



LIQUIDATING “PROGRESS PAYMENTS BASED ON COSTS” USING THE ALTERNATE LIQUIDATION RATE METHOD

Introduction

A fixed-price contract or subcontract for non-commercial items containing the “Progress Payments” clause at FAR 52.232-16 permits the contractor to submit a Standard Form (SF) 1443, Contractor's Request for Progress Payment, on a monthly basis to collect contract financing payments before the Government accepts deliverable products or services. These financing payments do not include any amounts for profit. The contractor can only submit invoices for the payment of certain eligible costs under categories that vary depending on whether the contractor is a large or a small business. Except for progress payments made to subcontractors, a percentage of these eligible costs are paid to the contractor at a rate specified in the Progress Payments clause. This rate is known as the progress payment rate. Progress payments that the contractor makes to subcontractors are paid at a rate of 100 percent, provided that (1) such payments cover only the subcontractor's eligible costs and (2) the payment rate to subcontractors is not more favorable than the progress payment rate contained in the prime contract.

Paragraph (a)(1) of FAR 52.232-16 specifies an 80 percent progress payment rate. In clause DFARS 252.232-7004, paragraph (a) specifies a 90 percent progress payment rate for small business concerns, and paragraph (b) specifies a 95 percent progress payment rate for small disadvantaged business concerns. Both the FAR and DFARS Progress Payment clauses also specify a rate known as the liquidation rate. It is important to note that the liquidation rate is different from the progress payment rate. Even though the numerical values of both rates are set equal to each other at the time of contract award, each rate has a different purpose, and each rate will affect contractor cash flow in different ways.

The Normal Liquidation Process

The Government recoups progress payments through the deduction of liquidations from payments that would otherwise be due to the contractor for completed items. Therefore, liquidation is a procedure where previous progress payments made to the contractor are subtracted from the contract price of a product or service in order to determine the final amount the customer pays to the contractor when it accepts that product or service. This final payment includes eligible costs not previously reimbursed and any earned profit. To illustrate the liquidation concept, assume that (1) a contract exists for one non-commercial "Gadget" system, (2) the price of the system is \$10,000,000, and (3) progress payments made to the contractor before the customer accepted the System were \$7,000,000 (80 percent of costs incurred). Then the normal progress payment liquidation procedure would be as follows:

\$10,000,000 - Contract Price
- 7,000,000 - Less Progress Payments
\$ 3,000,000 - Amount Paid Upon Acceptance

Usually, contracts require the delivery of more than a single item. But even in this case, progress payments made under the Progress Payments clause are generally made on a total contract basis and are not segregated by deliverable item, because the clause permits only one progress payment request per month. Therefore, the liquidation rate is used to allocate these progress payments to each separately priced item so that the liquidation procedure described



above can be accomplished when each item is accepted. Allocation of progress payments is effected by multiplying the item's price by the liquidation rate. Liquidation occurs by subtracting the resulting amount from the item's price to determine the amount paid to the contractor when the customer accepts that item.

Carrying the previous example further, assume that (1) the contract is for three of the same Gadget systems, (2) the unit price for each system is \$10,000,000 and there are no non-recurring costs included in the contract price, (3) progress payments made before the delivery of the first system were \$21,000,000 (80 percent of costs incurred, allocated evenly to each system), and (4) the liquidation rate is 80 percent (same value as the progress payment rate). In this case, the normal liquidation procedure would be as follows:

\$10,000,000 - Price of first system
 x .80 - Liquidation rate
 \$8,000,000 - Amount of progress payments allocated to the first system

\$10,000,000 - Unit price of the first system
 - 8,000,000 - Less progress payments allocated to the first system
 \$2,000,000 - Amount paid upon acceptance of the first system

As shown in this example, by following the normal liquidation/billing procedure required by the Progress Payments clause, the amount of the final payment for first system acceptance is \$1,000,000 less than what would be expected. In this scenario, since it is a fact that the eligible costs associated with the \$21,000,000 progress payments were spread evenly across the three systems, the amount of progress payments that should be associated with the first system is \$7,000,000; therefore, \$10,000,000 minus \$7,000,000 equals \$3,000,000 versus a payment of \$2,000,000. This discrepancy exists because, under the ordinary liquidation method prescribed in FAR 32.503-8, the value of the liquidation rate equals the value of the progress payment rate.

The negotiated contract price normally has two elements: "cost" dollars and "profit" dollars. In fact, in a fixed-price incentive, firm target (FPIF) contract, the target cost and the target profit are expressly stated as separate amounts. Still, the amount of progress payments paid to the company is based on a percentage (the progress payment rate) of the eligible costs; no profit is paid. When the liquidation rate is set equal to the progress payment rate, the terms of the Progress Payments clause implicitly assume that the contractor will realize zero profit dollars when contract performance is complete, and therefore will have spent the negotiated profit dollars to cover the cost of performance. Using the previous example, this assumed outcome can be demonstrated as follows:

\$8,000,000 – Progress payments allocated to first system by the 80% liquidation rate
 ÷ .80 – Divided by the progress payment rate
\$10,000,000 – Imputed cost of performance for the first system

Because the "\$10,000,000 imputed cost of performance" for the first system equals its contract price, the normal liquidation procedure assumes that no profit was earned for the first system, and, consequently, no profit is paid when the system is accepted. This explains why, in the previous example, the amount payable upon acceptance of the first system is only \$2,000,000 instead of \$3,000,000. The \$1,000,000 difference represents profit earned for the first system



that was not paid upon its acceptance. The impact of this liquidation process is that payment of this profit will be deferred until the acceptance of the third system; likewise, payment of the earned profit for the second system will be deferred to the acceptance of the third system. As a result in this scenario, payments for the acceptance of the first, second, and third systems will be \$2 million, \$2 million, and \$5 million, respectively, thereby adversely affecting contractor cash flow by pushing payment of all earned profit to the end of the contract.

The Alternate Liquidation Rate Method

As set forth in FAR 32.503-9, the objective of the alternate liquidation rate method is to permit the contractor to retain the earned profit element of the contract prices for completed items in the liquidation process. Therefore, contractors can alleviate the cash flow problem described above by negotiating an alternate liquidation rate that has a lower value than the progress payment rate. This lower alternate liquidation rate will allocate a lower amount of the total progress payments to each deliverable item than the ordinary liquidation rate, thereby permitting the billing of a greater dollar amount upon acceptance of that item in the liquidation process, thereby permitting the contractor to collect the earned profit dollars associated with the contract items at the time the Government accepts these items rather than at the end of the contract.

Calculation of the alternate liquidation rate is governed by FAR32.503-10, which specifies at 32.503-10(b) that the minimum liquidation rate usually is the expected progress payments divided by the contract price. Expected progress payments are calculated by multiplying the total contract estimated cost at completion (EAC) by the progress payment rate. The EAC is also referred to as the "total estimated costs eligible for progress payments". In accordance with FAR 32.503-10(b)(4), the alternate liquidation rate is generally expressed to tenths of a percent; however, decimals are rounded up to the next highest tenth, since rounding down would produce a rate below the minimum rate calculated. Therefore, the normal algorithm for calculating the alternate liquidation rate, as specified in FAR 32.503-10(b)(3)(i), is as follows:

$$(\text{EAC} \times \text{Progress Payment Rate}) \div \text{Contract Price} = \text{Alternate Liquidation Rate}$$

To illustrate the alternate liquidation rate method, let's continue with the above scenario but with the assumption that the total contract EAC is \$26,250,000, which is consistent with 80 percent progress payments in the total amount of \$21,000,000. The alternate liquidation rate would be calculated as follows:

$$\text{Alternate liquidation rate} = (\$26,250,000 \times .80) \div \$30,000,000 = \underline{.70}$$

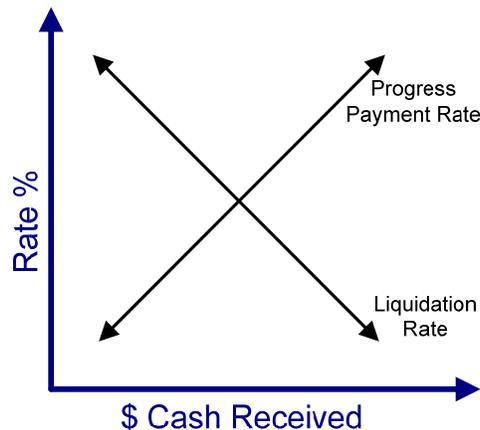
The effect of this 70 percent alternate liquidation rate on the liquidation process is reflected in the calculations below. Notice that the payment for the acceptance of the first Gadget system is now exactly what would be expected.

\$10,000,000 - Price of first system
 x .70 - Alternate Liquidation rate
 \$7,000,000 - Amount of progress payments allocated to the first system

\$10,000,000 - Unit price of the first system
 - 7,000,000 - Less progress payments allocated to the first system
 \$3,000,000 - Amount paid upon acceptance of the first system



The different purposes of the progress payment rate and the liquidation rate can be seen by comparing their respective effects on contractor cash flow as illustrated in the diagram below. The progress payment rate represents the percentage of the contractor's eligible costs that the contractor may collect as contract financing payments each month. As such, the progress payment rate reflects a direct relationship between the value of this rate and the amount of cash that can be collected (i.e., higher rate equals more cash). On the other hand, the liquidation rate reflects an inverse relationship between the value of this rate and the amount of cash that can be collected (i.e., lower rate equals more cash). As such, a lower liquidation rate will increase cash flow to the contractor, and a higher rate will decrease the contractor's cash flow.



EAC and Contract Price Adjustments

Correctly calculating the alternate liquidation rate can be more complex, because there are other factors to consider that affect the EAC and contract price components of the alternate liquidation rate algorithm. Both the EAC and the contract price are affected by undefinitized contract changes, and the previous examples assumed there were none. In addition, the contract price will be affected if the contract price is flexible, such as in a FPIF contract or a fixed price contract with economic price adjustment (FP/EPA). The previous examples assumed the contract to be FFP. Because these conditions can affect the computation of the correct alternate liquidation rate, adjustments to the EAC and the contract price components should be considered when calculating the appropriate rate.

Such adjustments are permitted in accordance with FAR 32.503-10(b)(2). Note, however, that FAR 32.503-10 (b)(2) states that any adjustments to the EAC or contract price used to calculate the alternate liquidation rate shall neither exceed the Government's estimate for such undefinitized contract changes nor exceed the funds obligated to the contract. Consequently, when calculating the alternate liquidation rate, the value of any adjustments to both the EAC and the contract price elements of the algorithm are subject to negotiation by the parties. For simplicity, the following examples will assume that there is no controversy between the contractor and the Government concerning the estimated value of the EAC and other contract price adjustments.



Revising our ongoing example, assume that the EAC is now \$28,000,000. The alternate liquidation rate would be calculated as follows. Notice that the liquidation rate is higher than the previous example because there is now less profit being earned by the contractor at the firm-fixed-price of \$30,000,000.

$$\text{Alternate liquidation rate} = (\$28,000,000 \div \$30,000,000) \times .80 = \underline{.74}$$

Now assume that the contract type is FP/EPA and that the estimated economic price adjustment will be \$1,000,000. Because this adjustment will increase the total contract price from \$30,000,000 to an estimated contract price of \$31,000,000, the alternate liquidation rate would be calculated as follows:

$$\text{Alternate liquidation rate} = (\$28,000,000 \div \$31,000,000) \times .80 = \underline{.72}$$

Now assume that the \$1,750,000 difference between the previous EAC of \$26,250,000 and the new EAC of \$28,000,000 represents the value of undefinitized contract changes and that the estimated profit associated with these changes is \$250,000. Based on these assumptions, the contract price would increase from \$30,000,000 to an estimated contract price of \$32,000,000 (i.e., \$30,000,000 + 1,750,000 + 250,000). The alternate liquidation rate would be calculated as follows:

$$\text{Alternate liquidation rate} = (\$28,000,000 \div \$32,000,000) \times .80 = \underline{.70}$$

Now assume that the contract is FPIF, the \$1,750,000 amount in excess of the previous EAC of \$26,250,000 represents cost overrun, the target price is \$30,000,000, and the Government/contractor share ratio is 70/30 percent. As a result of these assumptions, the contract price would increase from \$30,000,000 to an estimated contract price of \$31,225,000 (\$1,225,000 [1,750,000 x .70] + 30,000,000). The alternate liquidation rate would be calculated as follows:

$$\text{Alternate liquidation rate} = (\$28,000,000 \div \$31,225,000) \times .80 = \underline{.71}$$

As these examples illustrate, even though the actual contract/unit prices had not been changed, consideration of EAC increases and undefinitized contract changes and other undefinitized price adjustments can significantly affect the calculation of the alternate liquidation rate. Therefore, any factor or combination of factors that might affect the EAC and the estimated contract price should always be considered when calculating the alternate liquidation rate to assure that the contractor is not being overpaid or underpaid upon the acceptance of partial contract deliveries.

Conditions that Affect Implementation of an Alternate Liquidation Rate

Even though an alternate liquidation rate could be calculated at contract award based on the negotiated cost and profit amounts, FAR 32.503-8 states that only the ordinary liquidation method may be used at the beginning of the contract. It is FAR 32.503-9 that permits the negotiation of an alternate liquidation rate, but only during contract performance and only under certain conditions. First, FAR 32.503-9(a)(1) puts the onus on the contractor to request a reduction in the liquidation rate. Therefore, unless the contractor submits a timely request for the use of the alternate liquidation method, the ordinary liquidation method will apply.



Next, FAR 32.503-9(a) states that the Contracting Officer *may* (as opposed to *shall*) adjust the liquidation rate. For example, in accordance with the guidance specified in FAR 32.503-12(b), the PCO should not agree to lower the liquidation rate if the progress or the quality of contract performance is unsatisfactory or if the rate of rejection, waste, or spoilage is excessive. Barring these extreme conditions, FAR 32.503-9(a)(2), (3), and (4) set forth the following threshold conditions that must be satisfied before an alternate liquidation rate would even be considered. First, the rate must not have been reduced in the preceding 12 months. Second, the contract delivery schedule must extend at least 18 months from the contract award date. Third, data on actual costs must be available either for the items delivered or, if no deliveries have been made, for a performance period of at least 12 months.

Once having satisfied the preceding threshold conditions, FAR 32.503-9(a)(5), (6), (7), (8), and (9) establish other conditions that must be satisfied before the liquidation rate will be reduced. First, the contemplated alternate liquidation rate must still result in a proper allocation of previous progress payments to each item that is delivered and accepted so that the Government recoups the appropriate amount of progress payments that are associated with that item. Second, the proposed rate must not allow payment of more than the costs of the items delivered and accepted (less allocable progress payments) and the earned profit on those items. Third, the unliquidated progress payments must not exceed either the progress payments made against incomplete work or the value of the incomplete work. Incomplete work is defined as the supplies and services required by the contract, for which contractor delivery and invoicing and Government acceptance are incomplete. Fourth, the parties must agree on an appropriate rate. Fifth, the contractor must agree to certify annually, or more often if requested by the Contracting Officer, that the alternate liquidation rate continues to meet the first three conditions described above, namely FAR 32.503-9(a) (5), (6), and (7).

Finally, implementation of the alternate liquidation rate requires a formal contract modification. Once all of the above conditions are satisfied, FAR 32.503-9(c) provides that the Contracting Officer shall issue a contract modification to specify the alternate liquidation rate in the Progress Payments clause. FAR 32.503-9(c) further stipulates that adequate consideration for the alternate liquidation rate is already provided by the consideration included in the initial contract.

Negotiating an Alternate Liquidation Rate

As stated above, use of the alternate liquidation method requires that the contractor make a formal request and that the Contracting Officer issue a contract modification. If it is apparent that the contractor will earn a profit on the contract, and if the threshold implementation conditions described above apply (namely, FAR 32.503-9(a)(2), (3) and (4)), then the contractor can submit a contract change proposal (CCP) pursuant to FAR 32.503-9 to modify the Progress Payments clause to specify the alternate liquidation rate.

The contractor should submit this CCP well in advance of the expected completion date of the first deliverable item so that the Contracting Officer will have sufficient lead time to act on the CCP before the item is actually tendered for acceptance. The Contracting Officer should have adequate opportunity to evaluate the request, receive assessments from other sources such as the contract administration office (CAO) or DCAA, conduct fact finding and negotiations, and issue the appropriate contract modification. It must be emphasized that while FAR 32.503-9(b) expressly permits retroactive application of increases in the liquidation rate to items already delivered, the FAR is silent on whether to also allow retroactive application of decreases in the liquidation rate to such items. Therefore, although retroactive use of the alternate liquidation rate



is not expressly prohibited, an untimely CCP may delay additional payment for delivered items or, if payment has already been made, may make subsequent negotiation and application of an alternate liquidation rate to previously delivered items more difficult to achieve.

To accelerate fact finding and negotiation, the CCP should contain all amounts, calculations, and rationale to support the proposed alternate liquidation rate. In this regard, the contractor should ensure that (1) the EAC amount is correct and is consistent with the EAC being reported in the monthly progress payment requests (i.e., the SF 1443) or that any differences are adequately explained, (2) the estimated contract price accurately reflects the impact of any undefinitized changes or other undefinitized price adjustments, and (3) the alternate liquidation rate algorithm is correctly used. Finally, as required by FAR 32.503-9(a)(9), the CCP should expressly state that the contractor will certify annually, or more often if the Contracting Officer requests, that the alternate liquidation rate continues to meet the conditions of FAR 32.503-9(a), subdivisions (5), (6), and (7).

By following the process described above, both the Government and the contractor can assure that the contractor is paid a proper amount of money upon delivery of the required products or services when the contract contains a Progress Payments clause.