COMPTROLLER

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MEMORANDUM FOR UNDER SECRETARIES OF DEFENSE
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DIRECTORS OF THE DOD FIELD ACTIVITIES

SUBJECT: Change in Financial Reporting Practices for Progress Payments Based on Cost

Effective Quarter 4, fiscal year (FY) 2006, the Department of Defense (DoD) implemented a change in the financial reporting practices for progress payments based on cost, a type of contract financing payment that is authorized in contracts that include Federal Acquisition Regulations (FAR) contract clause 52.232-16, "Progress Payments." The purpose of the change in reporting practice was to recognize a contingent liability in the Balance Sheet for the estimated amount of contractor-incurred cost in excess of authorized progress payments based on cost. Recognition of this contingent liability alerts the financial statement user of a potential outflow of resources that is conditional upon the future delivery and Government acceptance of the product/service.

The attached document, entitled "Change in Financial Reporting Practices, Progress Payments Based on Cost," describes the Department's procedures for computing and reporting the quarter-close estimated contingent liability and corresponding increase in other assets. The DoD Financial Management Regulation will be updated to reflect this change in reporting practice.

My point of contact is Ms. Carol Phillips, who can be contacted by telephone at 703-693-6503 or e-mail at carol.phillips@osd.mil.

Robert P. McNamara
Acting Deputy Chief Financial Officer

Attachment:
As stated

Change in Financial Reporting Practices
Progress Payments Based on Cost

Effective Quarter 4, fiscal year (FY) 2006, the Department implemented a change in reporting practices for progress payments based on cost, one of several types of contract financing payments that are defined in the Federal Acquisition Regulations (FAR), Part 32, as an authorized Government disbursement of monies to a contractor prior to acceptance of supplies or services by the Government. The purpose of the change in reporting practice is to recognize a contingent liability in the Department's Balance Sheet for the estimated amount of contractor-incurred cost in excess of authorized progress payments based on cost.

Background

Contract financing payments serve as a means to lower the overall costs of defense procurement, permit more companies to compete for defense contracts, and provide prudent levels of financing on long-term, high-value contracts. The Department uses several different types of contract financing payments, such as advances, performance-based payments, and progress payments based on cost.

The change in financial reporting practice implemented in Quarter 4, FY 2006, applies solely to progress payments based on cost, authorized in contracts that incorporate contract clause FAR 52.232-16, "Progress Payments." Progress payments based on cost provide the contractor with interim financing payments that are based on a contract-specified rate applied to the contractor's cumulative allowable cost incurred. As deliveries and Government acceptance occurs, the financing payments are liquidated in accordance with contract terms and conditions.

FAR 52.232-16 includes language that protects taxpayer funds in the event of contract nonperformance. The Department's liability to pay the contractor in excess of the authorized progress payments based on cost arises only upon delivery and government acceptance of a satisfactory end item. Because it is probable that, in most of these contracts, the contractor will deliver and the government will accept a satisfactory product (in 2004, an estimated 92 percent of DoD contracts with progress payments based on cost were fully executed), and the amount of the contingent liability is estimable, federal Generally Accepted Accounting Principles require that the Department recognize a contingent liability in its Balance Sheet. Recognition of this contingent liability alerts the financial statement user of a potential outflow of resources that is conditional upon the contractor's future delivery and Government acceptance of the product/service.

Reporting Procedures

At quarter close, the Defense Finance and Accounting Service (DFAS) will query the Mechanization of Contract Administration Services (MOCAS) entitlement system for the balances of cumulative, unliquidated progress payments based on cost. Using these balances and the contract-specified progress payment rate, DFAS will estimate the contractor's total allowable incurred cost. The estimated total allowable incurred cost, less the reported MOCAS unliquidated progress payment balances, will equal the estimated Contingent Liability to be recognized in the Balance Sheet.

Example

Balance, Unliquidated Progress Payments	$4,000,000
(Divided by) Contract progress payment rate	80%
Total estimated contractor-incurred cost	$5,000,000
Less: Unliquidated Progress Payment Balance	$4,000,000
Estimated Contingent Liability	$1,000,000

In the above example, the MOCAS entitlement system has reported $4,000,000 in unliquidated progress payments for Contract X. The $4,000,000 unliquidated progress payment balance, divided by the contract-authorized progress payment rate of 80 percent, results in an estimated total contractor incurred cost of $5,000,000. The $1,000,000 difference, which results from subtracting the MOCAS unliquidated progress payment balance from the estimated total contractor-incurred cost, is the estimated Contingent Liability, which will be paid to the contractor conditional upon the future delivery and Government acceptance of the end product/service.

The DFAS will calculate and provide each accounting station with the amount to record as a contingent liability. The Component accounting sites will be responsible for entering the adjusting journal entry, recognizing the contingent liability and the corresponding increase in outstanding contract financing payments. Upon request, the DFAS will supply the reporting unit with the supporting detail and calculations for the adjusting journal entry.

The calculation of the estimated contingent liability and adjusting journal entries will be updated each quarter based on the unliquidated progress payment balances extracted from the MOCAS system at quarter close. The specific proprietary and budgetary adjusting journal entries and related explanatory note disclosures will be provided to Components in the Department's quarter close financial statement reporting guidance. The DoD Financial Management Regulation will be updated to reflect this change in reporting practice.