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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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B-162578 BEST DOCUMENT AVAILABLE DEC 11 1972

Dear Mr. Chairman:

During hearings held by your Subcommittee on March 27, 1972, progress payments made to the Lockheed Aircraft Corporation on the C-5 aircraft contract were discussed. You were particularly interested in our (1) comments on a February 20, 1970, report of the Defense Contract Audit Agency which stated that overpayments of about $400 million had occurred as of January 20, 1970, and (2) comments in our Atlanta regional office staff study that the Air Force made an additional $705 million available for progress payments to Lockheed between January 1970 and May 31, 1971.

We advised you that we planned to examine the progress payment practices in effect before the contract was restructured in May 1971. In conducting our examination, we interviewed officials of Lockheed, the Air Force, the Defense Contract Audit Agency, and the Office of the Secretary of Defense, and examined available correspondence and reports pertaining to progress payments made to Lockheed on this contract.

Our findings and observations are presented below.

THE PURPOSE OF PROGRESS PAYMENTS

Sometimes a Government contract requires a long period of performance or substantial expenditures before the contractor makes delivery and receives full payment. Using private capital in such cases may not be economical or feasible because the financial requirement may exceed the contractor's capability or impair its ability to perform.

Thus, the Government has followed the practice of reimbursing the contractor for part of the costs incurred on work in process but not yet delivered. For a cost-reimbursement contract, payment of allowable costs is made as the work progresses. This letter is concerned with how progress payments are made under fixed-price contracts.

COMPUTATION OF PROGRESS PAYMENTS
ON FIXED-PRICE CONTRACTS

The standard progress payment clause provides for payment of a stipulated percentage of the contractor's incurred costs. For the C-5 aircraft contract, the cumulative progress payments could not exceed 90 percent (subsequently increased to 100 percent) of the ceiling price established in the contract.

When an item is delivered and invoiced, the progress payments received by the contractor during its production are deducted from the total amount due. This is known as liquidating the progress payments. The C-5 aircraft contract provided that the amount of unliquidated progress payments not exceed 90 percent of the costs incurred on undelivered items or 90 percent (subsequently increased to 100 percent) of the contract price of the undelivered items.

The regulations provided that the costs for undelivered items be determined by deducting the costs attributable to items delivered, invoiced, and accepted from the total costs incurred. The regulations also provided that the costs of delivered items be computed as follows:

> "In order of preference, these costs are to be computed on the basis of one of the following:
>
> (a) The actual unit cost of items delivered, giving proper consideration of the deferment of the starting load costs;
>
> (b) projected unit costs (based on experienced costs, plus estimated costs to complete the contract), where the contractor maintains cost data which will clearly establish the reliability of such estimates; and
>
> (c) the total contract price of items delivered."

LOCKHEED'S COMPUTATION OF PROGRESS PAYMENTS

Lockheed followed method (c) in computing the cost-of-delivered items. Therefore, in arriving at the cost of undelivered items, Lockheed deducted from the total costs incurred an estimated cost based on the contract billing price of delivered items rather than on actual or projected costs. Use of method (c) meant that cost overruns for delivered items were not deducted from the total cost in computing the maximum permissible progress payments.

An illustration of the effect of using contract billing prices when a contractor is experiencing a cost overrun is presented below.

	Method (a)	Method (c)
Total costs incurred	$200	$200
Less cost of delivered items:		
Actual costs	70	-
Estimated cost based on contract billing price		50
Total costs eligible for progress payments	$130	$150
Maximum permissible progress payments at 90 percent	$117	$135

Using method (c), a contractor having overruns receives more in progress payments than it would receive using method (a). This situation was shown in the Defense Contract Audit Agency's February 1970 report, which stated that Lockheed had been overpaid about $400 million.

The regulations of the Department of Defense permitted this procedure. (See p. 2.) The Air Force's written comments to the General Accounting Office on this matter pointed out that:

--Both parties recognized that an upward adjustment in the contract ceiling was essential because of several factors, including inflation, repricing because of the number of aircraft being procured under "Run B," and repricing because of overceiling costs on "Run A."

--This method of computing progress payments had been in effect from the start of the contract. Because the contractor had filed an appeal with the Armed Serv-
3 ices Board of Contract Appeals indicating an intent 300
to litigate contractual differences, the Air Force considered that progress payments should be continued using this method. The Air Force believed that to do otherwise might incur a breach-of-contract action.

--The Air Force felt that, were progress payments suspended or past payments significantly recouped, C-5 aircraft production would come to a halt and the ultimate cost of completing the program would greatly increase.

After the Defense Contract Audit Agency's report was issued, the Air Force acted to provide additional funds for progress payments. Between February 1970 and May 1971, when the contract was restructured, the Air Force increased the ceiling price of the contract by about $557 million, as shown below.

Increase in ceiling price	Amount of increase (millions)
To recognize:	
Abnormal fluctuation of the economy	$143
Provisional items and change orders for which firm prices had not been established	114
Interim repricing adjustments for Run B	300
Total	$557

The Air Force also changed the limit on the percentage of the contract price that would be available for progress payments. Originally, progress payments were limited to 90 percent of Lockheed's allowable incurred-costs, up to a maximum of 90 percent of the contract ceiling price. In April 1970 the Air Force changed this maximum to 95 percent of the ceiling price, which provided an additional $73 million for progress payments. The contract was again changed in September 1970 to allow progress payments up to 100 percent of the ceiling price and thus made available an additional $75 million. Therefore, by changing the limit from 90 percent to 100 percent, an additional $148 million was made available for progress payments to Lockheed. This $148 million and the $557 million increase in the ceiling price comprise the $705 million discussed in the staff study.

The contract was converted to a cost-reimbursement contract in May 1971, and the contractor stopped receiving progress payments and started receiving reimbursement on the basis of costs incurred. Negotiations to convert the contract considered all payments previously made to Lockheed.

The method Lockheed used was allowable under the contract and was permitted under the regulations then in effect; however, as previously illustrated, this method permitted the contractor to receive progress payments for costs incurred on delivered items in excess of the unit prices for such items. By June 1968, 6 months after Lockheed started using this method, Lockheed and the Air Force were projecting an overrun on the contract.

It is our opinion that the method used for computing the progress payments was inappropriate under the circumstances. Progress payments are to help contractors finance the cost of undelivered items, and we believe that when an item is delivered and accepted the actual costs to produce the item should be deducted from total costs incurred when computing the maximum permissible progress payments.

As a result of the Defense Contract Audit Agency report and of subsequent Office of the Secretary of Defense studies, it was recommended in November 1971 that using method (c) to compute costs of delivered items be discontinued. Defense Procurement Circular 94, dated November 22, 1971, announced plans to revise the progress payment request form, and a new form omitting method (c) became effective on April 1, 1972.

We trust that the information presented above is responsive to your needs. We shall be pleased to discuss this information with you or members of your staff.

Sincerely yours,

Comptroller General
of the United States

Cl The Honorable William Proxmire, Chairman
Subcommittee on Priorities and
Economy in Government
Joint Economic Committee
Congress of the United States

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