GAO

United States
General Accounting Office
Washington, D.C. 20548

Office of the General Counsel

Subject: Alleged violations of the Antideficiency Act in the Air Force's procurement of advanced cruise missiles.

File: B-255831

Date: July 7, 1995

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Derek J. Vander Schaaf
Deputy Inspector General
Department of Defense

Dear Mr. Vander Schaaf:

You asked for our views on three questions concerning the Air Force's procurement of advanced cruise missiles (ACM) for fiscal year (FY) 1987 and 1988. The questions involve alleged violations of the Antideficiency Act pertaining to the FY 87 procurement. The Act, codified in part at 31 U.S.C. § 1341, prohibits federal employees from incurring obligations in excess of available funds. Attempting to avoid a violation of the Antideficiency Act, in April 1992 the Air Force terminated its contract for ACMs because projected cost overruns would have exceeded available funds. In this respect, we reported in 1994[1] that the ACM program had to be restructured dramatically in 1992 in key part because of the lack of funds to cover FY 87 and 88 cost overruns.

You question whether three separate aspects of the Air Force actions violated the Antideficiency Act. The first is the failure to commit funds to cover the ceiling price of the contract and the resulting projection of unfunded cost overruns. Second, you ask whether the Air Force violated the Act when it allowed contract performance to continue unabated until all available funds were exhausted. Third, you assert that costs actually incurred by the contractor prior to termination exceed available funds in the account, thus causing a deficiency.

We do not believe that the Act was violated. While it is clear the Air Force could have done substantially more to manage the contract effectively, a projection of overruns does not in itself constitute an Antideficiency Act violation. Further, we see no violation in allowing contract performance to continue, as opposed to terminating the contract based on the projection overruns. Moreover, the Air Force's termination strategy avoided costs that, had the transaction been structured differently, may have caused a deficiency.

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[1] STRATEGIC MISSILES: Issues Regarding Advance Cruise Missile Program Restructuring, GAO/NSIAD-94-145 (May 1994).

Our finding that the Air Force did not violate the Antideficiency Act should not be taken as an endorsement of its actions with regard to the FY 87 ACM procurement. In view of the difficult technical and cost problems that delayed contract definitization for a year and a half, the Air Force should have anticipated that cost overruns likely would take the contract to ceiling price. Yet, at the time of definitization, the Air Force did not act to commit sufficient funds in the appropriation account to complete the contract. Even after definitization, as the likelihood of overruns approached reality, the Air Force took no steps to manage the contract (e.g., cutting back the number of missiles), or the account (e.g., reducing other demands on the account), to cover the ceiling. Other than requesting additional funds from the Congress, this left the Air Force with only one practical option as costs continued to increase while the account was being exhausted: termination of the contract.

BACKGROUND

Contract Award and Performance History

In March 1986, the Air Force awarded an undefinitized contract to General Dynamics Corporation, Convair Division (GD/C), to begin production of advanced cruise missiles for FY 87 (referred to as "Lot III").[2] It was not until September 12, 1989, that the Air Force definitized this fixed-price-incentive (FPI) contract (No. F33657-88-C-0103).[3] At definitization the firm target price under the Lot III contract was $537.2 million and the ceiling price was $613.1 million for 150 missiles. The contract contained an option for an additional 100 missiles for FY 88 ("Lot IV') at a target price of $231.7 million and a ceiling price of $261.9 million. The contractor was to be liable for 30 percent of any overrun of the target cost, in the form of reduced profit; the ceiling price established the government's maximum liability. The Air Force exercised the Lot IV option on January 30, 1990.

Both before and after Lot III definitization, the serious design and production problems persisted on GD/C's'1985 and 1986 ACM contracts (Lots I and II). In November 1989, 2 months after definitization of Lot III, these continuing problems culminated in the Air Force ordering GD/C to halt deliveries of all missiles on all production lots until the technical difficulties were resolved.[4] In November 1990,

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[2] In August 1992, General Dynamics Convair Division was acquired by Hughes Corporation. This opinion will refer to the contractor throughout as GD/C.

[3] The definitized contract took effect on September 22, 1989, after approval by the Assistant Secretary.

[4] Deliveries did not resume until June 1990. This did not resolve all the problems, however. The Air Force again found it necessary to suspend deliveries, from April to

GD/C formally alerted the Air Force to the probability that the difficulties would cause the Lot III contract to exceed the target cost by $40.9 million. The contractor sought to correct the problems and eventually did so. Meanwhile, the Air Force was trying to verify the exact amount the contract costs would increase. The Air Force's final cost estimate was completed in October 1991, 11 months after the contractor's formal notice of increasing costs. By that time, however, the projected overrun for the contract had increased to approximately $100 million.

Contract Funding

The Air Force definitized the Lot III contract just 2-1/2 weeks before the FY 87 Missile Procurement, Air Force account ("account 3020")" was to expire, and obligated the account only for the target price. Air Force officials did not commit additional funds in the account to cover predictable cost overruns. As a result, when the cost overruns were later projected, the account balance was not sufficient to cover them.

An Air Force audit completed in September 1994 indicates that in order to cover the overruns Air Force officials had intended to seek access to the merged surplus account.[5] The merged surplus account housed large unobligated balances without fiscal year identity that could be used for upward adjustment of obligations from expired fiscal years. However, those balances were canceled by statute in 1990.[6] Because FY 87 and 88 funds were nearly exhausted and the merged surplus account was no longer available when the cost overruns were firmly estimated in the fall of 1991, the Air Force needed to find another source of funds, take some action to limit costs charged by the contractor, or request a deficiency appropriation.

The Air Force pursued only the first of those options, as Air Force officials began discussions with the Assistant Secretary of the Air Force (Financial Management and Comptroller) about funds to cover the projected overrun. In October 1991, these discussions culminated in requests for expired year funds. The amounts requested were $71.5 million from FY 87 and $27.1 million from FY 88. These requests were denied because such large amounts were not available.

Next, the Air Force asked to use FY 92 ACM funds to finish the Lot III and IV contract. The request relied on the theory that the new legislation allowed the use of current year funds to carry out contract changes within the original scope of work. The

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October 1991. See STRATEGIC MISSILES: ACM Program, Opportunity for Additional Savings, GAO/NSIAD-92-154 (Nov. 1992).

[5] Report of Audit, Projects 94063015, Sept. 9, 1994.

[6] Pub. L. No. 101-510, § 1405, 104 Stat. 1485, 1675, (1990).

Assistant Secretary at first agreed with that position.[7] Ultimately, the Department of Defense (DOD) Comptroller denied the request to use 1992 funds to complete the contract.[8] When the use of current year funds finally was ruled out, the Air Force decided to terminate the contract for Lot III to prevent an Antideficiency Act violation. On April 6, 1992, the Air Force terminated the Lot III contract with GD/C for the convenience of the government. Days later, the Air Force also terminated 24 missiles from Lot IV. Only 54 of the 250 missiles in Lots III and IV had been delivered as of the date of termination.

Immediately prior to termination, obligations on the contract had reached $565 million ($28 million over target, and $48 million below ceiling). On March 31, 1992, the FY 87 unobligated balance in account 3020 was $25.188 million. The balance increased slightly as of the end of April 1992. According to the Air Force's calculations, termination prevented contractor-incurred costs from surpassing available budget authority. For that reason, Air Force officials believe their action avoided an Antideficiency Act violation.

Subsequent Procurement

Actions on Lots III and IV occurred against a backdrop of other changes to the ACM program. In January 1992, citing changing defense needs in the post-Cold War era, the President announced a major cutback in total ACM procurement. The President determined that only 640 missiles were needed, instead of the previously planned 1,000. On February 27, 1992, the Air Force program manager issued a stop work order for activities related to the FY 92 procurement of 120 ACMs.[9] The stop work order directed GD/C immediately to suspend advance buy and long lead activities then underway for FY 92 and later years. The ACM program was later reduced still further to 520 missiles.[10]

Two months later, the 1987-88 contract was terminated for lack of funds. The day after terminating the Lot III contract, the Air Force used 1992 funds to enter into a new sole-source contract with GD/C for 120 missiles at a firm, fixed price. This contract used 96 partially completed missiles from the terminated contract, and 24

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[7] See GAO/NSIAD-92-154, supra.

[8] Memorandum from Sean O'Keefe to Assistant Secretary of the Air Force (Financial Management and Comptroller), Mar. 31 1992,

[9] A second stop work order was sent to McDonnell Douglas Corporation, which had a contract as the second supplier of ACMs in FY 92.

[10] Additional program restructuring reduced the number of missiles the Air Force eventually acquired to 461. GAO/NSIAD-92-154, supra.

that were about to be terminated from the Lot IV contract, as government-furnished equipment. These 120 missiles filled out the final missile complement of 520.

Congressional Ratification

On April 28, 1992, the Air Force notified the Senate Appropriations Committee of the termination of the FY 87 and FY 88 ACM production lots and the subsequent procurement of 120 missiles with FY 92 funds. Congressional response to that notification came on May 20, 1992, in the conference report on the 1993 rescission legislation. In that legislation, Congress rescinded $344 million of the $433.1 million originally appropriated for ACM procurement in FY 1992. Some of the $89.1 million that was not rescinded had already been expended on the suspended 1992 long lead effort. As to the remainder, the conferees "specifically directed" the Air Force to use "remaining fiscal year 1992 funding . . . to complete the procurement of the fiscal year 1987 and 1988 missiles. . . ."[11]

ANALYSIS

Antideficiency Act

An agency that obligates or expends funds in excess of the amount available in the appropriation account violates the Antideficiency Act. 31 U.S.C. § 1341. Inspector General Report No. 93-053, dated February 12, 1993, alleged three violations of the Antideficiency Act arising from the Lot III contract. First, the report asserted that because the government had a contract requiring it to pay the cost overruns, the prediction of unfunded overruns was a violation of the Antideficiency Act. Second, the report stated that the Air Force violated the Act when it failed to make immediate adjustments in funding sources, obligation levels, or contract requirements as soon as the escalating costs became apparent. Finally, the report suggested that the contract did in fact incur costs in excess of available funds, thereby causing a deficiency.

The report's conclusion seems to proceed from the assumption that exposing the government to a situation in which liability for costs on a valid contract has the potential to exceed available appropriations violates the Antideficiency Act. We disagree. In this case, the Air Force initially obligated an amount equal to the target price of the contract, which is the accepted practice.[12] In terms of appropriation accounting, the difference between the target and ceiling prices is a contingent liability that may or may not require future obligations. An officer of the government violates the Act only by incurring or authorizing an obligation or making an

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[11] H.R. Rep. No. 530, 102d Cong., 2d Sess. 28.

[12] See, e.g., Federal Acquisition Regulation, 48 C.F.R. § 32.703-1.

expenditure that puts the appropriation account in a deficiency status. That did not happen here. Because the Air Force terminated the contract, no obligation was ever incurred or authorized for the unfunded portion of the projected overrun.

An agency faced with a possible violation of the Antideficiency Act has a duty to act to prevent the violation or at least to mitigate its consequences. One example of government action that would reduce the contingent liability would be the modification of the contract to include design or quantity changes that would allow the contract to be completed within available funds. In fact, your criticism of Air Force officials for not taking such steps implicitly recognizes that such actions would avoid an Antideficiency Act violation.[13]

Another option to avoid a possible Antideficiency Act violation is termination of the contract for the convenience of the government. Termination is the ultimate tool at the government's disposal to prevent a contractor from incurring costs beyond the account 's limit. Convenience termination of a contract to prevent an Antideficiency Act violation is a drastic measure with serious consequences. Termination costs can be substantial. Moreover, the government loses the value of its original bargain with the contractor.

Despite its negative aspects, however, termination for the convenience of the government is an effective means of avoiding an Antideficiency Act violation. As we said in 55 Comp. Gen. 768, 773 (1975), termination "will fix the Government's final obligation . . . at the amount payable pursuant to the Termination for Convenience clause." If that amount is less than what would otherwise be due under the contract, termination is "the most that can be done" to prevent a violation. In that case, the violation was so large that contract termination was sufficient only to reduce it. In the current circumstances, the Air Force, in terminating the contract for convenience, minimized the attendant costs so as to successfully avert a violation.

In this respect, it has been suggested that the Lot III termination costs exceeded the amount remaining in the 3020 account. If that were true, the need to pay termination cost with FY 87 funds might have caused an Antideficiency Act violation. The Air Force has reported, however, that sufficient funds were available at all times to cover all contract and termination costs. The way the transaction was structured, that appears to be an accurate statement.

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[13] To the extent that deobligation of other funds in the account was possible, that would also have prevented an Antideficiency Act violation in the circumstances described. Deobligation, however, could have a negative programmatic impact on the "donor" program or programs.

The use of the 1992 letter contract allowed GD/C and the Air Force to avoid the expenses normally associated with terminating a contract for the convenience of the government.[14] Because its work was not interrupted, GD/C sustained minimal termination related costs. In fact, GD/C was willing and agreed to perform on the letter contract for approximately the same total amount as would have been paid under the Lot III contract, including the 30/70 cost sharing ratio.

At the time of termination, the prime contractor had outstanding subcontracts worth $7.6 million. The subcontracts were orders for materials, parts, and supplies GD/C placed with subcontractors before the Air Force terminated the contract. Upon termination, the unliquidated payments due subcontractors became potential termination expenses of Lot III. Under the termination clause in the contract, the contracting officer may approve, as part of the termination agreement, the prime contractor's proposed termination settlement with its subcontractors. See 48 C.F.R. § 52.249-2. Here, because its performance on the letter contract would have required it to obtain the same items previously subcontracted, GD/C apparently elected to continue rather than terminate the subcontracts. The result was that costs that might have been associated with terminating the subcontracts were avoided.[15]

Another element of cost avoidance was the letter contract's direction that partially assembled missiles from Lot III and other related inventory in the contractor's possession be used in its performance. The Federal Acquisition Regulation confers broad discretion on a contracting officer to make termination arrangements that are fair and reasonable. 48 C.F.R. §§ 49.103 and 49.105(c). The Lot III termination achieved that objective.

Funding and Contract Management

As stated at the outset of this letter, the Air Force's successful avoidance of an Antideficiency Act violation does not mean that its actions in this situation should be condoned. It was the Air Force's own failure to deal with serious funding issues effectively and timely that placed it in a position where it needed to take drastic contract action to avoid violating the law.

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[14] The Air Force was able to make use of the letter contract because, as discussed earlier, it needed 120 missiles to reach the full missile complement of 520, and had an FY 92 authorization and appropriation to buy them.

[15] In any event, the 3020 account balance of $25 million at the time of termination would have been sufficient to cover the $7.6 million in subcontract costs, had that become necessary.

In our view, the Air Force should have known well before contract definitization that it would not be able to pay for the number of missiles required in the letter contract with the funds it would have available. GD/C had experienced numerous problems, and cost overruns, on the Lots I and II contracts for ACMs. Moreover, work on the Lot III contract was well under way by the time of definitization in September 1989. The negotiations leading up to definitization were unusually lengthy and had to alert the parties to technical problems substantial enough that their resolution would materially affect the contract costs. Accordingly, we think that Air Force officials either knew or should have known there was a significant risk that the Lot III contract as structured would reach its ceiling price.

The Air Force, pursuant to its own regulations and DOD accounting procedures, should have taken actions to commit funds in the appropriation account to cover foreseeable cost overruns up to the ceiling price. The Air Force and DOD accounting manuals have procedures for recording obligations in connection with incentive contracts.[16] Although the manuals state that the minimum obligation to be recorded at contract award is the target or base price (which is what the Air Force did),[17] the same manuals provide guidance on how to plan for overruns to the ceiling price. The manuals direct the contracting agency to estimate the amount by which a FPI contract is anticipated to exceed its target. The agency then is to "commit," or reserve, the estimated amount, so that funds will be assured to cover foreseeable cost overruns.[18] An agency that fails, as the Air Force did, to commit funds in the account to cover cost increases to the ceiling price runs the risk of facing unfunded contract liabilities and Antideficiency Act problems. Had the Air Force followed established procedures for committing funds, the account might have been able to support the

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[16] Air Force Regulations 170-8, Accounting for Obligations, and 170-13, Accounting for Commitments; DOD Instruction 7220.9-M, Standards for Recording Commitments and Obligations.

[17] This practice is also approved in the Federal Acquisition Regulation at 48 C.F.R. Part 32.703-1, and in the GAO Fiscal Policy and Procedures Manual for the Guidance of Federal Agencies, title 7, § 3.4.C.

[18] The directives and the manuals do not require an agency to commit the full ceiling price in each instance. Instead, they require the officials to use their best judgment of the amount of funds that will be needed, and they encourage realistic estimates. An agency also has the option of obligating the additional funds instead of committing them.

contract,[19] and there would have been no need to terminate the contract or look to the merged surplus account for funds.

Further, to the extent the Air Force may not have been fully aware on or before definitization exactly how bad the Lot III situation would be, it certainly knew the target price would be breached well before the actual termination decision. GD/C advised the Air Force almost 1-1/2 years before termination that it would exceed the target cost by more than $40 million. We recognize that the precise quantum of the problem may not have been know until later, but its significance certainly was.

In its report on ACM Contracting and Financial Activities,[20] the Air Force Audit Agency found that the Air Force did not use available tools and processes for identifying and quantifying the contract's over–target condition. The report specifically criticized managers' neglect of accurate accountability over changes in the contract values, and senior managers' failure to take timely action in response to early indications of target overruns.[21] The audit agency further concluded that the Air Force's failure to explore was to cure the funding situation essentially was caused by program officials' anticipation that the merged surplus account would be available, as it historically had been, to fund the Air Force's share of over-target costs. As stated above, however, the Congress canceled those unobligated balances in 1990. That legislation was based in large part on the Congress's general concern that controls over the use of appropriations were not effective, but also on its finding that DOD in particular was spending merged account funds without sufficient assurance that there was authority for the expenditures or in ways that the Congress did not intend.[22]

CONCLUSION

While there is no Antideficiency Act violation in the current facts, the Air Force failed to commit funds for reasonably predictable cost overruns. We pointed out as long ago as 1955 that when an obligation is recorded at the target price, failure to reserve to reserve funds up to the ceiling price exposes the contracting agency to the risk of

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[19] The contract was definitzed on September 12, 1989. At the end of the prior month, there was enough money in account 3020 to cover the ceiling. By the end of September, however, the unobligated account balance was only $48.6 million, whereas the target/ceiling difference was $76 million, as we reported in May 1994. The account balance on September 12 is not available.

[20] Report of Audit, Project 94063015, Sept. 9, 1994.

[21] For example, the Air Force did not convene a senior review team to address contract and funding problems.

[22] <u>See</u> 72 Comp. Gen. 343, 345 (1993).

an Antideficiency Act violation. 34 Comp. Gen. 418 (1955). Moreover, the Air Force did not make use of other opportunities to avoid termination of the Lot III contract by taking effective, affirmative measures to manage costs or reduce quantities.

We trust the foregoing is helpful to you.

Sincerely yours,

Robert P. Murphy
General Counsel

Digest

1. The Air Force did not violate the Antideficiency Act when it terminated a fixed-price-incentive contract for lack of funds. Termination of a contract prior to incurring obligations in excess of funds available in the appropriation account prevents an Antideficiency Act violation.

2. Projected cost overruns between the target and ceiling prices of a fixed-price-incentive contract are not de facto obligations. Until the contractor has a legal right to be paid for costs incurred, potential cost overruns are contingent liabilities.

3. Air Force regulations permit a procuring entity to limit the initial obligation on a fixed-price-incentive contract to the target price. Regulations also require the procuring entity to commit funds to cover the expected cost of contract. Failure to follow those regulations on the advanced cruise missile contract for fiscal year 1987, where overruns were foreseeable, resulted in insufficient funds being available when needed to complete the contract at the ceiling price.