DHG
DIXON HUGHES GOODMAN LLP
Contract Types and Associated Risks
December 17th, 2015
The Fundamentals of Government Contracting Webinar Series
Your Presenters

David King
Dixon Hughes Goodman LLP
703.970.0433
david.king@dhgllp.com

Mike Mardesich
Dixon Hughes Goodman LLP
703.970.0508
mike.mardesich@dhgllp.com
Fundamentals of Government Contracting at a Glance

• Challenges of Contracting with the Federal Government (*November 2015*) - Completed

• **Contract Types and Associated Risks (** *December 2015*) – You are Here!**

• Year-End Closing (*January 2016*)

• An Introduction to the Incurred Cost Submission
  – Part II: Preparation and Adequacy Review (*March 2016*)
  – Accounting Systems and Setups (*April 2016*)
Fundamentals of Government Contracting at a Glance

• Accounting System Adequacy 101 (May 2016)
• The Composition of Total Cost (June 2016)
• Making Way for 2017 – Budgeting and Provisional Rates (July 2016)
• Procurement Systems: DFARS Business Systems Rule and Criteria (August 2016)
• Exploring the Gray Area of Unallowable Costs (September 2016)
• Policy and Procedures Manual: What’s In It and Why Do You Need One? (October 2016)
The Fundamentals of Government Contracting Webinar Series

Contracts Background
What is a Contract?

• Legal and binding agreement
• Essential elements:
  – Offer
  – Acceptance
  – Consideration
  – Competency and capacity (CO’s warrant)
  – Mutuality of obligation
• Consideration – Price to include reward for risk
• Contract includes terms and conditions
Impact of Contract Type

• Significant impact on price and competition
• Most contracts fit into one of two broad categories:
  – Fixed Price - the contractor is required to deliver the product specified and there is a maximum limit on the amount of money the government must pay.
  – Cost Reimbursement - the contractor is required to deliver a "best effort" to provide the specified product. All allowable costs must be reimbursed, regardless of delivery, up to the level specified in the contract.
• In between are various incentive contracts tailored to the uncertainties involved in contract performance.
Why a certain type of contract may be selected
Selecting Contract Types (FAR 16.101)

• Risk vs Reward

• Risk - Degree and Timing of Contractor Responsibility

• Reward - Amount & Nature of Profit Incentive Encouraging Contractor to Achieve Goal
Contract Risk

- Cost-Plus-Fixed-Fee (CPFF)
- Cost-Plus-Award-Fee (CPAF)
- Cost-Plus-Incentive-Fee (CPIF)
- Cost-Sharing (CS)
- Fixed-Price-Incentive (FPI)
- Firm-Fixed-Price (FFP)

Greatest Risk on Government

Greatest Risk on Contractor

Sharing Risk
<table>
<thead>
<tr>
<th></th>
<th>Cost Reimbursement</th>
<th>Fixed Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Promise</td>
<td>Best Effort</td>
<td>Shall Deliver</td>
</tr>
<tr>
<td>Contractor risk</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Government risk</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>Cash Flow</td>
<td>As Incurred</td>
<td>On Delivery</td>
</tr>
<tr>
<td>Progress Payments</td>
<td>None</td>
<td>% of actual</td>
</tr>
<tr>
<td>Administration</td>
<td>Maximum Gov’t</td>
<td>Minimum Gov’t</td>
</tr>
<tr>
<td>Fee/Profit</td>
<td>Max: 15% / 10% CPFF 6% A&amp;E</td>
<td>No Limit, Except 6% A&amp;E</td>
</tr>
</tbody>
</table>
Factors In Selecting Contract Type (FAR 16.104)

- Price competition
- Price analysis
- Cost analysis
- Type and complexity of the requirement
- Urgency of the requirement
- Period of performance or length of production run
- Contractor's technical capability and financial responsibility
- Adequacy of the contractor's accounting system
- Concurrent contracts
- Extent and nature of proposed subcontracting
- Acquisition history
Negotiating Contract Type (FAR 16.103(a))

• Selecting the contract type is generally a matter for negotiation and requires the exercise of sound judgment.

• Negotiating the contract type and negotiating prices are closely related and should be considered together.

• The objective is to negotiate a contract type and price (or estimated cost and fee) that will result in reasonable contractor risk and provide the contractor with the greatest incentive for efficient and economical performance.
Preference for Fixed Price

• A firm-fixed-price contract will be used when:
  – It utilizes the basic profit motive of business enterprise
  – the risk involved is minimal or can be predicted with an acceptable degree of certainty
• Government choosing cost type contracting at times when scope can not be easily determined.
• Contractors must negotiate with the government to ensure that cost type contracting is not selected when unnecessary.
Contract Clauses

• Certain clauses carry compliance risk
  – Allowable Cost and Payment clause (FAR 52.216-7)
  – Payments under Time and Materials and Labor-Hour Contracts (FAR 52.232-7)
  – Cost Accounting Standards (FAR 52.230-2)
  – Contractor Business Systems (DFARS 252.242-7005)
  – Audit and Records—Negotiation (FAR 52.215-2)

• Read and understand your contract terms and conditions!
Distinct contract types available to government contractors
Fixed Price Contract Types

- Firm Fixed Price
- Fixed Price with Economic Price Adjustment
- Fixed Price Incentive
- Fixed Price Prospective Price Redetermination
- Fixed Ceiling Price with Retroactive Price Redetermination
- Fixed Price Level of Effort
Firm Fixed Price (FAR 16.202)

• Attributes
  – Price not subject to adjustment
  – **Contractor at maximum risk and full responsibility**
  – For profit
  – For loss
  – Minimum administrative burden on parties

• Application
  – firm-fixed-price contract is suitable for acquiring commercial items or …other supplies or services on the basis of reasonably definite functional or detailed specifications when the contracting officer can establish fair and reasonable prices at the outset…
Incentive Contracts

• Attributes
  – When firm fixed price is not appropriate
  – Supplies and services can be acquired at lower costs by relating profit to performance
  – Delivery and technical performance can be acquired at lower costs by relating profit to performance

• Application
  – Incentive types:
    • Cost incentives
    • Performance incentives
    • Delivery incentives
    • Multiple incentives
Basic Cost Reimbursement Contract Types

- Cost
- Cost sharing
- Cost plus incentive fee
- Cost plus award fee
- Cost plus fixed fee
Cost Reimbursement Contracts (FAR 16.302)

• Attributes
  – Contractor provides a specified “level of effort”
    • For reimbursement for Allowable Incurred Cost
    • Cannot estimate accurately enough for FP contract
    • Obligate funds and establish a ceiling

• Application
  – Used only when:
    • Adequate contractor accounting system
    • Appropriate government surveillance
    • Statutory limit on the fee (FAR 15.404-4(c)(4))
    • Acquisition of non-commercial items
Cost-Plus-Fixed Fee (CPFF) (FAR 16.306)

• Attributes
  – Payment of negotiated fee fixed
    • Statutory fee limitations apply (FAR 15.404-4(c)(4))
  – Fee may be adjusted as a result of contract changes
  – Permits contracting efforts where contractors may otherwise be at too great a risk
  – Contractor has minimal incentive to control costs
  – Not used once preliminary studies indicate achievable results

• Application
  – Suitable for
    • the performance of research or preliminary exploration or study, and the level of effort required is unknown; or
    • the contract is for development and test, and using a cost-plus-incentive-fee is not practical
    • normally should not be used in development of major systems
Cost Incentive Contracts (FAR 16.302)

• Attributes
  – When firm fixed price is not appropriate
  – Supplies and services can be acquired at lower costs by relating profit to performance
  – Delivery and technical performance can be acquired at lower costs by relating profit to performance
  – Prohibited: Cost-Plus-Percentage-of-Cost
Cost Type Contracts – Compliance Risks

- Allowable Cost and Payment clause (FAR 52.216-7)
  - Incurred Cost Submission

- Adequate contractor accounting system

- Appropriate government surveillance

- Statutory limit on fee (FAR 15.404-4(c)(4))

- Acquisition of non-commercial items

- Financial risk is to the government while compliance risk is to the contractor
Other Contract Types

- Indefinite Delivery
- Time & Materials
- Labor-Hour
- Letter Contracts
- Basic Agreements
- Basic Ordering Agreements (BOAs)
Indefinite Delivery (FAR 16.5)

• **Definite Quantity Contracts**
  – Definite quantity of supplies or services during a fixed period

• **Indefinite Quantity Indefinite Delivery (IDIQ) Contracts**
  – Minimum & maximum
  – Indefinite quantity of supplies or services during a fixed period

• **Requirements Contract**
  – Best Estimated Quantity (BEQ)
  – Provides for filling actual requirements by placing order during a fixed period
  – All known government requirements (of that sort) will be placed with that contractor
• Attributes
  – Payment for direct labor hours at a fixed hourly rate (including overhead, G&A and profit)
  – Payment for materials at cost (including handling costs)
  – No positive profit incentive for cost control or labor efficiency

• Application
  – May be used only when:
    • it is not possible at the time of placing the contract to estimate accurately the extent or duration of the work or
    • to anticipate costs with any reasonable degree of confidence
  – May be used only:
    • after the contracting officer executes a determination and findings that no other contract is suitable; and
    • if the contract includes a ceiling price that the contractor exceeds at it’s own risk.
• FAR 52.232-7 Payments under Time and Materials and Labor-Hour Contracts.
  – Payment for materials is subject to the Allowable Cost and Payment clause (FAR 52.216-7).
  – Incurred Cost Submission trigger

• Audit Items
  – Labor Hours
  – Timekeeping System
  – Labor Categories
  – Resumes
Letter Contracts (FAR 16.603)

- **Attributes**
  - Preliminary contract that authorizes contractor to begin work immediately
  - Includes (not to exceed) price ceiling

- **Application**
  - May be used when:
    - the government’s interests demand that the contractor be given a binding commitment so that work can start immediately and
    - negotiating a definitive contract is not possible in sufficient time to meet the requirement.
Basic Agreement & Basic Ordering Agreement (FAR 16.601)

- **Attributes**
  - Use when multiple awards anticipated w/contractor
  - Written statement of understanding containing clauses
  - BOAs: Possible description of supplies and services
  - Neither are contracts

- **Application**
  - When a substantial number of separate contracts may be awarded to a contractor during a particular period and significant recurring negotiating problems have been experienced with the contractor.
Join us next month for **Year-End Closing: Accounting and Contracts** on Thursday, January 28th