



November 12, 2013

Congressional Committees

## **Preliminary Observations on DOD Estimates of Contract Termination Liability**

This report responds to Section 812 of the National Defense Authorization Act (NDAA) for Fiscal Year 2013, which mandates that we report to the congressional defense committees on the extent to which the Department of Defense (DOD) is considering potential termination liability as a factor in entering into and terminating covered contracts.<sup>1</sup> Section 812 also mandates that DOD assess its relevant acquisition guidance and take appropriate actions to ensure that program managers for major defense acquisition programs (MDAP) are preparing estimates of potential termination liability for covered contracts.<sup>2</sup> This is the first of two reports we plan to issue in this area for these committees. The second report, in response to a mandate in the Senate Report, 112-173, on the NDAA for Fiscal Year 2013, addresses program cancellations and will be issued in early 2014. To meet our requirement under Section 812, this report (1) describes the results of DOD's assessment, and (2) presents preliminary observations on termination liability estimates.

To conduct this work, we reviewed DOD's assessment, in which DOD reviewed relevant acquisition guidance and collected information on a sample of six MDAPs. We also interviewed DOD officials responsible for conducting the assessment. In addition, we leveraged our ongoing work looking at program cancellations to further assess DOD efforts to consider potential termination liability. We interviewed DOD officials, obtained documentation on guidance and directives, and analyzed termination cost data for selected MDAP contracts terminated from 2004 through 2011. We are also collecting information on whether selected DOD programs have been requiring contract termination liability estimates before award and during the course of a contract. As part of our annual weapons assessment, we selected a non-generalizable sample of weapons programs that represent Air Force, Army and Navy, that cover a range of platforms including aircraft, ships and satellites, and that represent programs in both development and production phases. We requested answers to a standard set of questions to determine how DOD officials consider termination liability costs prior to contract award and before contract termination, and to identify guidance used in making those decisions. We will report on these and other findings in our early 2014 report on program cancellations.

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<sup>1</sup>Pub. L. No. 112-239 (2013). The NDAA does not define "termination liability", nor did DOD when conducting its assessment. For consistency with the Contract Funds Status Reports used by DOD, in this report we use the term "termination liability" to include costs incurred because of termination, as well as profit or fee owed. We do not include cost incurred for the work performed.

<sup>2</sup>The Act defines a covered contract as a contract for the development or production of a major defense acquisition program for which potential termination liability could reasonably be expected to exceed \$100,000,000.

We conducted this performance audit from July 2013 to November 2013 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

## Results in Brief

According to DOD, weapons programs generally receive estimates of termination liability from contractors, though there is no comprehensive guidance on how or when programs should require or consider termination liability estimates. DOD plans to include additional language to help ensure that program managers are aware of the need to consider termination liability before contract award and during the life of a contract in its next update of its acquisition management guidance.<sup>3</sup> However, our preliminary observations show that while programs are receiving estimates of termination liability from the contractors, in some cases, DOD's ability to predict actual termination costs with these estimates appears limited. We will continue to monitor this issue and will report our final results in early 2014.

## Background

DOD may enter into one or more contracts with a prime contractor for the development, production, or maintenance phases of a major defense acquisition program. In some cases, during the period of performance of a contract, changed circumstances can require termination of the contract before it is completed. The Federal Acquisition Regulation (FAR) grants the government the right to fully terminate or partially terminate a contract for the government's convenience at any time during the performance of a contract and provides various termination for convenience clauses depending on the type and dollar amount of the contract.<sup>4</sup> Terminating a contract for the convenience of the government is allowed because in some cases, termination of a contract is in the government's best interest. Even if the contractor is performing acceptably, the government can end its contractual obligation if it no longer needs the weapons or supplies provided under the contract because of a reduction in military force or the end of a war. However, the government is generally obligated, within certain limitations, to compensate the contractor for certain costs. Examples include the costs of disposing of inventory and negotiating with subcontractors. The FAR specifies these limitations and the categories of costs to which a contractor may be entitled when the government terminates a contract for convenience.<sup>5</sup> To assist the government in budgeting for the potential incurrence of termination liability costs and in determining if the rate of funding for a contract is sufficient, DOD cost-type contracts may contain a requirement for the contractor to provide funding data, including potential termination liability estimates, by submitting Contract Funds Status Reports (CFSR)

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<sup>3</sup>Department of Defense Instruction 5000.02, *Operation of the Defense Acquisition System* (Dec. 8, 2008).

<sup>4</sup>See, e.g., FAR §§ 52.249-2 and 52.249-6.

<sup>5</sup>Under a fixed-price contract, the contractor is entitled to compensation for the work done, the preparations made for the terminated portions of the contract, profit on work done and preparations made by the contractor for the terminated portion of the contract, and the costs of settlement of the work terminated. FAR §§ 49.201(a), 49.202(a), 52.249-2(f)-(g). Under a fixed-price contract, the government's liability is limited to the contract price plus the amount of settlement expenses. FAR §§ 49.207, 52.249-2(f). Under a cost-reimbursable contract, the contractor is entitled to compensation for the costs reimbursable under the contract for performance of the contract before the effective date of the termination, the costs of settlement of the work terminated, and a portion of the fee payable under the contract. FAR §§ 31.205-42, 49.305-1(a), 52.249-6(h).

(DD Form 1586) at the end of each calendar quarter or contractor accounting period nearest the end of each quarter during the contract period of performance.<sup>6</sup>

### **DOD Found Termination Liability Estimates Are Being Considered but That Additional Guidance Is Needed**

DOD provided us with its assessment of efforts to prepare estimates of potential termination liability for covered contracts. DOD reported program managers are preparing estimates of termination liability, though we found it was unclear whether program managers were developing their own estimates or using CFSR estimates. DOD determined based on its review that potential termination liability is a factor in decision making when terminating covered contracts and at certain points during the life cycle of a program. For example, DOD reported that all six MDAPs DOD reviewed considered potential termination liability estimates during the life of the contract. One of the six program offices reported that the office considered termination liability estimates before awarding the contract. According to DOD's assessment, in several instances program contracts required a CFSR from the contractor. Additionally, the DOD assessment found that cost estimators within DOD's Cost Assessment and Program Evaluation (CAPE) organization consider termination liability estimates when they conduct independent cost estimates.<sup>7</sup> We were told by a CAPE official that potential termination liability is not the major focus of the independent cost estimates. According to DOD officials, CAPE's review is to determine cost risks associated with technology and schedule and their impact on a program's budget, and occurs only at a program's milestone decision points before a program can proceed to the next acquisition phase. CAPE might not review costs in the interim between these phases, which can last several years, and would not necessarily be aware of changes in cost estimates until the next milestone decision point.

DOD found there is no comprehensive guidance on how or when programs should consider termination liability. Limited guidance is currently available in the Financial Management Regulation, Volume 2 and on the CFSR form.<sup>8</sup> According to DOD officials, when they talked with program officials in their sample, none of the program officials expressed the need for additional guidance because they felt adequate training on contract termination is offered through the Defense Acquisition University. However, DOD officials told us they are drafting new guidance for the DOD 5000.02 instruction to help ensure program managers are aware of the need to consider termination liability before contract award and during the execution of a contract. A DOD official stated that the revised instruction would likely not be adopted before the start of 2014. DOD determined that no additional actions are needed to address the mandate.

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<sup>6</sup>The CFSRs supply funding data about defense contracts to program managers for: (a) updating and forecasting contract funds requirements, (b) planning and decision making on funding changes in contracts, (c) developing funds requirements and budget estimates in support of approved programs, (d) determining funds in excess of contract needs and available for deobligation, and (e) obtaining rough estimates of termination costs.

<sup>7</sup>An independent cost estimate is conducted independently of the program office or defense agency. It is a full life-cycle cost estimate including all costs of development, procurement, military construction, and operations and support for a system. An independent cost estimate is required to be approved before a major defense acquisition program can enter the development phase or production phase of the acquisition lifecycle. 10 U.S.C. § 2434; Department of Defense Instruction 5000.02, Operation of the Defense Acquisition System Encl. 4, Table 2-1 (Dec. 8, 2008).

<sup>8</sup>Volume 2 of DOD's Financial Management Regulation requires that programs with certain types of contracts submit termination liability estimates with their budget estimates.

## **DOD's Ability to Predict Actual Termination Costs with Available Estimates Appears Limited**

Through our ongoing work looking at termination liability and program cancellations, we found weapons programs generally received estimates of termination costs from contractors in the CF SR. However, this information did not necessarily enable DOD to predict the actual cost of terminating a contract. The cost data included in these reports are developed by contractors and are rough estimates of costs that would be necessary to liquidate all government obligations if the contract were terminated. These reports are provided to DOD on a quarterly basis. Because they are estimates and the various factors affecting termination liability change through the life of contract, they can fluctuate over time. Our past work found that DOD officials questioned the reliability of these estimates because they were provided by the contractors and were not given high priority for verification by the government.<sup>9</sup> Some program officials we spoke with during our ongoing work were uncertain of how contractors arrived at these estimates, and were not aware of any additional information provided by contractors to support these estimates. Further, during our ongoing work we have learned that contractors may increase these estimates if termination of the contract seems probable. However, according to DOD officials, estimates of the termination costs can be useful for planning and budgeting decisions surrounding contract terminations. We will continue to monitor this issue and report our final results in our forthcoming report on program cancellations. In addition, our forthcoming report will include our findings from the questions we submitted to selected DOD programs about whether officials have been considering contract termination liability estimates before award and during the course of a contract.

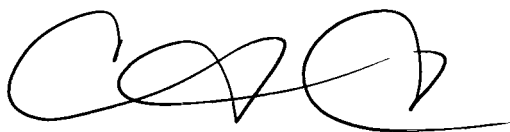
### **Agency Comments**

We requested comments on a draft of this report from the Department of Defense, but none were provided.

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We are sending copies of this report to the appropriate congressional committees. We are also sending a copy to the Secretary of Defense. This report will also be available at no charge on our website at <http://www.gao.gov>. Should you or your staff have questions, please contact me at (202) 512-4841 or [chaplainc@gao.gov](mailto:chaplainc@gao.gov).

Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report were Katherine Trimble, Assistant Director; Ann Marie Udale, Peter Anderson, Maria Durant, Kristine Hassinger, Raffaele Roffo, and Matt Shaffer.



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<sup>9</sup>GAO, *Defense Contracting: Terminating Major Weapons Contracts for the Government's Convenience*, NSIAD-91-255 (Washington, D.C.: Aug.30, 1991).

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