

# Improper Billing of Costs on Progress Payments<sup>1</sup>

<sup>1</sup>Progress payments are not interim vouchers or invoices that the government pays based on the allowable costs incurred and charged to the contract. Instead, progress payments based on costs are a form of government contract financing used for fixed price contracts that are provided in recognition of the need for working capital, long lead items, and work in process expenditures. Progress payments provide interim financing for a contractually stated percentage of allowable costs incurred for undelivered and uninvoiced items. As contract items are delivered and accepted, progress payment amounts are reduced (liquidated) against payments due for completed items as stated in the contract. Other forms of contract financing include progress payments based on percentage of completion, performance-based payments, and advanced payments. Progress payments are submitted on Standard Form (SF) 1443 and require contractor certification.



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# **Risk Assessment-Research and Planning: Communication with the Requester to Clarify Expectations and Concerns**

When assigning the auditor a progress payment audit, the supervisor explained that the Defense Contract Management Agency (DCMA) Administrative Contracting Officer (ACO) requested the audit because of concerns with the last progress payment submitted and the contractor's performance on the contract. The auditor contacted the ACO to discuss the audit request. The ACO stated that this was the 9<sup>th</sup> progress payment submitted on the contract, but the Contracting Officer's Technical Representative (COTR) expressed concern about ongoing delivery delays. The COTR also told the ACO that several delivered items did not meet contract requirements and the contractor had not finished the required rework on the returned items.



# Risk Assessment-Research and Planning: Communication with the Requester to Clarify Expectations and Concerns (Cont'd)

The ACO recognized that the performance and delivery issues were indicators that the contractor could be suffering losses in its operations. However the ACO noted that the current progress payment request did not indicate that the contract was in a loss position<sup>2</sup>. The ACO told the contractor that no further progress payments would be made until DCAA completed its audit of the current request. The auditor asked the ACO and COTR when they started having these concerns. The COTR said they knew the first deliveries were a little behind the contract deliverable schedule but then some delivered items began needing rework to meet the contract specifications. The ACO added that they noticed costs incurred on the progress payments had really increased on the last 2 progress payment requests.

<sup>2</sup>A loss position would be indicated on the progress payment request when the sum of total costs and the estimate to complete (SF Form 1443 Lines 12.a and 12.b) exceed the contract price (Line 5). Then, current and future progress payments are reduced to exclude the loss impact. This calculation is done to protect the Government's interest. The contracting officer adjusts the progress payments to ensure the fair value of undelivered items equals or exceeds the amount of progress payments that have yet to be liquidated. The financing provided, which is based on allowable costs incurred, is then available throughout the entire period of contract performance. The contractor will only be paid at final delivery for the negotiated fixed price.



# **Risk Assessment-Research and Planning: Communication with the Requester to Clarify Expectations and Concerns (Cont'd)**

The auditor requested the ACO to provide all the previous progress payments (Form SF-1443) submitted, and copies of all DoD material inspection and receiving reports (Form DD 250). The contractor used the Form DD 250s to identify the separate contract items that were delivered. The auditor also asked the ACO if a DCMA technical review would be requested to support the audit. The ACO stated that it was the auditor's decision whether a technical review was needed. The auditor agreed to discuss this with the audit supervisor and to make a determination about the technical review after completing the audit risk assessment.



# Risk Assessment-Research and Planning: Review of Contract and Permanent File

The auditor began the information gathering procedures for the audit by checking the permanent file for available data regarding the contractor. The auditor found that DCAA had only minimal audit experience with the contractor and that the internal control questionnaire (ICQ) was from 3 years prior. The auditor used the Electronic Document Access<sup>3</sup> (EDA) online system to obtain a copy of the contract and a profile of the contractor's current contracts. The auditor documented facts relevant to the audit from the information gathering.

- The contractor's main business was providing guidance device systems to multiple military customers.

<sup>3</sup>Electronic Document Access (EDA) program is a web-based system that provides authorized users secure online access, storage and retrieval of acquisition documents such as contracts, contract modifications, vouchers, contract deficiency reports, and government bills of lading. The website is located at <http://eda.ogden.disa.mil/>.



# **Risk Assessment-Research and Planning: Review of Contract and Permanent File (Cont'd)**

- The outdated ICQ indicated \$55 million in contractor sales from primarily 4 Government firm-fixed-price (FFP) contracts and 1 time and material (T&M) contract. Per the auditor's review of EDA, the contractor had an additional 3 FFP contracts with Government sales now close to \$80 million. The contract related to the progress payment under review was one of the additional contracts.
- The contract associated with the progress payment audit was a 2-year FFP contract to fabricate and deliver guidance device systems to the Air Force for multiple drone models. The product deliverable lots were broken out into individual contract line items (CLINS). The auditor noted that the contract required the costs to be charged and segregated by CLIN.



# **Risk Assessment-Research and Planning: Review of Contract and Permanent File (Cont'd)**

- DCAA had performed a proposal audit on the contract and on another FFP proposal 3 years ago. Neither audit had any major findings.
- DCAA also performed a post award accounting system 1 ½ years ago and reported that the contractor's accounting system was adequate for accumulating and billing costs on Government contracts.



# Preliminary Analytical Procedures



The auditor analyzed the progress payment request and the ACO-provided data noting the following risk considerations for the progress payment audit.

- The auditor noted that the current progress payments covered 9 of the 24 months of contract performance (3.75 percent) but billed about 55 percent of the estimated total contract costs. The estimated cost to complete on the current progress payment request equaled the negotiated contract price less profit.
- Per the DD 250s submitted, the contractor had delivered only six lots on the contract. The contract deliverable schedule indicated that the contractor should have delivered eight lots by the date of the progress payment. According to the COTR two of the delivered lots were returned to the contractor for rework.



# Initial Contact with Contractor

The auditor contacted the contractor representative to discuss the upcoming audit, schedule an entrance conference, and request some preliminary information. Per that discussion, the auditor emailed the contractor representative an initial information request that included providing a detailed job cost ledger report by account for performance to date on the contract, the most current estimate to complete/estimate at completion analysis, and the completed contractor organization section of the internal control questionnaire. The auditor requested that the data be provided electronically if possible.



# Entrance Conference

The auditor met with the contractor's representative to discuss the audit scope and the required supporting data. The billing manager who had certified the progress payment also provided a demonstration of how the progress payment was completed. This included the basis for the entry on each progress payment line item and the related accounting and billing source documents. The auditor asked the following questions during the meeting.

**Auditor Question: "Please describe any major organizational or structural changes to the company over the last 2 years?"**

*Contractor Response: "Well, we are now a fairly large company that grew very rapidly over the last two years thanks in part to winning several sizable DoD FFP contracts like this one. We also have commercial work although our Government contracts are now probably 65 percent or more of our business base."*



# Entrance Conference (Cont'd)

**Auditor Question:** “What changes have been made to the accounting and billing systems since our last audit?”

*Contractor Response: “We have not made any changes to either of these systems. We still use the same commercial ERP (enterprise resource planning) system as before.”*

**Auditor Question:** “According to job cost ledger report previously provided costs on this contract are not segregated or charged by CLIN. How does the system determine the costs associated with the items delivered, e.g. Line 20a on the progress payment?”

*Contractor Response: “We do not typically accumulate contract costs to that level unless specifically required by the contract. As explained in the demonstration, the biller knows from the contract what percentage of the total contract costs each deliverable represents so that is the amount recorded on the progress payment when deliverables are submitted.”*



# Entrance Conference (Cont'd)

**Auditor Question:** “Section H.3 of the contract requires costs to be accumulated and billed by CLIN. So how are costs charged in the accounting system to comply with this requirement?”

*Contractor Response: “I see what you mean. Our project engineers track CLIN cost data outside of the accounting system but we have found it is just as easy to record the deliverable costs as their percentage of total costs for the progress payment. The deliverables are basically the same guidance device systems just for different drone models, and the costs are generally incurred evenly throughout the contract.”*

**Auditor Follow-up:** “We will need those offline CLIN records.”

*Contractor Response: “Okay, but not sure how much this will help your audit.”*

**Auditor Question:** “In the demonstration, the billing manager explained that the estimate to complete (ETC) entered on Line 12b. of the progress payment was from data received by project engineers on the contract. How do they calculate the ETC?”

*Contractor Response: “The project engineers perform an analysis every month and provide us with a detailed estimated cost at completion by cost element. The biller then takes their estimate at completion and subtracts the costs incurred. That becomes the ETC for the progress payment.”*



# Entrance Conference (Cont'd)

**Auditor Question:** “The previously provided job cost ledger reports showed a large percentage of the estimated costs for this contract have already been charged or incurred. Is this reflected in the ETC and Line 12c., the total estimated cost of performance?”

*Contractor Response: “Oh yes, the COTR asked about that too. We procured most of the materials/supplies that are needed for this contract in bulk in the early stages so we could get the best price. I believe the estimate at completion analysis by the project engineers took this into account.”*

**Auditor Question:** “As part of the audit we will:

- (1) verify billed material costs back to invoices and other supporting documentation;**
- (2) analyze the aging of accounts payable to confirm timely payment of vendors in accordance with FAR progress payment regulations;**
- (3) verify a sample of labor charges back to timesheets; and**
- (4) review the CLIN cost data that we previously discussed.**

**To finish the audit by the requested due date, we need the supporting documents within two weeks.”**



# Entrance Conference (Cont'd)

*Contractor Response: "Our accounting department is really swamped right now with month-end coming up, but I think we can get you the information you need in a couple of weeks after you give us the list of items selected for review."*

**Auditor Response: "The ACO will not approve the progress payment request for payment until the audit is finished; therefore it is in the company's best interest to get us the requested support. We will send the sample items selected in the next two days."**

**Auditor Question: "What does the company see as the greatest risk for fraud in progress payment billings?"**

*Contractor Response: "We do not really consider the billing process at risk for fraud; it is more like at risk for billing errors. Preparing progress payments can be tricky at times. Also I guess there could be a risk of fraud related to the costs that are charged in the accounting system which we record on the progress payment. We do have a hotline that employees can use to anonymously report instances of potential fraud, waste or abuse."*



# Entrance Conference (Cont'd)

**Auditor Question:** “Is the company aware of any allegations of fraud or suspected fraud made by employees, former employees, regulators or others related to this contract or to progress billings on this contract?”

*Contractor Response: “I do not have access to that type of information, e.g. hotline allegation or qui tams. I will have to check with our legal department.”*

**Auditor Question:** “Is the company aware of any fraud or suspected fraud related to this contract or to progress billings on this contract?”

*Contractor Response: “I do not have access to this information, for example, contractor disclosures submitted to the contracting officer. These issues are managed by our legal department. So I will need to check with them before we can answer that question.”*



# Audit Team Brainstorming for Fraud Risk Assessment



The auditor met with the supervisor to discuss the results of the risk assessment/preliminary audit procedures performed and to consider the potential fraud risks associated with the audit. The following indicators were noted and documented.

- Contractor is behind on deliveries and could experience cost overruns due to reworking some delivered products. The contractor estimate at completion analysis does not reflect any additional costs for rework.
- Contractor incurred significant amounts of costs, in particular material costs, in relation to the overall period of performance. This is also not reflected in the estimate at completion analysis. The estimate at completion analysis shows that the labor and material costs generally are incurred evenly throughout the contract. Thus, the risk exists that total costs are overstated and the ETC is understated which would maximize the amount billed and paid by the Government.



# Audit Team Brainstorming for Fraud Risk Assessment (Cont'd)

- The contractor representative made contradictory statements in the entrance conference. First the contractor representative stated that costs are generally incurred evenly throughout the contract. Later he stated that material costs were procured up front to obtain bulk product discounts.
- The contractor's cost accounting system does not accumulate cost by CLIN, as required by the contract, making it easy to manipulate and understate the costs for items delivered and invoiced under one CLIN. The supporting offline CLIN cost data worksheets that the contractor provided were incomplete and had limited detail.
- The contractor has experienced rapid growth especially in its Government business base.

Based on these identified risk factors, the audit team decided to include the following in the audit plan.

- Auditor will request that Defense Contract Management Agency (DCMA) complete a full technical evaluation of the work completed and remaining on the contract to assist the auditor in assessing the ETC used in the progress payment.



# Audit Team Brainstorming for Fraud Risk Assessment (Cont'd)

- Auditor will perform a statistical sample of incurred material costs using a large sample size based on the auditor not willing to accept even moderate misstatements for the cost element (low tolerable misstatement). The testing will verify each sample item to the supporting purchase order, invoice, and payment, as well as to the related shipping/receiving documents.
- Auditor will analyze the accounts payable aging report covering the period from contract inception to present to determine whether the contractor is paying its vendors timely (usually within 30 days) in accordance with the FAR. The testing should include identification of any sample item not paid in a timely manner.



# Results from Audit Procedures

The auditor completed the above procedures; however, the contractor took several weeks to produce the requested supporting data. The auditor notified the ACO of the resulting delays. The testing results were as follows:

- Twenty-six percent of the sampled material items were not supported by purchase orders, invoices, and/or payment documents; and 72 percent did not have any receiving or shipping documents. The contractor representative explained that a recent warehouse fire destroyed much of the shipping and purchasing documentation.



# Results from Audit Procedures (Cont'd)

- The evaluation of the accounts payable aging report confirmed that the contractor usually paid its vendors within 30 days. However, when verifying the sampled material items to the contractor-provided aging report, the auditor found numerous cases where the dates on the actual invoices and payment checks did not match the dates listed on the aging report. The actual invoice and payment check dates showed that the contractor had not paid the invoices within 30 days. The contractor also did not include several vendor invoices for material sampled items on its aging report. Based on the invoice dates, the contractor had not made vendor payment in over 120 days.



# Expanded Audit Procedures and Results

The auditor and supervisor discussed the audit results to date with both the ACO and COTR. The audit team decided to perform the following additional procedures:

- The auditor sent confirmation letters to the vendors from whom the contractor purchased the sampled material items that were not adequately supported in the original testing. The confirmation request asked the vendor to verify the cost of the material item/s purchased and payment date. Vendors were only able to confirm 25 percent of the purchased material items because:
  - multiple mailings were returned as undeliverable;
  - some companies replied that they did not have any business with the contractor; and
  - some companies confirmed a purchase price and/or material quantity lower than shown on the contractor's purchase orders.



# Expanded Audit Procedures and Results (Cont'd)

In addition, several vendors confirmed the purchase price but stated they had been waiting between 4 to 6 months for payment.

- The auditor also conducted an unannounced material inventory inspection to verify purchase existence and consumption of any of the sampled material items that were not adequately supported in the original testing. The contractor was unable to account for the location or use of over 60 percent these items. These results in conjunction with the results of the confirmation testing indicate that the contractor could be billing for materials items not that were never purchased or received.



# Further Actions

The auditor, supervisor, ACO and COTR discussed the results of the expanded testing. The ACO stated that the DCMA technical review was still in process, but preliminary findings were that the ETC was understated and the contract might be in a loss position. Overall these results strongly suggested that the contractor inappropriately included costs either not incurred or not paid timely on the progress payment request. The contractor also may have significantly understated the ETC. The audit team stated that they would submit a fraud referral for the potential false billing and issue a deficiency report for the identified noncompliances with the Defense Federal Acquisition Regulation Supplement (DFARS) billing requirements [DFARS 252.242-7006(c) (16)]. The team also suggested the ACO request DCAA review the most current progress payment request on the other five FFP contracts that permit progress payments. The additional progress payment reviews will determine whether similar problems exist on those contracts.



# General Comments/ Lessons Learned

Any audit that reviews a request for payment is sensitive. The auditor should always be aware of and consider factors that might indicate the contractor's financial condition is weak. A weak financial condition may motivate the contractor to bill items improperly. In addition to reviewing the billed costs, the auditor must also review other calculations that impact the amount of costs paid. Those include the estimate at completion, the cost of undelivered work, the liquidation rate and a flexible progress payment rate, if applicable. Problems found in those situations should be further analyzed for possible referral. Since progress payments are a financing vehicle, the main risk to the Government with overstated progress payments is the time value of money. However a declining financial condition that might prompt a contractor to overbill on a progress payment could also lead to the Government not receiving goods for which financing/payments were provided and/or potential contract default.



# Fraud Indicators

- Slow in paying suppliers or non-payments to suppliers, employees or government entities.
- Billing costs that were not incurred on the contract.
- Lack of support for calculations of key figures, such as estimate to complete (ETCs) or cost of undelivered work.
- ETCs that are not developed within 6 months of the progress payment date and/or do not reflect current contract delivery schedule or work performance.
- ETCs used for billing or contract performance reports that differ from other internal financial projections without reasonable explanation.
- Little or no physical progress even though significant costs have been billed and the contract delivery schedule indicates that significant physical progress should have occurred.
- Continued work performance, delivery or rework issues identified by Government official.
- Supporting documents missing or unavailable for review.
- Unreasonable time period for contractor to produce records that should be readily available.

