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CONTRACT FINANCING
FOR SMALL BUSINESS

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CONTRACT FINANCING FOR SMALL BUSINESS

EXECUTIVE SUMMARY

To perform effectively on a contract, a firm needs operating capital. DoD both screens prospective contractors for financial responsibility and assists its contractors with procedures that reduce their operating capital requirements.

DoD policies and practices with respect to pre-award determinations of financial responsibility are effective. Before rejecting a small business on the basis of nonresponsibility, DoD must refer the case to the Small Business Administration for its determination. DoD must accept the SBA's finding. The SBA rulings of competency are negligible compared to DoD's total contracting with small business.

The overwhelming majority of contracts are for amounts less than \$10,000 or have short delivery times. On such contracts, any cost of contract financing is built into the price. For most other contracts, existing DoD policy shifts nearly all the burden of financing operating capital to the Government. This is done primarily through prompt payment of invoices for cost reimbursements or progress payments. Biweekly billing is permitted for costs incurred under cost-reimbursement contracts.

The progress payment program allows contractors whose fixed-price contracts require significant expenditures prior to billable deliveries to receive payments based on a percentage of costs incurred. Those payments assist small business firms with contracts requiring four months or more to first delivery. The program is vital and effective.

Payment delays are not a major problem. The Defense Contract Administration Services' payment offices employ techniques by which most contract payments are made promptly. Delays occur, however, when automated procedures break down and when inspection and approval of shipments take place at the destination rather than at the supplier's location. Promptness is not expected for some payments, such as the first or last in a series.

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1. BACKGROUND

To perform effectively on a contract, a firm needs operating capital. DoD both screens prospective contractors for financial responsibility and assists its contractors by providing some operating capital.

Contract financing problems are generally more serious for small businesses than for large firms. Small businesses have fewer contracts and are less able to cope with financing problems on any one contract. Small businesses tend to have more limited financial resources and usually must pay higher interest rates for borrowed money. They are less likely to have accounting systems that would allow them to prepare invoices as frequently as the Government is willing to pay.

Interest rates have increased dramatically in recent years. A logical question is whether the impact of higher interest rates on small businesses necessitates a change in DoD contract financing policies and DoD methods of determining financial capability.

We conclude that DoD contract financing policies and procedures for small business contractors are effective. We find contract financing problems to be minor. DoD policies and procedures with respect to pre-award determination of financial responsibility are sound.

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There is a cost associated with operating capital. In Government contracting, however, none of the contractor's cost of operating capital is recognized. Interest is not allowed as a cost. And, unlike the imputed cost of facilities capital, no imputed cost of operating capital is allowed as a cost.

Since the cost of operating capital is not an allowable cost on Government contracts, it must be recovered in profit received by the contractor. Therefore, contract profitability is dependent in part on the extent and cost of the operating capital supplied by the contractor.

For the overwhelming majority of contracts -- those for amounts less than \$10,000 or those with short delivery times -- any cost of contract financing must be built into the price. For most other contracts, whether with small business firms or other contractors, existing DoD policy shifts nearly all the burden of financing operating capital to the Government. For cost-reimbursement contracts, the Government permits a contractor to bill biweekly for his incurred costs. For fixed-price contracts, the Government has a progress payment program. In unusual circumstances, guaranteed loans and advance payments may be used to provide operating capital.

Progress payments allow contractors to bill the Government monthly based on a percentage of costs incurred. Progress payments are used on fixed-price contracts which require significant expenditures prior to billable deliveries. For small businesses, this means contracts which involve at least four months between the beginning of contract work and the first production delivery. The progress payment rate for small business contractors is 95% of incurred costs. The term "incurred costs" includes all contract-related costs measured on an accrual basis and may therefore include unpaid costs.

The progress payment program for small businesses is quite different from that for other contractors. The pre-delivery period of four months for small businesses compares with six months for others. Incurred costs for contractors other than small businesses may not include unpaid costs. Except for small business contractors, contracts of less than \$1,000,000 are not normally eligible for progress payments. The rate of 95% for small businesses compares with 90% for other contractors.

FINANCIAL RESPONSIBILITY

An important feature of DoD's acquisition policy is that purchases "shall be made from, and contracts shall be awarded to, responsible prospective contractors only."¹ The policy statement is unequivocal: "Doubt as to productive capacity or financial strength which cannot be resolved affirmatively shall require a determination of nonresponsibility."² When there is a prospect of awarding a contract to a firm about which the contracting officer does not have adequate information to support a determination of responsibility, he normally requests a pre-award survey of a prospective contractor's competence.

Pre-award surveys are most frequently conducted by the Defense Contract Administration Services in connection with proposed awards to small business firms, often those which have not previously performed under defense contracts. The present regulations require a pre-award survey prior to a determination of nonresponsibility of a small business contractor except where the award is to be made under the small purchase procedures. Financial capability is one of several factors to be investigated.

The survey team financial analyst seeks information in a number of places. He obtains copies of a contractor's balance sheets and operating statements for the most recently completed two years and the most recently completed interim period. If available, the analyst obtains a cash flow statement and an analysis of the current backlog of orders and expected delivery schedule. Information from creditors, commercial financial services (such as Dun & Bradstreet and Standard & Poor's), and the potential contractor's bank is also sought.

¹Defense Acquisition Regulation (DAR) 1-902.

²Ibid.

Using the available information about the potential contractor and the proposed contract, the analyst must make a recommendation to award or not to award the proposed contract. If the analyst cannot obtain sufficient information within the time constraints of the survey, he must recommend against the award.

If the contracting officer is about to reject a bid or proposal on the basis of the nonresponsibility of the proposed small business contractor, the matter must be referred to the Small Business Administration (SBA). DoD furnishes to SBA all relevant information, including the DoD pre-award survey findings. SBA then undertakes its own review, which may result in a finding that the proposed small business contractor is competent. SBA is empowered by Section 8(b)(7) of the Small Business Act (P.L. 85-536):

to certify to Government procurement officers, and officers engaged in the sale and disposal of Federal property, with respect to the competency, as to capacity and credit, of any small-business concern or group of such concerns to perform a specific Government contract. In any case in which a small-business concern or group of such concerns has been certified by or under the authority of the Administration to be a competent Government contractor with respect to capacity and credit as to a specific Government contract, the officers of the Government having procurement or property disposal powers are directed to accept such certification as conclusive, and are authorized to let such Government contract to such concern or group of concerns without requiring it to meet any other requirement with respect to capacity and credit.

A DoD contracting officer must accept a Certificate of Competency (CoC) issued by the SBA as conclusive evidence of a prospective contractor's overall ability to perform. Even a record of past delinquencies or defaults by a company which has a CoC is not a sufficient basis for refusing to make an award.

2. FINDINGS

CONTRACT FINANCING

Assistance is Important to Contractors

The current high cost of short-term loans for small businesses is indeed a problem. Small business contractors devote considerable management attention to operating capital and cash flow.

Small business contractors are keenly aware of the value of the DoD contract financing assistance. Contractors place a high value on the reliability of the payment process. When a payment is delayed unexpectedly, they can have a serious problem in meeting cash requirements.

Progress Payment Program is Effective

The progress payment program successfully shifts nearly all of the burden of financing operating capital to the Government. Because progress payments can be claimed on costs that have been incurred but not yet paid, small business contractors can receive cash from DoD before making some disbursements. This further reduces the need for contractor-provided operating capital.

Payment Reliability is Generally Good

Most contract payments are made through the payment offices of the Defense Contract Administration Services regional offices. As a result of a major effort toward prompt payments, these offices have made dramatic improvements within the past year or so. Some payment problems remain, however. The automated techniques have resulted in dependence on machines which are sometimes "down." Contractors have difficulty getting information about the status of their invoices. Once diverted from the mainstream of automated

processing, invoices can be delayed for long periods. When the terms of a contract are changed, contractors often have difficulty in obtaining prompt payments. Notice of the change is not always promptly reflected in the automated system, and a valid invoice can be refused.

Destination Acceptance Can Cause Payment Delays

DoD often accepts the contractor's product at the plant. In such cases, the contractor can support his request for payment with proof of delivery. When the DoD accepts items at a receiving agency, the invoice cannot be paid until a report of satisfactory receipt is supplied to the payment office. There is an exception, however, for contracts of not more than \$10,000, under which the contractor can request fast payment on destination acceptance contracts. Acceptance at destination, for contracts in excess of \$10,000, implies a reduction in profitability because of the greater lapse of time to receipt of payment.

To expedite payments involving destination acceptance, DoD should expand the use of fast pay procedures and permit automatic payment of any destination acceptance invoice which has been waiting more than 15 days for a report of delivery from the receiving activity.

First Article Approvals Can Put Contractors at Risk

Contractors who are required to obtain first article testing, evaluation, and approval can incur substantial costs for which DoD financing assistance is delayed. To meet delivery dates, they must often acquire materials and components and perform preliminary manufacturing operations related to production quantities before first article approval. Unless these actions have been authorized by the contracting officer, such costs are at the contractor's risk and are not compensated until after first article approval.

FINANCIAL RESPONSIBILITY

Pre-Award Survey

Procedures are Effective. The DoD procedures are effective in evaluating a prospective contractor's financial capability.

Most Reports are Positive. Even though a survey team must resolve any doubts about a contractor's financial capability in favor of the Government, favorable findings are far more frequent than unfavorable ones. The rate of positive findings is usually between 80% and 90%.

SBA Certificate of Competency Program

Program is Small. The SBA program for issuing Certificates of Competency is small relative to DoD's total contracting with small business. In 1980 DoD awarded 289 contracts (worth about \$70 million) on the basis of SBA Certificates of Competency; these awards were based on 1538 cases (worth about \$590 million) referred by DoD. This compares with a total of about seven million awards (worth about \$13.6 billion) to small business firms by DoD in 1980.

CoC Contractor Performance appears Worse. CoC contractors appear to experience higher rates of default than DoD contractors in general. The SBA estimates that about 6% of its CoC contracts, Government-wide, result in termination for default. The rate per agency is not known. By contrast, fewer than 0.5% of DoD contracts over \$10,000 were terminated for default in 1979.

3. CONCLUSIONS

We conclude that DoD contract financing policies and procedures for small business contractors are effective. We find contract financing problems to be minor and do not justify adoption of alternatives such as allowing paid interest as a contract cost, recognizing an imputed cost of operating capital, or providing for the cost of operating capital explicitly in the profit objective.

Our specific conclusions are:

1. DoD contract financing assistance to small business contractors is successful in shifting nearly all of the burden of financing operating capital to the Government.
2. The progress payment program for small business contractors is vital and effective.
3. Most contract payments are made promptly. Payment delays are not a major problem.
4. DoD procedures with respect to pre-award determinations of financial responsibility are sound.

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<p>The DoD is trying to increase the number and volume of contracts it awards to small businesses. To enhance prospects, it wants to assure that small businesses are not disadvantaged by its contract financing procedures. DoD policies and practices for evaluating financial capability are effective. Reimbursements are prompt in the vast majority of cases. On fixed-price contracts exceeding four months to first delivery, progress payments shift most of the burden of financing operating capital to the Government. The program is vital and effective.</p>		