34	DAAH2301D00890004	Helicopter Upgrades	Construction WIP
35	DAAH2302D03210001	MILSTRIP Item	Inventory WIP
36	DAAB0700CJ012	Doppler Navigation Set	Construction/Inventory WIP *
37	DAAH2301D00480005	Aircraft	Construction WIP
38	DAAH2301D00480003	Aircraft	Construction WIP
39	DAAH2301D00480003	Aircraft	Construction WIP

*These sample items included both working capital funds and general funds. The portions of the sample paid out of working capital funds would most likely be classified as Inventory WIP and those paid out of the general funds would most likely be classified as Construction WIP.

Presentation of Accounts Payable and Assets in Process Related to Progress

Payments. In addition to recording these items incorrectly, the DoD has understated its accrued accounts payable liability by not reporting an estimated amount of costs incurred by the contractor that remain unpaid until the completed asset is delivered. DoD should have recorded an accounts payable for the unpaid contractor costs because they represent future and probable cash outlays owed to Defense contractors for unpaid costs on DoD contracts.

Additionally, the progress in the work made toward an end item for which the funds were withheld was not disclosed as an asset in the accounting records or financial statements. DoD did not recognize as in-process assets the amount of progress made on the contract end item that was not paid by the progress payment.

The FAR Part 32.501-1, "Progress Payment Rates," allows administrative contracting officers to approve up to 80 percent of a contractor's cumulative costs for progress payments. The remaining 20 percent is paid when the item is delivered.

DFAS Columbus contract payment history files contained detailed records on progress payment balances by contract. Based on DFAS records of all available contracts with progress payment balances and corresponding progress payment rates, we calculated that as of September 30, 2004, about \$3.6 billion of unpaid measurable contractor costs existed.

The DFAS personnel responsible for compiling the Military Departments accounts payable balances for FY 2003 stated that the reported balances did not include any amounts for unpaid contractor costs associated with progress billings. The DFAS personnel were not aware of any policy to include these amounts.

DoD should have recognized \$3.6 billion in a corresponding asset in process for the work performed by its contractors that were not paid for by the progress payments. See Appendix A for the methodology used to calculate the estimated \$3.6 billion liability and associated asset in-process accounts that DoD should have reported.

Adequacy of DoD Policy

The USD(C/CFO) had not implemented guidance in the DoD Financial Management Regulations (FMR) to report contract financing payments in accordance with Federal accounting standards. Additionally, the USD(C/CFO) had not implemented guidance to account for unpaid contractor work progress as a liability and the corresponding asset in progress. We believe the resistance to these changes in the past was unfounded and corrections to policy are needed.

DoD Guidance on Contract Financing Payments. DoD FMR volume 6B, chapter 10, "Notes to the Financial Statements," requires reporting entities to present contract financing payments as Other Assets on the Balance Sheet. This policy is not in accordance with Federal guidance, which requires Federal agencies to report these amounts in a Construction or Inventory WIP account. Therefore, DoD guidance on contract financing payments prevents DoD and the Military Departments from complying with the Federal accounting standards.

The DoD policy to present contract financing payments as Other Assets also does not meet the intent of SFFAS No. 3 or SFFAS No. 6 and needs to be changed. The Federal accounting standards require that in the case of constructed PP&E, the PP&E shall be recorded as Construction WIP. In addition, a mediation decision from the OMB Deputy Controller for Office of Federal Financial Management concluded that DoD policy should be changed. Of the 39 DoD contract financing payments that we reviewed, 36 represented production of DoD weapon system assets and should have been presented in accordance with Federal accounting standards and reported as an asset in process account. Specifically, DoD should implement a policy to require reporting entities to report contract financing payments as either Construction WIP or Inventory WIP.

DoD Accounting Policy for PP&E. The American Institute of Certified Public Accountants gives the Federal Accounting Standards Advisory Board the authority to set Federal generally accepted accounting standards. This is accomplished by the issuance of SFFAS. To provide more detailed instruction to DoD accounting personnel, DoD implements the SFFAS through its FMR. The DoD policy for presenting PP&E on the financial statements meets the intent of SFFAS No. 6 but conflicts with DoD FMR policy for presenting contract financing payments. DoD FMR volume 4, chapter 6, “Property, Plant, and Equipment,” August 2000, states that in the case of constructed General Assets, the cost to construct the asset shall be recorded as construction-in-progress until the asset is complete and available for use. This policy implements the requirements of SFFAS No. 6 but conflicts with DoD FMR volume 6B, chapter 10 policy that requires DoD reporting entities to present all contract financing as Other Assets.

Guidance on Reporting Unpaid Contractor Costs. SFFAS No. 5, “Accounting for Liabilities of the Federal Government,” September 1995, states that a liability is a recognized future outflow of resources that results when the event occurs if the future outflow of events is measurable and probable. It also defines Accounts Payable as amounts owed to other entities for goods and services received, progress in contract performance, and rents due.

DoD has not established implementing policy that would ensure compliance with the Federal requirements to report all known liabilities. DoD does not have adequate guidance to report the liability and corresponding asset account for all of the known progress and associated costs its contractors have incurred related to the production of DoD assets. Progress billings represent contractor progress toward performance because the cost data provided by the contractor provides a means of measuring paid and unpaid progress. In contrast, the FMR volume 6B, chapter 10 policy states that DoD is not liable for goods until the contractor delivers a satisfactory product. We consider this assertion to be rooted in cash accounting and not in accordance with accrual accounting requirements.

The FMR further asserts that if the contractor does not deliver a satisfactory product, DoD is not obligated to reimburse the contractor for its costs and the contractor is liable to repay DoD for the full amount of any contract financing provided. Although we agree that DoD should require its contractors to deliver satisfactory products, it is probable (more likely than not) that, in the ordinary course of business, DoD will fully pay the remaining costs incurred by the contractor. We believe that payment is probable because Federal regulations require the administrative contracting officer to monitor the contractor’s use of the contract financing provided and the contractor’s financial status. In addition, for every progress payment, a contracting officer must certify that in the

ordinary course of business, the work reflected has been performed; quantities and amounts involved are consistent with the requirements of the contract; and that there are no encumbrances against the property which would affect or impair the Government's title.

In addition, a liability exists because the likelihood of contractor default or contract termination is more the exception than the rule. For example, DFAS contract payment records on contract termination for the first 6 months of FY 2004 indicated that of the 4,172 contracts that had contract financing associated with them, only 5 had any related termination transactions. This evidence supports our conclusion that payment of the remaining contractor costs associated with contract financing is at least probable. Therefore, it is appropriate for DoD to report a liability for costs that have been incurred and provided to DoD on the progress payment invoices.

Other Support for Recording Contract Financing as In-Process Assets. The FAR provides that title vests to the Government when property is or should have been allocable or properly chargeable to this contract. Property includes parts, materials, inventories, and work in process. In addition, the SFFAS definition of PP&E states that a reporting entity should record an asset when title passes to the entity. Although we recognize that DoD ultimately has the legal prerogative to demand that the contractor return the contract financing provided, such a perspective for presenting contract financing payments would not be representative normal contract execution within DoD.

Compliance with SFFAS No. 5. USD(C/CFO) personnel indicated that there are contracts awarded by DoD where the contractor does not request financing and the Department does not, in those cases, record the entire amount of the contract as a liability. We did not obtain information on those contracts. However, in those types of contracts title does not pass to the Government until payment is made and the completed product is delivered. When financing payments are made title passes to the Government for the items produced using the financing.

The submission of the incurred costs by the contractor in a progress payment request and the subsequent payment of the allowable portion of the costs (according to the progress payment rate) results in a measurable liability to DoD. This is an accounting event because title of all the costs incurred has passed to the Government, and a Government agent has certified that work progress is in accordance with the contract, which leads to the probable and measurable amount that will be paid. In contrast, according to USD(C/CFO) personnel, some DoD contracts do not provide progress payments for weapon system production costs. In these contracts, a contractor has not received contract financing but has incurred costs, title has not passed, a Government agent has not certified that the contractor is performing the work in accordance with the contract, and DoD has no knowledge of the costs incurred. Therefore, any costs incurred on contracts without financing payments do not represent a liability because the eventual payment is not as probable, and is not measurable for DoD.

Effect on Financial Statement

The misclassification and underreporting by DoD of contract financing payments and the unpaid contractor work progress will result in under and overstatements of asset and

liability accounts. Specifically, the Other Assets account was overstated by about \$18.9 billion and in-process assets (such as Construction WIP and Inventory WIP) were understated by at least \$22.5 billion on the FY 2003 Consolidated Balance Sheet. Additionally, the liabilities on the Balance Sheet were understated by about \$3.6 billion. Without needed improvements, future DoD Consolidated Balances will include the same misclassification of assets, understatement of assets and liabilities, and noncompliance with Federal accounting standards for presenting assets and liabilities.

Recommendations, Management Comments, and Audit Response

We recommend that the Office of the Secretary of Defense (Comptroller)/Chief Financial Officer:

1. Revise the DoD Federal Management Regulation to require the Military Departments to record and account for contract financing for Property, Plant, and Equipment and inventory purchases as construction work in process and inventory work in process, respectively.

Management Comments. The Deputy Chief Financial Officer (Comptroller) nonconcurrent with the recommendation and stated that DoD contract financing policy is compliant with Federal Accounting Standards and reflects the legal and financial status of the Department. The Deputy Chief Financial Officer stated that the audit results erroneously equate the accounting practices and DoD Financial Management Regulation policies that relate to fixed-price construction contracts with contract financing payments.

She stated that DoD properly records property obtained through fixed-price construction contracts as Construction WIP. The Deputy CFO also stated that when such assets are placed into service, the balance is transferred to PP&E. She disagreed that contract financing payments should be classified as Construction WIP or Inventory WIP. The Deputy CFO stated that contract financing payments do not meet the Federal Accounting Standard definitions of PP&E.

The Deputy CFO also stated that SFFAS No. 6 allows the Department to recognize PP&E when the title passes to the entity or when PP&E is delivered to the entity. Accordingly, she stated that if contract financing payments were determined to fall under the SFFAS definitions of PP&E or Inventory, the DoD practice of recognizing the assets upon delivery is compliant with Federal Accounting Standards.

Audit Response. Management comments are not responsive. We disagree that the current DoD contract financing accounting policy accurately reflects the legal and financial status of the Department. The audit shows that DoD contract financing payments are funding the production of PP&E and Inventory type assets. SFFAS No. 6 states that in the case of constructed PP&E, the PP&E shall be recorded as Construction WIP until it is placed in service. DoD policy should require that these assets be presented in the appropriate financial statement account and not elsewhere on the financial statements.

We disagree that DoD should have different accounting policies for fixed-price construction contracts versus other fixed-price contracts with financing payments. SFFAS No. 6 makes no such distinction. In both types of contracts, the title of the asset in process passes to DoD upon payment. In both types of contracts, DoD is funding the production of assets that will be recorded as PP&E. The substance of the transactions is essentially the same. DoD is providing the contractor funding for the purchase of identifiable in-process assets.

We agree with the Deputy CFO's interpretation of SFFAS No. 6 regarding recording PP&E either when title passes or upon delivery of the item. However, adopting a policy of recording contract financing related PP&E upon delivery would be inconsistent with the DoD accounting policy for reporting fixed-price construction contracts. DoD FMR requires that construction contracts be reported as PP&E Construction in Process. Such a change to DoD accounting policy would be much less representative of the financial status of DoD PP&E. We request that the Deputy reconsider her comments and provide additional comments on the final report.

2. Revise the DoD Federal Management Regulation to require DoD and the Military Departments to record and account for unpaid contractor work in progress amounts associated with progress payments as a liability and corresponding asset in progress.

Management Comments. The Deputy CFO nonconcurred with the recommendation and stated that DoD policy is compliant with SFFAS No. 1 "Accounting for Selected Assets and Liabilities," and SFFAS No.5 "Accounting for Liabilities of the Federal Government." The Deputy CFO stated that SFFAS No.1 addresses only those selected liabilities that routinely recur in a normal operation and are due within a fiscal year. She stated that SFFAS No. 5 is applicable and defines a liability as a probable future outflow of resources as a result of past transactions or events. She disagreed that a liability for unpaid contractor costs exists because the past transaction or event has not occurred. She defined the accounting event as either acceptance or delivery of the goods or services.

The Deputy CFO also stated that the Government's liability to pay for a product arises only when the product is delivered by the contractor and the Government determines that the product meets contract requirements and accepts the product. She stated that recognizing unpaid contract financing payments as a liability before final delivery and acceptance would not accurately reflect the legal status of the Government's contractual obligation, the Department's financial status, or compliance with Federal accounting standards.

Audit Response. Management comments are not responsive. We agree that the disclosure requirements of SFFAS No. 1 relate to liabilities resulting from normal operations and that those liabilities are due for payment within a fiscal year. Unpaid contractor costs related to contract financing payments meet the requirements of this standard. However, DoD has not established policy to record an Accounts Payable for any amounts associated with unpaid contractor progress. In the case of contract financing payments, we disagree that the accounting event for recording a liability for unpaid costs occurs upon acceptance or delivery of the

product. According to SFFAS No. 5, a liability can exist if the accounting event has occurred and the future outflow of resources is probable and measurable. In the case of contract financing, an accounting event has occurred prior to delivery and acceptance because the title to the assets has passed to the Government, and a Government agent has certified that work progress is in accordance with the contract, and an amount to be paid is probable and measurable.

In instances such as contract financing, the accounting criteria for disclosing a liability is different than the circumstances that establish a legal liability to make a payment to a contractor. The DoD Office of General Council stated that a liability to pay only exists upon delivery and acceptance. However, a reporting entity should disclose that a financial liability exists prior to that time. The standards for making the conclusion are based on different criteria. For financial reporting purposes, DoD is required to disclose a liability for the unpaid contractor costs for which DoD has accepted title, as required by SFFAS No. 1.

We disagree that the current DoD contract financing accounting policy accurately reflects the legal status of the assets for which DoD has taken title. According to the DoD Office of General Counsel clarification memorandum provided, DoD takes title to the full value of the contractor work when a contract financing payment is made. Therefore, the current policy of valuing the contractor progress at the amount paid (versus the amount of the contractor costs), does not reflect the financial or legal status of the DoD assets. We request that the Director reconsider her comments and provide additional comments on the final report.

Appendix A. Scope and Methodology

We reviewed Federal and DoD accounting policy related to the presentation of contract financing payments on the financial statements, including related policy for presenting assets and liabilities. We also determined whether DoD adequately implemented U.S. generally accepted accounting principles as they relate to contract financing payments.

We reviewed the FY 2003 DoD Consolidated and the Military Departments financial statements to determine the accounts used to present contract financing payments. We obtained an understanding of the accounting processes used by the DFAS to pay, process, post, summarize, and present contract financing payments on the financial statements. The Military Departments reported \$18.9 billion in contract financing payments as Other Assets on the FY 2003 Consolidated Balance Sheet.

To obtain our judgmental sample, we obtained all recorded contract financing payments and adjustments made by DFAS Columbus' Mechanization of Contract Administration Services (MOCAS) from October 2003 through March 2004. The DFAS payments records included fields such as Accounting Classification Reference Number, transaction type (adjustment, collection, or disbursement), shipment number, amount, date, accounting station, and appropriation. We selected 39 high dollar value sample contract financing payments with shipment numbers starting with PBP (for performance-based payment), PPR (for progress payment), and CFI (for commercial finance interim).

We obtained access to the Electronic Data Management system at DFAS Columbus to review scanned contracts and electronically-generated entitlement information to determine what Contract Line Item Numbers and Accounting Classification Reference Numbers were associated with each judgmental sample item. We obtained access to and searched the Electronic Data Access (EDA) system to determine the type of asset that each contract payment was financing. For contracts in which the EDA lacked sufficient contract information, we contacted the Administrative Contracting Office (ACO) to inquire about the asset purchased. Based on ACO-provided information, we used auditor judgment to determine the asset classification of these sample items (Construction WIP, Inventory WIP, or Expense).

Calculation of Unpaid Contract Financing Accounts Payable and Related Asset Amount. To calculate the amount of unreported accounts payable and related asset in process, we relied on DFAS Columbus contract history data. DFAS provided progress payment disbursement history information as of September 30, 2003. DFAS was only able to provide progress payment rates for 3,357 of 4,096 contracts with outstanding progress payments amounts as of September 30, 2003. We calculated \$3.5 million of liability associated with these contracts. For the remaining 739 contracts, we used the FAR customary progress payment rate of 80 percent on the remaining contracts. Support for using the FAR rate comes from its similarity to the observed rate (84 percent) for the 3,357 contracts. We estimated \$0.1 million of liability associated with these contracts. To perform our calculation of estimated accounts payable and assets in

process, we calculated the estimated total contractor-billed amounts using progress payments paid to date and the corresponding progress payment rate. We reduced the estimated total contractor-billed amount by the progress payments made. The remaining amount represented the amount of accounts payable and associated contractor work progress that should have been reported in the DoD financial statements.

This financial audit was conducted from April 2004 through February 2005. The audit was made in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the IG, DoD. We included tests of management controls considered necessary.

We did not attempt to verify that the contract financing amounts reported by the Military Departments were accurate. The accuracy of reported contract financing amounts will be addressed in future DoD IG audit reports. We also did not verify the accuracy of the amounts provided to us by DFAS Columbus concerning the progress payment rates and outstanding amounts.

Use of Computer-Processed Data. We relied on computer-processed data from the MOCAS system to identify contract financing payments disbursed from October 1, 2003, through March 31, 2004. We also relied on MOCAS contract history data for progress payments and progress payment rates. Although we did not perform a formal reliability assessment of the computer-processed data, we determined that the contract number, shipping numbers, and disbursement amounts on the contracts and invoices selected for review generally agreed with the information in the computer-processed data. We did not find errors that would preclude use of the computer-processed data to meet the audit objectives or that would change the conclusions of this report.

Government Accountability Office High-Risk Area. The Government Accountability Office has identified several high-risk areas in DoD. This report provides coverage of the Defense Financial Management high-risk area.

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 the management controls of the Military Departments over the presentation of contract financing payments on the Balance Sheet. Specifically, we determined whether the Military Departments consistently reported contract financing payments, whether contract financing payments were properly classified on the financial statements, and whether all associated accounting entries were made. We also reviewed the adequacy of management's self-evaluation of those controls.

Adequacy of Management Controls. We identified a material management control weakness for the Office of the USD(C/CFO) as defined by DoD Instruction 5010.40. Office of the USD(C/CFO) management controls were not adequate to ensure that contract financing payments were presented in accordance with Federal accounting standards including associated accounts payable balances. Recommendations 1 and 2, if implemented, will correct the weakness. A copy of the report will be provided to the senior officials responsible for management controls in the Office of the USD(C/CFO).

Adequacy of Management's Self-Evaluation. The Office of the USD(C/CFO) has identified the preparation of audited financial statements as an assessable unit. The USD(C/CFO) issued accounting policy to improve the presentation of contract financing payments. However, the accounting policy did not correct the material management control weakness because it was not in accordance with Federal accounting standards.

Prior Coverage

During the last 5 years, the DoD IG issued two reports discussing presentation of contract financing payments on the DoD Consolidated Balance Sheet. Unrestricted DoD IG reports can be accessed at <http://www.dodig.osd.mil/audit/reports>.

DoD IG Report No. 98-139, "Financial Statement Presentation of DoD Progress Payments," May 27, 1998

DoD IG Report No. 98-022, "Reporting of Contract Holdbacks on the DoD Financial Statements," November 17, 1997

Appendix B. Office of Management and Budget Decision



CONTROLLER

OFFICE OF THE UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

MAY 22 1998

Mr. Norwood J. Jackson, Jr.
Deputy Controller
Office of Federal Financial Management
Office of Management and Budget
Washington, DC 20508

Dear Mr. Jackson:

In recent audit reports, the Office of the Inspector General (OIG), Department of Defense, has concluded that the Department did not recognize accurately in accounting records, or report accurately in financial statements, progress/finance payments for work performed by Defense contractors. The OIG also has stated that the work which has been completed but for which payments have not been made should be reported as a liability (contract holdbacks) in the accounting records and financial statements.

In our response to the OIG, my office agreed that progress payments based upon percentage-of-completion efforts should be recorded as work-in-process and that any associated holdback amounts should be recorded as liabilities. However, we do not agree that the same standards apply to fixed-price contracts on which the Department makes financing payments because the government generally is not liable for the goods being produced until the Department has accepted the goods.

Because we were unable to resolve this issue within the Department, the OIG and this office agreed to seek adjudication of the progress payment issue from an independent authority. An issue paper is enclosed highlighting the issues we consider pertinent to the dispute. The OIG has concurred in the submission of this matter to the OMB for resolution.

Request that your office resolve this matter by indicating your decision in the enclosure. I, and members of my staff, as well as the OIG, are available to discuss this matter in more detail if you desire.

My staff contact for this matter is Mr. Oscar G. Covell. He may be reached by e-mail: covello@ousdc.osd.mil or at (703) 697-6149.

Sincerely,


Nelson Toye
Deputy Chief Financial Officer

Enclosure

CONTRACT FINANCING AND RECORDING AMOUNTS WITHHELD FROM CONTRACTORS

Issue: How should the Department of Defense (DoD) recognize, in accounting records and for financial statement purposes, progress and financing payments as well as amounts not financed for costs incurred by Defense contractors?

BACKGROUND:

The Statement of Federal Financial Accounting Standards (SFFAS) No. 1, *Accounting for Selected Assets and Liabilities*, addresses advances and prepayments in a number of paragraphs. Paragraph 57 provides that "Advances are cash outlays made by a federal entity to its employees, contractors, grantees, or others to cover a part or all of the recipients' anticipated expenses or as advance payments for the cost of goods and services the entity acquires. Examples include travel advances disbursed to employees prior to business trips, and cash or other assets disbursed under a contract, grant, or cooperative agreement before services or goods are provided by the contractor or grantee."

Paragraph 58 of SFFAS No. 1 states that "Prepayments are payments made by a federal entity to cover certain periodic expenses before those expenses are incurred. Typical prepaid expenses are rents paid to a lessor at the beginning of a rental period. Progress payments made to a contractor based on a percentage of completion of the contract are not advances or prepayments."

Since SFFAS No. 1 was published in March 1993, the Office of the Under Secretary of Defense (Comptroller) (OUSD(C)) and the Office of the Inspector General (OIG), DoD, have disagreed on whether all types of financing payments made to contractors must be categorized as "work-in-process" or whether some financing payments may be properly treated as "advances and prepayments."

The Department makes two types of progress payments. One is for payments that are based upon percentage-of-completion efforts. Such payments are characterized by the Department's ownership of the portion of the efforts (work-in-process) that have been completed, as well as a potential liability. In this paper, these payments are referred to as "progress payments" by the OUSD(C). The other type of payment is based on costs incurred by a contractor. Such payments are characterized by a lack of ownership (by the Department) of the portion of any efforts completed by the contractor, and the absence of a liability. In this paper, these payments are referred to as "finance payments" by the OUSD(C).

The Department has issued guidance requiring that progress payments be reported as work-in-process and that finance payments be reported as advances and prepayments. (As indicated above, progress payments are a method of financing based upon a percentage-of-completion method cited in SFFAS No. 1, paragraph 58; while financing payments are not based on a percentage-of-completion method.) Some reporting entities within the Department, however, have interpreted SFFAS No. 1 to apply to all progress and finance payments and have thus reported all progress and finance payments in the "work-in-process" category.

Enclosure

The OIG has recommended that the Department seek assistance to clarify this matter. In addition, the OIG has recommended that the Department consistently apply financial information on progress/finance payments in the preparation of its financial statements. The Department agrees with both of these recommendations.

In addition to the matter of whether all finance payments should be reported as progress payments, the OIG has criticized the Department for failing to report a liability for the difference between the customary finance payment rate, normally 75 percent of the total cost of the contract, and the total amount of the contract. This difference typically is referred to as a contract holdback, although there is no reference to the phrase "contract holdback" in the Federal Acquisition Regulation (FAR)—which is the primary source of contract guidance for the acquisition community.

DISCUSSION:

Office of the Inspector General, DoD, position:

A. On Recognizing the Contract Liability. The government's liability should be recognized when incurred and not delayed until the contract item(s) is delivered. The government becomes aware of the costs incurred by the contractor based on the request for a progress payment. In SFFAS No. 1, the Federal Accounting Standard Advisory Board (FASAB) defines a liability as "a probable and measurable future outflow of resources arising from past transactions or events," and defines an accounts payable as "an amount owed for goods and services received from, progress in contract performance made by, and rents due to other entities." The FASAB further states that, for facilities and equipment constructed or manufactured by contractors, amounts recorded as payables should be based on an estimate of work completed under the contract.

The receipt of the progress payment request provides a sufficient estimate of work completed and requires a posting of a liability because it is highly probable that the Department will pay the remaining amount of the contractor cost and the amount is known and measurable. This amount should be reported in the financial statements with adequate explanation in the footnotes. The GUSD(C) position regarding the distinction between percentage-of-completion contracts and fixed-price contracts lacks merit based on the published federal accounting guidance for liabilities and accounts payable.

The applicable FASAB and FY 1996 DoD Form and Content guidance on liabilities and accounts payable require that the Department record a liability for known amounts owed to defense contractors for work progress made on a contract. As mentioned previously, the Department is provided knowledge of the progress and cost incurred through progress payment requests and currently has an automated mechanism for tracking these costs at the Defense Finance and Accounting Service-Columbus Center.

B. On Recognizing the Contract Holdback Liability. The DoD financial statements should include amounts for contract holdbacks as liabilities. Excluding contract holdback amounts related to fixed-price contracts would violate federal accounting policy and understate known liabilities to Defense contractors. The Department should have a policy for reporting accounts

payable that is consistent with other federal entities to facilitate consolidation of financial information for higher levels of reporting.

OUSD(Comptroller) Position:

A. **On Recognizing the Contract Liability.** The Department agrees that progress payments based upon percentage-of-completion efforts should be recorded as work-in-process and any associated contract holdback amounts should be recorded as liabilities. (Percentage-of-completion progress payments are applicable generally to military construction and shipbuilding contracts.) However, the Department does not agree that percentage-of-completion standards apply to fixed-price contracts on which the Department makes finance payments. The Department's position recognizes that the Department generally is not liable for goods being produced under a fixed-price contract until, and unless, the Department accepts the goods.

The SFFAS No. 1 addresses advances and prepayments in a number of paragraphs. It is clear that the SFFAS No. 1 specifically excludes progress payments based upon percentage-of-completion from the definition of advances and prepayments. However, as stated above, payments based upon percentage-of-completion represent only one type of payment that the Department is authorized to make.

Financing payments to the Department's contractors have long been used as a means of providing contract financing, before the delivery of goods, under fixed-price contracts. The government adopted the use of so-called "finance payments" in the 1950s. These payments were designed then, and are used now, to hold down the cost of programs. Many large, complex, DoD contracts take considerable time to complete. Under a commercial contract, the contractor would have to borrow money to finance the cash flow associated with fulfilling the contract. Since the government generally can borrow money more cheaply than a contractor, it was decided years ago that the Department would make periodic finance payments so that contractors could avoid borrowing money. (This approach, it was believed, would result in lower overall costs to the government because the higher costs of borrowing money that would be incurred by contractors would be passed along to the Department in higher prices.) Nevertheless, in order to protect the government's interest, the DoD pays contractors only 75 percent (90 percent for small businesses) of the costs incurred that otherwise would be eligible for finance payments. Since these payments are considered finance payments, and not work-in-process, contractors are not required to identify the specific work completed when finance payments are provided.

The Department strongly believes that finance payments, as described in the FAR, Part 32, do, in fact represent a type of advance or prepayment that is disbursed under a contract in advance of services or goods being provided by a contractor, as addressed in SFFAS No. 1, paragraph 57. Such finance payments are made before the delivery of goods specified in the contract and are liquidated from invoice billings submitted by the contractor following acceptance by the Department. Under the terms of these fixed-price contracts, the government generally is not liable for the goods being produced until they are accepted. Additionally, the costs incurred by the contractor are not used as a measure of the Department's liability. Rather, they are used to determine what a reasonable level of contract financing should be at the time a request for a

finance payment is submitted. Further, should the Department reject the contractor's product, the contractor would be expected to repay the entire amount of finance payments previously received.

B. On Recognizing the Contract Holdback Liability. The Department agrees that contract holdback amounts for progress payments that are based on percentage-of-completion efforts should be recorded as liabilities. However, the Department also believes that costs incurred by a contractor that exceed the amount of any finance payments made to a contractor should not be recorded as a liability. Such costs incurred by a contractor are not used as a measure of the Department's liability; rather they are used only to determine what a reasonable level of contract financing should be at the time the finance payment is made. The finance payment itself does not represent the settlement of a liability--the event that gives rise to a liability is the delivery and acceptance of the completed contract item. Accordingly, the amount of costs incurred by a contractor in excess of finance payments likewise is not a liability because the event required for the recognition of a liability (delivery and acceptance) under these contracts has not yet occurred.

RECOMMENDATION:

That OMB resolve this matter by addressing the requirement to record and report (1) the liability relative to progress payments based on percentage-of-completion contracts and any associated contract holdback amounts, and (2) the liability, if any, relative to finance payments on fixed-price contracts and any associated costs incurred by a contractor in excess of finance payments.

Pending resolution by the OMB, the Department will include guidance--in the "DoD Guidance for Form and Content of Agency Financial Statements"--that requires DoD organizations to report liabilities for percentages-of-completion progress payment billings, as well as, the associated liabilities for contract holdbacks; and report finance payments as advances and prepayments.

DECISION:

Alternative A: Finance payments should be reported in a manner identical to other progress payments. That is, finance payments should result in work-in-process; and costs incurred by a contractor that are in excess of finance payments should be reported by the Department as a liability. (This is the position advocated by the OIG, DoD.)

Approved:  12/2/98

Disapproved: _____

Alternative B: Finance payments under fixed price contracts should be reported as advances and prepayments. Costs incurred by a contractor, under fixed price contracts, that are in excess of finance payments should not be reported by the Department as a liability. (This is the position advocated by the Office of the Under Secretary of Defense (Comptroller).)

Approved: _____

Disapproved: _____

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)/Chief Financial Officer
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)
Director, Program Analysis and Evaluation

Department of the Army

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

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Assistant Secretary of the Navy (Manpower and Reserve Affairs)
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

Combatant Commands

Inspector General, U.S. Joint Forces Command

Other Defense Organizations

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

Non-Defense Federal Organization

Office of Management and Budget

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

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
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

Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer Comments



COMPTROLLER

OFFICE OF THE UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

APR 01 2005

MEMORANDUM FOR PROGRAM DIRECTOR, DEFENSE FINANCIAL AUDITING
SERVICE, OFFICE OF INSPECTOR GENERAL,
DEPARTMENT OF DEFENSE

SUBJECT: Draft Report entitled "Recording and Accounting for DoD Contract
Financing Payments," (Project No. D2004FJ-0126)


This is in response to subject draft report of February 1, 2005, provided to this
office for review and comment.

Upon review of the draft report, we do not concur with the Office of Inspector
General (OIG), Department of Defense (DoD) recommendations that the Department
revise the Department of Defense Financial Management Regulation (DoDFMR) to
require the military departments to record and account for contract financing payments
for property, plant and equipment, and inventory purchases as construction work in
process and inventory work in process, respectively, and to require the military
departments to record and account for unpaid contractor work in process amounts
associated with contract financing payments as a liability and corresponding asset in
progress.

We maintain that the Department's accounting practices and the DoDFMR
policies for contract financing payments are compliant with Federal Accounting
Standards, and accurately reflect the legal and financial status of the Department. Our
detailed response to the report findings and recommendations is outlined in
Attachment 1. We have also attached a copy of the legal opinion provided by the
Department's Office of General Counsel (OGC) (Attachment 2).

We recognize that the draft audit report contains issues that have remained
unresolved for some time. We appreciate the opportunity to respond to your draft audit
report and look forward to working with your staff to resolve these issues.

My point of contact is Mrs. Carol Phillips. She can be contacted by telephone at 703-693-6503 or e-mail at carol.phillips@osd.mil.


for Teresa McKay
Deputy Chief Financial Officer

Attachments:
As stated

cc:
OGC(F)
OGC(AT&L)

DRAFT REPORT DATED FEBRUARY 1, 2005
PROJECT NO. D2004FJ-0126

“Recording and Accounting for DoD Contract Financing Payments”

OIG AUDIT RECOMMENDATIONS

OIG RECOMMENDATION 1. The Office of the Inspector General (OIG), Department of Defense (DoD), recommends that the Under Secretary of Defense(Comptroller)/Chief Financial Officer (CFO) revise the Department of Defense Financial Management Regulation (DoDFMR) to require the military departments to record and account for contract financing for property, plant, and equipment and inventory purchases as construction work in process and inventory work in process, respectively.

OIG RECOMMENDATION 2. The OIG, DoD recommends that the OSD(C)/CFO revise the DoDFMR to require DoD and the military departments to record and account for unpaid contractor work in process amounts associated with progress payments as a liability and corresponding asset in process.

USD(C) RESPONSE

The Department does not concur with the OIG recommendations. The Department’s accounting practices and the DoDFMR policy for recording and accounting for contract financing payments are compliant with Federal Accounting Standards (FAS), and accurately reflect the legal and financial status of the Department.

The OIG draft report erroneously equates the accounting practices and DoDFMR policies related to payments made under fixed-price construction contracts with contract financing payments. Federal Acquisition Regulation (FAR) 32.001, which defines contract financing payments as an authorized disbursement of monies to a contractor prior to acceptance of supplies or services by the Government, specifically states that payments made under fixed-price construction contracts are not contract financing payments. We have attached a table that identifies the unique characteristics of these two different types of payments.

The confusion between the two types of payments may result from the common use of the term, “progress payments,” to refer to both types of payments; however, failure to recognize the legal distinction between payments made under

fixed-price construction contracts and contract financing payments results in a misinterpretation and misapplication of FAR, FAS, and DoDFMR policies.

To enhance understanding of the Department's accounting practices, our response separately addresses the accounting treatment and DoDFMR policies for payments made under fixed-price construction contracts and contract financing payments.

A. Payments Under Fixed-Price Construction Contracts. The Department's accounting principles and practices, and DoDFMR policy for payments made under fixed-price construction contracts are compliant with FAS.

As mandated in the Defense Federal Acquisition Regulations Supplement (DFARS), the Department uses Progress Payments Based on a Percentage of Completion only for construction of real property, shipbuilding, ship conversion, alteration, and repair. These payments are commensurate with work accomplished on construction of real property and are typically paid in full; however, FAR allows the Contracting Officer to retain up to 10 percent of the request for payment if he determines the contractor's progress is unsatisfactory, and he may also withhold a fair amount from the final payment pending final inspection, acceptance, and closeout. Payments are subject to the Prompt Payment Act; accordingly, the Government is required to make an interest payment to the contractor for a delay in payment. Title, liability, and reservation of rights become the sole property of the government at the time of payment. The asset typically is constructed on Government property, and the Government is responsible for safeguarding the property from loss.

As reflected in DoDFMR Volume 4, Chapter 6, Property, Plant, and Equipment, and in DoDFMR, Volume 4, Chapter 8, Financial Control of Liabilities, the Department records property obtained through fixed-price construction contracts as Construction in Process under Property, Plant, and Equipment (PP&E) until such assets are placed in service, at which time the balance is transferred to PP&E. If the Contracting Officer opts to withhold up to 10 percent of the payment due to unsatisfactory performance or withhold a fair amount from the final payment pending final acceptance, inspection, and closeout, the amounts are recorded and recognized as liabilities in the financial statements. These practices are compliant with Statement of Federal Financial Accounting Standard (SFFAS) No. 6, Property, Plant, and Equipment, and SFFAS No. 5, Accounting for Liabilities of the Federal Government.

B. Contract Financing Payments. The Department's accounting principles and practices and DoDFMR policy for recording and accounting for contract financing payments are compliant with FAS.

Contract financing payments are defined as an authorized Government disbursement of monies to a contractor prior to acceptance of supplies or services by the Government. The more common type of contract financing payment used by the Department are Progress Payments Based on Cost, where payments to the contractor are based on a fixed percentage of the contractor's claimed incurred cost, such percentages usually ranging between 80 to 95 percent based on business size. Contract financing payments are not subject to the provisions of the Prompt Payment Act and, therefore, the Government is not required to make an interest payment to the contractor for a delay in payment. To protect taxpayer funds paid prior to final delivery and Government acceptance, title to all property purchased for the contract vests in the Government; however, the contractor bears the risk for loss, theft, destruction, or damage to property. If loss of property occurs, the contractor is required to repay the Government the amount of unliquidated progress payments. In order to be eligible to receive contract financing payments, FAR requires that the contractor have an acceptable financial condition, allow the government access to its books and records, and maintain an adequate accounting system.

1. Accounting for Liabilities. The OIG reports that the Department's fiscal year 2003 consolidated balance sheet understates the Department's liabilities and the corresponding asset-in-process accounts by \$3.6 billion, due to the Department not reporting the amount of costs incurred by the contractor but not paid by the Government until the completed asset is delivered. The OIG report cites SFFAS No. 1, Accounting for Selected Assets and Liabilities, which states that accounts payable are set up to record an entity's liability for goods and services received or work in process made by a contractor for which payment has not been made. Further, the OIG reports that DoD should have recorded an accounts payable for unpaid contractor costs because they represent future and probable cash outlays owed to Defense contractors, and the likelihood of contractor default or contract termination is more the exception than the rule.

OSD Response. The Department's practices for recording liabilities are compliant with FAS. As stated in SFFAS No. 1 and SFFAS No. 5, Accounting for Liabilities of the Federal Government, SFFAS No. 1 addresses only those selected liabilities that routinely recur in a normal operation and are due within a fiscal year. Because amounts withheld on contract financing payments extend beyond one fiscal year, we have applied the accounting principles directed in SFFAS No. 5, which addresses those liabilities not covered in SFFAS No. 1.

Attachment 1
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SFFAS No. 5 defines a liability as a probable future outflow or other sacrifice of resources as a result of past transactions or events. This standard states that the existence of a past event, defined as a happening of financial consequence to an entity, is essential for liability recognition. In our opinion, unpaid amounts do not meet the FAS definition of a liability, because the past financial event that would generate the liability to pay the contractor for the work, i.e., acceptance or delivery of the goods or services, has not occurred. SFFAS No. 5 states, "Executory contracts, where goods and services have not been received, are not generally recognized as liabilities in financial accounting, although they are generally recognized as obligations in governmental budgetary accounting."

At our request, the Department's Office of General Counsel (OGC) provided a clarification of the legal rights and obligations conveyed to the Government under the Progress Payments clause. In its March 17, 2005 response (Attachment 2), the OGC states that the "Government's liability to pay for a product arises only when the product is delivered by the contractor and the Government determines that the product meets contract requirements and accepts the product. Concomitantly, the government has no obligation to pay for the end item until acceptance."

In our opinion, recognizing unpaid contract financing payments as a liability before final delivery and acceptance would not accurately reflect the legal status of the Government's contractual obligation, the Department's financial status, or compliance with FAS.

2. Classification and Recognition of Contract Financing Payments.

The OIG reports that the Department should record and account for contract financing payments for property, plant, and equipment and inventory purchases as construction work in process and inventory work in process, respectively. In addition, the OIG reports that the Department's fiscal year 2003 consolidated balance sheet understates the Department's asset-in-process accounts by \$3.6 billion, due to the Department not reporting the amount of costs incurred by the contractor but not paid by the Government until the completed asset is delivered.

OSD Response. The Department's practices for classification and recognition of contract financing payments are compliant with FAS. We do not agree that contract financing payments should be classified as Construction Work in Progress or Inventory Work in Progress, as these payments do not meet the FAS definitions of Plant, Property, and Equipment (PP&E) or Inventory, nor do we agree that these assets should be measured at the amount of total claimed costs incurred by the contractor.

SFFAS No. 6, Property, Plant, and Equipment (PP&E), defines PP&E as tangible assets that have an estimated useful life of two years or more, are not intended for sale in the ordinary course of operations, and are intended to be used or available for use by the entity. SFFAS No. 3, Accounting for Inventory and Related Property, defines inventory as tangible personal property that is (1) held for sale, (2) in the process of production for sale, or (3) to be consumed in the production of goods for sale or in the provision of services for a fee. Contract financing payments are cash disbursements made to a contractor to finance performance under the contract prior to acceptance of goods or services. Identifying these cash disbursements as PP&E or Inventory, prior to acceptance of goods, would imply that we have acquired tangible assets that are intended to be used or available for use by the Department.

SFFAS No. 6 allows the Department to recognize PP&E and Inventory when title passes or when the PP&E is delivered to the entity or an agent of the entity. Accordingly, if contract financing payments were determined to fall under the SFFAS definitions of PP&E or Inventory, the Department's practice of recognizing the assets upon delivery is compliant with FAS.

The OIG reports that the Department's fiscal year 2003 consolidated balance sheet understates assets by \$3.6 billion because the Department does not measure the asset based on the total amount of costs incurred by the contractor; rather, the Department measures contract financing payments at the amounts paid to the contractor. We agree that under the Progress Payments clause, the Government receives title to the contractor's work; however, the total cost incurred by the contractor does not reflect the value of the property for which title has passed. Unlike payments made under fixed-price construction contracts, where payments are based on inspection of completed segments of work, contract financing payments are based solely on contractor claimed cost incurred. The contractor's initial work under contract may primarily include design or planning activities, consisting of labor and overhead cost; therefore, the title vested in the Government will not be reflective of the true value of the asset. Consequently, measuring the asset based solely on the contractor's cost incurred would not reflect the value of property conveyed to the Government and would distort the value of the assets currently captured within the PP&E and Inventory category.

As reflected in the OGC's legal opinion (Attachment 2), Government title ensures that public funds are protected if paid during the course of contract performance, rather than at the end of contract performance. If the Government takes possession of the property before completion of contract performance, usually as a result of bankruptcy or contract termination, the progress payment inventory belongs to the Government; however, the difference

between the value of the property seized and the payments made would be sorted out in the termination settlement and the bankruptcy proceedings.

We note that the OIG report states that “Federal Accounting Standards require that contract financing payments be recorded in an asset in process account such as Construction Work in Process or Inventory Work in Process.” We were unable to locate this requirement in the FAS. However, we did note that SFFAS No. 6 states, “in the case of constructed PP&E, the PP&E shall be recorded as construction work in progress until it is placed in service, at which time the balance shall be transferred to PP&E.” As previously discussed, the Department’s practice is to record constructed real property under Construction in Progress under PP&E. FAR 2.101 defines construction as “construction, alteration, or repair (including dredging, excavating, and painting) of buildings, structures, or other real property,” and specifically states that construction does not include the manufacture, production, furnishing, construction, alteration, repair, processing, or assembling of vessels, aircraft, or other kinds of personal property.

We agree that contract financing payments are assets, defined by FAS as owned by the federal government and which would have probable economic benefits that can be obtained or controlled by the federal government entity. As reflected in the DoDFMR, Volume 6B, Chapter 10, Notes to Financial Statements, contract financing payments are recorded and presented in the Department’s consolidated balance sheet under the category of Other Assets, in a subcaption entitled “Contract Financing Payments.” Explanatory Note 6, Other Assets, defines contract financing payments and discloses the military component balances that comprise the total amount reported. In our opinion, classifying contract financing payments under Other Assets, with full disclosure in Note 6 as to the nature of these payments, provides relevant and reliable information to decisionmakers and financial statement users and is fully compliant with FAS.

SUMMARY

In summary, we do not concur with the OIG findings and recommendations and maintain that the Department’s accounting practices and DoDFMR policies for contract financing payments and payments under fixed priced construction contracts, defined in FAR, are compliant with FAS.

**CONTRACT FINANCING PAYMENTS
VERSUS
PAYMENTS UNDER FIXED-PRICE CONSTRUCTION CONTRACTS**

CONTRACT FINANCING PAYMENTS	PAYMENTS UNDER FIXED-PRICE CONSTRUCTION CONTRACTS
Defined as Contract Financing Payments in FAR Part 32.001	Specifically excluded from the definition of Contract Financing Payments in FAR 32.001
Used under contracts for personal property.	Used only on contracts for construction of real property, shipbuilding, ship conversion, alteration, or repair.
Payments are not subject to the Prompt Payment Act. The Government is not required to make interest payments to the contractor for a delay in payment.	Payments are subject to the Prompt Payment Act. The Government is required to make interest payments to the contractor for a delay in payment.
Most commonly used payments are Progress payments Based on Cost and Performance-Based Payments.	The Department only uses Payments Based on a Percentage of Completion, where Agency procedures must ensure payments are commensurate with work accomplished.
For contract financing payments based on cost incurred, payments are limited to a specified percentage, usually 80 – 90 percent of total incurred cost, primarily dependant on business size.	Payments are made in full. Contracting Officer may withhold up to ten percent of payment for unsatisfactory performance, or withhold a fair amount from final payment pending final inspection, acceptance, and closeout.
Contractor bears risk of loss for property, including risk for loss, theft, destruction, or damage, even though title is vested in the Government.	Real property is usually constructed on Government property. The Government bears the risk of loss for property.



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March 17, 2005

MEMORANDUM FOR ACTING DIRECTOR, ACCOUNTING AND FINANCE POLICY
AND ANALYSIS DIRECTORATE

SUBJECT: Request for Clarification of the Rights Conveyed to the Department under FAR
52.232-16, Progress Payments

This is in response to your memorandum of January 13, 2005, in which you requested an opinion regarding the nature of the ownership interest the Department has in progress payment inventory held by contractors. Your inquiry stems from a draft report from the DoD Inspector General (IG), in which the IG states that the method currently used by the Department for accounting for progress payments, booking them in the Other Assets—Outstanding Contract Financing Amounts, is incorrect, and that the progress payment property should be accounted for as Work-in-Progress, with unpaid progress payments reflected as liabilities.

You enumerated specific questions regarding the application of FAR 52.232-16, Progress Payments, that you believe will help you to put the progress payments in the appropriate account on the DoD Financial Statements. Your questions are restated in italics, with our answer following:

1. The rights conveyed to the Government under FAR 52.232-16(d). Also, please define the legal distinction, if any, in the rights conveyed in the verbiage, "title...shall vest," and a transfer of title, or transfer of ownership, to the Government.

The rights conveyed to the Government pursuant to FAR 52.232-16(d) are absolute ownership rights. This position has been sustained repeatedly over many decades of challenges, usually in the context of a contractor's bankruptcy or the termination and settlement of a contract. Most recently, the Government's absolute ownership of progress payment inventory, as well as other forms of contractor-held inventory acquired for use in the performance of government contracts, has been upheld in a series of state court actions in which the Government's ownership interest in property held by contractors has precluded the imposition of various state taxes on the contractors.

Title vests under the Progress Payment clause by operation of law; no additional action is needed to transfer ownership to the Government. Transfers of ownership otherwise require an affirmative action on the part of the transferor to convey ownership, such as signing a deed for realty, or signing a title for an automobile.

2. FAR 52.232-16(d) states, in part, that title to specific property, acquired or produced by the contractor, shall vest in the Government immediately upon the date of the contract.



Please explain the intent of this provision, and if possible, provide an example of when title to property would vest in the Government immediately upon the date of the contract.

The Progress Payment clause is based on 10 U.S.C. § 2307 and ensures that public funds are protected if paid during the course of contract performance, rather than at the end of contract performance. If taxpayer funds will be provided to the contractor before final delivery and Government acceptance of the end item, those taxpayer funds must be protected in the event of nonperformance by the contractor. If the contractor has material in stock that he intends to use in the performance of a Government contract containing the progress payment clause, those materials become identified to the contract at the time of contract award, and title passes.

3. FAR 52.232-16(d) states, in part, that title vests in the Government when the property is or should have been allocable or chargeable to the contract. The Government does not pay 100 percent of the contractor's claimed cost charged or allocable to the contract; rather, payments are limited, in accordance with FAR and contract terms, to a percentage of total claimed cost. Please clarify if title vests in the total value of the property that should have been allocable or chargeable to the contract, or if the value is limited to the amount of payments made to the contractor.

When the Government takes title pursuant to the progress payment clause, it takes full title. If the Government needs to take actual possession of the property before the completion of contract performance, usually as a result of a bankruptcy or contract termination, the progress payment inventory belongs to the Government, even if it is worth more than the 80% that the Government has paid. The difference in value is resolved during the termination settlement or the bankruptcy proceedings, but the property belongs to the Government.

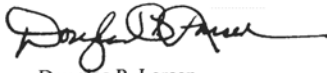
4. FAR 32.001 defines interim payments under a cost reimbursement contract, except for a cost reimbursement contract for services when Alternate I of the clause at 52.232-25, Prompt Payment, is used, as contract financing payments. Because FAR 52.232-16 is incorporated in fixed-priced contracts allowing for progress payments on costs, please explain the rights conveyed to the Government insofar as vesting or transfer of title to property under cost reimbursable contracts.

The passage of title to the Government is fundamentally the same for all contract financing payments. Cost-reimbursable contracts provide that title to property acquired by the contractor for performance of its Government contract, for which the contractor is entitled to be reimbursed as a direct item of cost, becomes Government property when the property is delivered to the contractor. For property other than direct items of cost, title vests in the Government when (1) the property is issued for use in contract performance; (2) processing the property commences for use in contract performance; or (3) the contractor is reimbursed for the cost of the property by the Government, whichever occurs first. Thus, regardless whether the contract is a firm-fixed-price contract with a progress payment clause, or a cost-reimbursable contract containing the Government Property clause at 52.245-5, title transfers to the Government as soon as the property is identified to the performance of the Government contract.

The draft IG report erroneously appears to equate progress payments with partial acceptance of the contracted end item; the report urges booking the Progress Payment inventory as Work-in-Process and the unpaid progress payment "withhold" as liabilities, in advance of full performance, delivery, and acceptance by the Government. The passage of title to the Government under the Progress Payment clause is not to be confused with the Government's acceptance of the end item at the conclusion of contract performance. The Government's liability to pay for a product arises only when the product is delivered by the contractor and the Government determines that the product meets contract requirements and accepts the product. Concomitantly, the Government has no obligation to pay for the end item until acceptance. Thus, there is no obligation to pay the 20% progress payment "withhold" until acceptance. To book unpaid progress payments as a liability before final delivery and acceptance does not accurately reflect either the legal status of the Government's contractual obligations or the Department's financial status.

Whether the progress payment inventory is booked as Work-in-Process or as an Other Asset is a matter of accounting policy, for which we defer to the Comptroller. We are concerned, however, that the Department's legal liabilities be accurately reflected on the Department's Balance Sheet; recording unpaid progress payments as a liability when there is no liability to pay until delivery and acceptance causes us concern. At the same time, we do not want to undermine in any way the longstanding history that title to progress payment inventory vests fully in the Government.

If you have any questions or would like to discuss this further, please contact Kathy Brown at 695-3413 or Kathy.Brown@osd.pentagon.mil.



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