Reader Dave asked us to expand on our previous post re: PBPs, focusing on the following comment:

Never mind that (from the contractor's side) use of PBPs leads to enhanced cash flow and reduced audit support efforts. Never mind that (from the government's side) use of PBPs leads to reduced oversight requirements and increases depth of competition. Nope. PBPs are not well-understood and they are hard to plan, and so the contracting parties have learned to avoid them in favor of the traditional cost-based progress payments that offer reduced cash flow, increased audit oversight …

Dave commented: "I initially read this as PBP lead to enhanced cash flow THAT IS BETTER THAN progress payments (but now I think you mean generally over cost type), and also that there is less audit with PBPs than progress payments (but now I think you also meant this generally over other cost type)."

No, Dave. I meant what I wrote. Use of PBPs leads to enhanced cash flow that IS better than that offered by use of progress payments calculated as a percentage of cost incurred. Or, at least, it should. And there is definitely less oversight on PBPs than there is with progress payments.

Let's dive in.

Contract Financing

In general, the government provides contract financing payments when the contractor needs funds in advance of delivery. For example, if you have a 24 month-long contract with delivery at the end of 24 months, and the government only pays you on delivery, then you have to wait 24 months to get any cash in the door. That means you have to pay your employees (and suppliers) for two years, while waiting to get the funds to cover those payments. Most contractors don't have two years of cash flow in the bank and, even if they do, that's essentially a two-year interest-free loan to the Federal government. Not a good situation.

Thus, the government offers the ability to get paid prior to actual delivery. There are various types of contract financing payments; they are discussed in FAR Part 32. What's interesting about these payments is that not all contracts are eligible to receive them (see the qualification criteria at FAR 32.104). Also note that contract financing payments are limited to fixed-price contract types; you can’t get them on cost-reimbursement contracts, because the government is already paying invoices based on costs incurred (and not on delivery). Another interesting aspect is that many smaller contractors don’t know about them or are hesitant to request them, even when the contract would qualify. In other words, many of the contractors most in need of enhanced cash flow don’t request contract financing payments.

On the other hand, the bigger contractors know all about contract financing payments and make sure they receive them at every opportunity. After all, “cash is king.”

Progress Payments

Traditional progress payments are a contract financing method that enhances contractor cash flow by reimbursing a fixed percentage of the contractor’s costs, as they are being incurred. Progress payments are discussed (in general) at FAR 32.5, but one needs to review the contract clause (52.232-16) to really understand the duties and obligations of the parties.

According to FAR 32.501-1, “The customary progress payment rate is 80 percent, applicable to the total costs of performing the contract. The customary rate for contracts with small business concerns is 85 percent.” Right there that tells us that a large contractor is on the hook for funding at least 20 percent of costs incurred (15 percent if you’re a small business). Importantly, note that we are talking about *costs*, not price. Any profit is realized upon delivery and not through progress payments received.

And the contractor cannot just tally up costs incurred, multiply by 0.80 (or 0.85), and then submit a progress payment request via SF 1443. *Nope*. It’s not total costs, it’s total costs as calculated in accordance with the 52.232-16 contract clause.

For example, “Costs that are not reasonable, allocable to this contract, and consistent with sound and generally accepted accounting principles and practices” must be excluded from the basis on which progress payments are calculated. Remember, this is a fixed-price contract, so normally nobody cares about your unallowable costs. But use of progress payments effectively converts your FFP contract to a cost-type contract, with respect to identification and segregation of costs made unallowable by FAR Part 31. That takes effort.

[Editor's Note: It's important to note that progress payments are not conditioned on cost allowability. When I said "unallowable costs" in the foregoing paragraph, I was speaking about unallocable costs and unreasonable costs. Costs that are not compliant with the requirements of the FAR 31.205 selected cost principles may still be used as the basis for establishing costs incurred for progress payment requests. Just so you know ....]

But we're not done yet.

Contracts that are in a loss position require that the progress payment request be adjusted, because the government doesn't want to finance a contractor's loss. (Losses happen, especially on FFP contract types.) This issue is discussed in great detail at FAR 32.503-6(g). This can be an onerous calculation, as it involves estimates-to-complete and estimates-at-completion. But it is a calculation that must be made, because the government has the right to reduce or suspend progress payments when it believes the contractor is not complying with the requirements associated with them.

In order to do all the back-office accounting associated with properly administering progress payments, the contractor essentially needs to have an adequate accounting system. Normally, accounting system adequacy is a necessary prerequisite associated with cost-reimbursement contracts (or maybe T&M contracts); it's not usually associated with award of FFP contracts. But use of progress payments (once again) effectively converts your FFP contract to a cost-type contract, because your contract financing payments are associated with costs incurred.

And DCAA will be looking to see how you are doing.

DCAA has an entire **audit program** dedicated to audits of contractor progress payments requests. They will be looking to ensure you are complying with all the little administrative details associated with that Progress Payment contract clause. Thus, not only must you comply in all respects, but you will need to have trained staff on hand who can respond to audit requests and provide the requested support (including the ETC and EAC information that will inevitably be requested).

Summary: Progress payments can be a good thing! They can enhance cash flow and reduce the stress associated with making payroll and paying suppliers while working to deliver. However, they don't cover all costs, and they require additional resources, and lead to additional government oversight. They are certainly better than nothing, but I believe that Performance-Based Payments are better.

Performance-Based Payments

PBPs are discussed (in general) at FAR 32.10. PBPs are simple, at least in theory. The contracting parties agree, up front, on "events" that represent significant programmatic or technical milestones. Those events are valued—importantly, they are valued up front and memorialized by the parties. At the end of discussions, the parties have agreed on a series of milestones that represent program performance, each of which has an agreed-upon value. As the contractor achieves the event, it submits a request for contract financing payment equal to the negotiated value of that event.

Simple, right? It was designed to be.

FAR 32.1002 states:

Performance-based payments may be made on any of the following bases:

(a) Performance measured by objective, quantifiable methods.

(b) Accomplishment of defined events.

(c) Other quantifiable measures of results.

Talk about a blank slate! *Any quantifiable measure of results* can be used! Where else in the FAR do you find an opportunity for the parties so sit down and figure out how to measure program performance? Indeed, the origin of PBPs was the realization in the mid-1990's that progress payments didn't correlate to program performance; they correlated to the contractor's ability to spend money. Hence, PBPs were an attempt to link contracting financing payments to actual program performance and accomplishment.

Another aspect of PBPs is that the cumulative value of all PBP events cannot exceed 90 percent of the contract (or delivery item) price. *Price*. Price is not cost; price includes anticipated profit. Thus, instead of receiving up to 80 percent of adjusted contract costs, a contractor using PBPs can receive up to 90 percent of the negotiated contract price. Right there, one can see why PBPs enhance contractor cash flow.

However, it needs to be said that PBPs only enhance cash flow if the contractor is making progress. If the program is in trouble, those pre-negotiated milestone events may not be achieved as planned. In such circumstances, the contractor will lack the anticipated cash flow enhancement, and it will be on its own to make payroll and pay suppliers. So PBPs should not really be used on immature technology or where delivery problems are probable.

Other collateral benefits come with use of PBPs. They include: no need to adjust for unallowable costs; no need to adjust for contract losses; no need to have an adequate DCAA-audited accounting system; and no need for DCAA to deep-dive into your books and records. Accordingly, a lot of effort and resource-use (for both government and contractor) is avoided.

The only substantive guidance for valuation of PBPs is found at FAR 32.1004(b). Included therein is this snippet, which needs to be kept in mind as milestone events are being negotiated:

Performance-based payment amounts are commensurate with the value of the performance event or performance criterion, and are not expected to result in an unreasonably low or negative level of contractor investment in the contract. To confirm sufficient investment, the contracting officer may request expenditure profile information from offerors, but only if other information in the proposal, or information otherwise available to the contracting officer, is expected to be insufficient.

Consequently, neither party should be planning on accelerated cash flow (when compared to contractor expenditure profiles). The contractor should not plan on being “cash rich” when PBPs are used. If it happens, it happens. But don’t plan on it happening.

Summary: A bit more work up front to plan and negotiate the value of PBP event milestones. However, that up-front investment is more than offset by the reduced effort to be expected post-award. And, as I hope we’ve demonstrated, the contractor’s cash flow should be accelerated in comparison to traditional progress payments based on costs incurred (all things being equal).

Dave, have I adequately addressed your question?